

TELECOM ITALIA S P A  
Form 20-F  
June 26, 2003  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 20-F**

**.. REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended: December 31, 2002**

**OR**

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from N/A to N/A**

**Commission file number: 1-13882**

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# Telecom Italia S.p.A.

(Exact name of Registrant as specified in its charter)

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Italy

(Jurisdiction of incorporation or organization)

Corso d Italia 41, 00198 Rome, Italy

(Address of principal executive offices)

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Securities registered or to be registered pursuant to Section 12(b) of the Act.

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
American Depositary Shares, each representing 10 Ordinary Shares of 0.55 par value each	The New York Stock Exchange
Ordinary Shares of 0.55 par value each (the Shares )	The New York Stock Exchange*
American Depositary Shares, each representing 10 Savings Shares of 0.55 par value each	The New York Stock Exchange
Savings Shares of 0.55 par value each (the Savings Shares )	The New York Stock Exchange*

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Securities registered or to be registered pursuant to Section 12(g) of the Act.

None

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(Title of Class)

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.**

**None**

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(Title of Class)

**Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.**

**Not applicable**

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No  Not applicable

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

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\* Not for trading, but only in connection with the registration of American Depositary Shares representing such Shares or Savings Shares, as the case may be, pursuant to the requirements of the Securities and Exchange Commission.

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**INTRODUCTION**

Telecom Italia S.p.A. (the Company) is incorporated as a joint stock company under the laws of Italy.

Unless otherwise indicated, the financial information contained in this Annual Report has been prepared in conformity with the Italian law governing consolidated financial statements interpreted and integrated by the accounting principles established or adopted by the Italian Accounting Profession ( Italian GAAP ), which, as described in Note 26 of Notes to the Consolidated Financial Statements, differ in certain material respects from generally accepted accounting principles in the United States ( U.S. GAAP ). Unless otherwise indicated, any reference in this Annual Report to Consolidated Financial Statements is to the Consolidated Financial Statements of the Telecom Italia Group (including the notes thereto) included herein.

**Cautionary Statement for Purposes of the Safe Harbor Provisions of the United States Private Securities Litigation Reform Act of 1995.** The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. This Annual Report contains certain forward-looking statements, including, but not limited to, the discussion of the changing dynamics of the marketplace, including liberalization of the telecommunications industry, the opening to competition of public voice telephone services, the Company's outlook for growth in the telecommunications industry both within and outside of Italy, including sources of increasing revenues to offset the impact of increasing competition and the Company's outlook regarding the impact of tariff rebalancing on the telecommunications industry. Such statements include, but are not limited to, statements under the following headings: (i) Item 3. Key Information Risk Factors, (ii) Item 4. Information on the Telecom Italia Group Business Significant Developments during 2002 Updated Business Plan, (iii) Item 4. Information on the Telecom Italia Group Regulation, (iv) Item 5. Operating and Financial Review and Prospects, (v) Item 8. Financial Information Legal Proceedings and (vi) Item 11. Quantitative and Qualitative Disclosures About Market Risk, including statements regarding the likely effect of matters discussed therein. Actual results may differ materially from those projected or implied in the forward-looking statements. Such forward-looking information involves risks and uncertainties, which are outside the Telecom Italia Group's control, that could significantly affect expected results and are based on certain key assumptions.

The following important factors could cause the Telecom Italia Group's actual results to differ materially from those projected or implied in any forward-looking statements:

- the continuing impact of increased competition in a liberalized market, including competition from global and regional alliances formed by other telecommunications operators in the core domestic fixed-line and wireless markets of the Telecom Italia Group;
- the ability of the Telecom Italia Group to introduce new services to stimulate increased usage of its fixed and wireless networks to offset declines in its fixed-line business due to the continuing impact of regulatory required price reductions, market share loss and pricing pressures generally;
- the ability of the Telecom Italia Group to achieve cost-reduction targets in the time frame established or to continue the process of rationalizing its non-core assets;
- the impact of regulatory decisions and changes in the regulatory environment;
- the impact and consequences of the Merger;

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- the impact of the slowdown in Latin American economies and the slow recovery of economies generally on the international business of the Telecom Italia Group focused on Latin America and on its foreign investments and capital expenditures;
- the continuing impact of rapid changes in technologies;
- the impact of political and economic developments in Italy and other countries in which the Telecom Italia Group operates;
- the impact of fluctuations in currency exchange and interest rates;
- Telecom Italia Group's ability to continue the implementation of its 2003-2005 Industrial Plan, including the rationalization of its corporate structure and the disposition of Telecom Italia Group's interests in various companies;
- the ability of the Telecom Italia Group to successfully achieve its debt reduction targets;
- Telecom Italia Group's ability to successfully roll out its UMTS networks and services and to realize the benefits of its investment in UMTS licenses and related capital expenditures;
- Telecom Italia Group's ability to successfully implement its internet strategy;

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- the ability of the Telecom Italia Group to achieve the expected return on the significant investments and capital expenditures it has made in Latin America;
- the amount and timing of any future impairment charges for Telecom Italia Group's licenses, goodwill or other assets; and
- the impact of litigation or decreased mobile communications usage arising from actual or perceived health risks or other problems relating to mobile handsets or transmission masts.

The foregoing factors should not be construed as exhaustive. Due to such uncertainties and risks, readers are cautioned not to place undue reliance on such forward-looking statements, which speak only as of the date hereof. Telecom Italia Group undertakes no obligation to release publicly the result of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date hereof, including, without limitation, changes in our business or acquisition strategy or planned capital expenditures, or to reflect the occurrence of unanticipated events. See the related cautionary statement under Item 5. Operating and Financial Review and Prospects .

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**KEY DEFINITIONS**

The following terms appearing in this Annual Report have the meanings set forth below.

<b>Company</b>	means Telecom Italia S.p.A.
<b>Draghi Law</b>	means Legislative Decree No. 58 of February 24, 1998 and the specific implementing regulations issued by CONSOB.
<b>EU</b>	means the European Union.
<b>Finsiel</b>	means Finsiel-Consulenza e Applicazioni Informatiche S.p.A., the Telecom Italia Group's principal subsidiary operating in Information Technology Market Business Unit.
<b>Finsiel group</b>	means Finsiel and its subsidiaries.
<b>Framework Law</b>	means Law No. 481 of November 14, 1995, which provides for, among other things, the definition of a transparent tariff system based on the "price cap" method.
<b>Maccanico Law</b>	means Law No. 249 of July 31, 1997, which established the formation of the National Regulatory Authority for regulating the communications industry and implemented the Framework Law.
<b>Merger</b>	means the merger of Telecom Italia into Olivetti, approved by the shareholders of Telecom Italia on May 24, 2003 and expected to be effective in the first half of August 2003.
<b>National Regulatory Authority</b>	means the independent body, responsible in Italy for the regulation of the telecommunications, radio and television broadcasting sector, established by the Maccanico Law.
<b>New Telecom Italia</b>	means the entity which will result from the Merger and "New Telecom Italia Group" means such entity together with its consolidated subsidiaries.
<b>Olivetti</b>	means Olivetti S.p.A., the holding company and controlling shareholder of Telecom Italia.
<b>Savings Shares</b>	means the savings shares, 0.55 par value each, of Telecom Italia.
<b>SEAT</b>	means Seat Pagine Gialle S.p.A.
<b>Shares</b>	means the ordinary shares, 0.55 par value each, of Telecom Italia.
<b>Telecom Italia</b>	means Telecom Italia S.p.A., the operating company for fixed telecommunications services and the holding company for various businesses, principally telecommunications.
<b>Telecom Italia Group</b>	means the Company and its consolidated subsidiaries.
<b>Telecommunications Regulations</b>	means the telecommunications regulations (approved by Presidential Decree No. 318 of September 19, 1997 which became effective on October 7, 1997, 15 days after its publication) adopted to implement a number of EU directives in the telecommunications sector.

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<b>TILab</b>	means Telecom Italia Lab S.p.A. (formerly CSELT).
<b>TIM</b>	means Telecom Italia Mobile S.p.A., the Telecom Italia Group's subsidiary operating in the mobile telecommunications business.
<b>TIM Demerger</b>	means the demerger which separated mobile telecommunications services from the Company's predecessor company effective July 14, 1995.
<b>Tin.it</b>	means Telecom Italia Net S.p.A., the Telecom Italia Group's subsidiary providing Internet access which was combined with SEAT in November 2000.

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**PART I**

**Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

**Not Applicable**

**Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

**Not Applicable**

**Item 3. KEY INFORMATION**

**RISK FACTORS**

**Risk Factors Relating to the Business of the Telecom Italia Group**

*Continuing competition in a fully liberalized market may further reduce Telecom Italia Group's market share of domestic and international traffic and may cause further reductions in prices and margins.*

Domestic competition exists in all of the principal telecommunications business areas in which the Telecom Italia Group operates, including, most significantly, fixed-line and mobile voice telecommunications services, which have been open to competition since 1998 for fixed-line services and since 1995 for mobile services. As a result, the Company and TIM face competition in Italy. This competition may increase due to the consolidation and globalization of the telecommunications industry in Europe and elsewhere. Consolidation is increasing rapidly and competition is expected to rise at all levels in the future. In addition, the use of the single European currency could further intensify competition by facilitating international operators' entry into the Italian market and direct competition with Telecom Italia and with TIM in fixed and mobile telephony and in the local and long-distance markets. As of December 31, 2002, there were a number of significant competitors offering fixed-line services and two other operators (as a result of the merger of Blu with TIM) offering mobile services in the Italian domestic market; a third mobile competitor (H3G) has entered the market in 2003, offering 3G commercial services. Although the decline in Telecom Italia's market share slowed during 2002, continuing pressures on prices due to competition and further erosion in market shares could adversely affect Telecom Italia Group's results of operations. Additional changes in the regulatory regime, including carrier preselection, number portability and local loop unbundling could further increase competition for the services Telecom Italia Group provides which could also adversely affect its business.

*Telecom Italia Group's business may be adversely affected if it is unable to continue the introduction of new services to stimulate increased usage of its fixed and wireless networks.*

In order to maintain a positive trend in revenues despite increased competition and lower prices, Telecom Italia Group's strategy has been to introduce new services in both its fixed-line and wireless services to increase traffic on its networks and find alternative revenue sources. These services include non-voice services such as Internet, data traffic and value added services such as interactive mobile services that allow users to receive news or engage in simple banking transactions. TIM has also introduced multimedia messaging services (MMS) allowing users to send and to receive images, photos and files. Alternative revenue sources also include increased interconnection traffic from other operators using the Company's fixed-line network. In addition to the steps taken in recent years, the Telecom Italia Group continues to develop new products and services, such as new data services for business customers, broadband services, enhanced communication services and new voice packages, in order to attract and retain customers, particularly business customers, and to stimulate usage of its fixed and wireless telecommunications network. The Telecom Italia Group is also investing in new infrastructure and technologies to enable it to introduce new products and services. The Telecom Italia Group expects that these strategic initiatives will require substantial expenditures and commitment of human resources. The Telecom Italia Group may not be able to introduce commercially these new products and services, and even if it introduces them, they may not be successful.

*The Telecom Italia Group's business will be adversely affected if it is unable to successfully implement its business plans, particularly in light of the Merger. Factors beyond the Telecom Italia Group's control may prevent the Telecom Italia Group from successfully implementing its strategy.*

Following the change in control of the Company in late 2001, the Telecom Italia Group adopted its 2002-2004 Industrial Plan and established priorities for 2002. The main objectives were:

- Strengthen competitive capabilities;

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- Improve cost efficiency; and
- Strengthen the financial structure.

Significant portions of the 2002-2004 Industrial Plan were completed during 2002, particularly the sale of non-core assets and debt reduction. The Telecom Italia Group also took steps to strengthen its competitive position in its core domestic market through the introduction of new products and tariff packages and confirmed to focus on lowering costs through the reduction of operating expenses and capital expenditures.

In connection with the proposed Merger, the Company has confirmed the objectives of the 2002-2004 Plan and stated that it has established certain targets, which include strict limits on capital expenditures and cost controls, together with further assets sales, to reduce the significantly higher levels of debt the Telecom Italia Group will have as a result of the Merger. See *New Telecom Italia's total net financial debt will increase if the Merger of Telecom Italia and Olivetti is successful* below.

Factors beyond the Telecom Italia Group's control that could affect the further implementation and completion of the 2002-2004 Plan and the Telecom Italia Group reaching its targets for the period 2003-2005 include:

- Telecom Italia Group's ability to manage costs;
- Telecom Italia Group's ability to attract and retain highly-skilled and qualified personnel;
- Telecom Italia Group's ability to divest additional non-core businesses and the adequacy of the returns of such divestitures;
- Telecom Italia Group's ability to leverage on its core skills with particular focus on Latin America mobile and international broadband operations;
- difficulties in developing and introducing new technologies, managing innovation and providing value-added services;
- the need to establish and maintain strategic relationships;
- declining prices for some of the Telecom Italia Group's services and increasing competition;
- the effect of adverse economic trends on the Telecom Italia Group's principal markets; and
- the effect of foreign exchange fluctuations on the Telecom Italia Group's results of operations.

*Regulatory decisions and changes in the regulatory environment could adversely affect Telecom Italia Group's business.*



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Telecom Italia Group's fixed and mobile telecommunications operations, as well as its broadband services businesses, are subject to extensive regulatory requirements in Italy and its international operations and investments are subject to regulation in their host countries. In Italy, the Company is the only operator subject to universal service obligations, including the provision of fixed public voice telecommunications services in non-profitable areas, publication of telephone directories and provision of subscriber information services at affordable prices and provision of public payphones. In addition, the National Regulatory Authority has identified the Company as an operator having significant market power in all relevant markets. As a result, the Company is, or will be, subject to a number of regulatory constraints, including:

- a requirement to conduct its business in a transparent and non-discriminatory fashion;
- a requirement to have its prices for fixed-line telecommunications services approved by the National Regulatory Authority prior to implementation in accordance with a price cap mechanism which is currently being reviewed by the National Regulatory Authority; and
- a requirement to provide interconnection services, leased lines and access to the local loop to other operators at cost-oriented prices. These services include allowing other operators to interconnect to the Company's network and transport traffic through the network and offering certain services relating to its local access network, or local loop, on an unbundled basis to other operators to enable these operators to access directly end users by leasing the necessary components from the Telecom Italia Group.

As a member of the European Economic Area, or EEA, Italy is additionally required to adapt its regulatory framework to the legislative and regulatory framework established by the EU for the regulation of the European telecommunications market as far as the directives are made relevant to the EEA Agreement. The EU regulators

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approved revised telecommunications regulation in March 2002. Implementation of such regulation through Italian law is expected by July 2003. The implementation of the revised telecommunications regulation and possible future decisions relating thereto may change the regulatory accounting system currently used by the Telecom Italia Group in a manner adverse to the Telecom Italia Group. Please see Item 4. Information on the Telecom Italia Group Regulation in this report for more information on the regulatory requirements to which the Telecom Italia Group is subject.

The Telecom Italia Group is unable to predict the impact of any proposed or potential changes in the regulatory environment in which it operates both in Italy and internationally. Changes in laws, regulation or government policy could adversely affect the Telecom Italia Group's business and competitiveness. In particular, the Telecom Italia Group's ability to compete effectively in its existing or new markets could be adversely affected if regulators decide to expand the restrictions and obligations to which the Telecom Italia Group is subject or extend them to new services and markets. In addition, changes in tax laws in countries in which the Telecom Italia Group operates could adversely affect its results of operations. Finally, decisions by regulators regarding the granting, amendment or renewal of licenses, to the Telecom Italia Group or to third parties, could adversely affect the Telecom Italia Group's future operations in Italy and in other countries where it operates.

***The Telecom Italia Group may not be able to achieve the expected return on the significant investments and capital expenditures it has made in Latin America due to the competitive environment in these markets. Returns from the sale of non-core international assets may be lower than expected.***

In recent years the Telecom Italia Group pursued a significant strategic acquisition program in Latin America and Europe aimed at achieving a stronger competitive position and balancing the loss of market share in its domestic market. During the past 18 months the Telecom Italia Group has reconsidered this strategy. The Telecom Italia Group's strategy is now focused on:

- consolidating its international presence in Latin America;
- developing its international investments in high-growth market segments, such as wireless, data and Internet;
- strengthening its role of strategic partner in existing investments by increasing the transfer of its technological expertise and marketing know-how; and
- rationalizing its existing international portfolio by divesting minority participations in non-strategic geographical markets.

As a result of this change in strategy, in 2002 the Telecom Italia Group divested certain of its most significant European assets such as BDT (Bouygues Decaux Telecom), Autel (Mobilkom Austria), 9Telecom group and Auna and is still seeking to divest certain international non-strategic assets. In addition, certain investments which were made during the 1999-2001 period have declined significantly in value resulting in significant write-downs and asset impairments. Due to the current market situation, the general economic conditions and the high level of competition, the actual returns from the announced divestment of non-strategic assets may be lower than the ones originally expected and further impairment charges and goodwill writedowns may be required.

***Continuing rapid changes in technologies could increase competition or require the Telecom Italia Group to make substantial additional investments.***

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Many of the services the Telecom Italia Group offers are technology-intensive and the development of new technologies may render such services non-competitive. The Telecom Italia Group is already making and may have to make substantial additional investments in new technologies to remain competitive. The new technologies the Telecom Italia Group chooses may not prove to be commercially successful. In addition, the Telecom Italia Group may not receive the necessary licenses to provide services based on new technologies in Italy or abroad. As a result, the Telecom Italia Group could lose customers, fail to attract new customers or incur substantial costs in order to maintain its customer base.

*The value of the Telecom Italia Group's operations and investments may be adversely affected by political and economic developments in Italy or other countries.*

The Telecom Italia Group's business is dependent on general economic conditions in Italy, including levels of interest rates, inflation and taxes. A significant deterioration in these conditions could adversely affect the Telecom Italia Group's business and results of operations. The Telecom Italia Group may also be adversely

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affected by political and economic developments in other countries where it has made significant investments in telecommunications operators. Some of these countries have political, economic and legal systems that are unpredictable. Political or economic upheaval or changes in laws or their application in these countries may harm the operations of the companies in which the Telecom Italia Group has invested and impair the value of these investments. A significant risk of operating in emerging market countries is that foreign exchange restrictions could be established. This could effectively prevent the Telecom Italia Group from receiving profits from, or from selling its investments in, these countries.

### ***Fluctuations in currency exchange and interest rates may adversely affect the Telecom Italia Group's results.***

Because the Telecom Italia Group has made substantial international investments, primarily in U.S. dollars, and has significantly expanded its operations outside the euro zone, movements in the exchange rates of the euro against other currencies could have an adverse effect on the Telecom Italia Group's revenues and operating results. A rise in the value of the euro relative to other currencies in certain countries in which the Telecom Italia Group operates or has made investments would reduce the relative value of the revenues or assets of the Telecom Italia Group's operations in those countries and, therefore, may adversely affect the Telecom Italia Group's operating results or financial position. In addition, the Telecom Italia Group has raised, and may raise in an increasing proportion in the future, financing in currencies other than the euro, principally the U.S. dollar. Accordingly, the value of those liabilities will be affected by fluctuations of the currencies of the countries in which the TI Group operates against the currency in which the financing is denominated. The Telecom Italia Group generally enters into a number of forward currency transactions, swaps and options to manage foreign currency risk exposure with respect to its non-euro denominated liabilities. However, the Telecom Italia Group can give no assurances that it will be successful in managing foreign currency risk exposure, taking into consideration that appropriate foreign currency swaps and options may not be available as needed on the relevant financial markets.

In addition, total net financial debt at year end 2002 was 18,118 million. As a result of the Merger and on completion of the Merger, under Italian GAAP New Telecom Italia will have up to 43,576 million of pro forma net financial debt. The Telecom Italia Group generally enters into interest rate swaps and interest rate options to manage its exposure to floating interest rates. However, the Telecom Italia Group can give no assurance that fluctuations in interest rates will not adversely affect its results of operations.

### ***The Telecom Italia Group may not be able to realize the benefits of its investment in UMTS licenses and related capital expenditures.***

Through TIM and other subsidiaries, the Telecom Italia Group has acquired a third generation mobile telephone, or UMTS, license to commence operations of UMTS services in Italy and Greece. As of June 20, 2003, TIM has committed to pay 2,417 million (of which 2,300 million has already been paid) for its UMTS license in Italy and, through its international subsidiaries and affiliated companies, a further 145 million for UMTS licenses in Greece (of which approximately 101 million has already been paid). The size of the market for UMTS products and services is unknown and may fall short of the industry's expectations. The Telecom Italia Group cannot be certain that the demand for such services will justify the related costs. In some locations, the investments, although required under the licenses, may not be commercially desirable. In addition, the Telecom Italia Group has a number of significant competitors in each of its geographic markets.

The Telecom Italia Group will be rolling out the UMTS networks, together with its competitors, in compliance with the terms and conditions of their respective licenses. Given the substantial costs of upgrading Telecom Italia's existing networks to support UMTS and the uncertainty regarding the commercial adoption of UMTS, the Telecom Italia Group may not be able to recoup its investment according to its estimates, if at all. The Telecom Italia Group has entered into and intends to enter into arrangements with other operators to share the costs and infrastructure of its planned UMTS networks. However, the Telecom Italia Group cannot give any assurance that it will succeed in concluding the necessary agreements with other operators on satisfactory terms. Moreover, while network sharing is intended to reduce costs, the Telecom Italia Group cannot give any assurance that this will be the case or that it will be able to make such network sharing work commercially or technically.

*Devaluations of telecom assets and write-downs could adversely affect the Telecom Italia Group's financial condition and results of operations.*

Recent events in the market for telecom stocks and credit ratings of market participants, as well as the Telecom Italia Group's ongoing review and refinement of its business plan, has resulted and may result in substantial impairment write-downs of the Telecom Italia Group's assets at any time. Accounting standards

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relating to asset valuations and impairment may be refined to require the use of new criteria or methodology. Starting in fiscal year 2002, under U.S. GAAP, goodwill is tested for impairment pursuant to SFAS 142 Goodwill and Other Intangible Assets. In accordance with the provisions of SFAS 142, goodwill is no longer amortized, but is subject to annual impairment tests based on fair value. An interim assessment of goodwill may be necessary if an impairment indicator indicates that the fair value of a reporting unit may have decreased. Future changes in the fair value of the Telecom Italia Group's business units could adversely affect the Telecom Italia Group's U.S. GAAP results and financial conditions.

***Growth in the traditional mobile telecommunications industry has slowed significantly during the past few years and our revenues may not grow as rapidly as in the past.***

In recent years, the Telecom Italia Group's revenues have grown or remained stable in large part because of the rapid growth in the mobile communications business. This growth has been driven largely by the rapid expansion of the mobile telecommunications market in Italy. However, as a result of this growth, mobile phone use in the Italian market is approaching saturation levels.

Continued growth in the mobile telecommunications markets in which the Telecom Italia Group operates depends on a number of factors, many of which are outside the Telecom Italia Group's control. These factors include:

- the activities of TIM's competitors, including consolidation, tariff reductions and handset subsidies;
- the development and introduction of new and alternative technologies for mobile telecommunications products and services and the attractiveness of these to customers;
- customer usage habits;
- general economic conditions; and
- health risks or safety concerns associated with mobile telephones and transmission equipment.

If the mobile telecommunications markets in which TIM operates do not continue to expand, or TIM is unable to retain its existing customers or is unable to stimulate increases in customer usage, the Telecom Italia Group's financial condition and results of operations may be harmed.

***Actual or perceived health risks or other problems relating to mobile handsets or transmission masts could lead to litigation or decreased mobile communications usage.***

Various reports have alleged that certain radio frequency emissions from wireless handsets and transmission equipment may be linked to various health concerns and may interfere with various electronic devices. The Telecom Italia Group cannot rule out that exposure to electromagnetic fields or other emissions originating from wireless handsets will not be identified as a health risk in the future. The Telecom Italia Group's mobile communications business may be harmed as a result of these alleged health risks. For example, this could result in a lower number of customers, reduced usage per customer or potential consumer liability for the Telecom Italia Group. In addition, although Italian law already requires strict limits in relation to transmission equipment, these concerns may cause regulators to impose greater restrictions on the construction

of base station towers or other infrastructure, which may hinder the completion of network build-outs and the commercial availability of new services.

*The Telecom Italia Group may be adversely affected if it fails to successfully implement its Internet strategy.*

The Telecom Italia Group's ability to develop successfully its Internet dial-up and broadband operations and its strategy to provide contents and services to consumers and small and medium-sized companies may be adversely affected if:

- Internet usage in Italy grows more slowly than anticipated, for reasons such as changes in Internet users' preferences;
- competition increases, for reasons such as the entry of new competitors, consolidation in the industry or technological developments introducing new platforms for internet access and/or internet distribution; and
- Telecom Italia experiences any network interruptions or related problems with network infrastructure.

Any of the above factors may adversely affect the Telecom Italia Group's business and results of operations.

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***You may not be able to assert claims against Arthur Andersen***

The consolidated financial statements of the Telecom Italia Group for the year ended December 31, 2000, appearing in our annual report on Form 20-F have been audited by PricewaterhouseCoopers S.p.A., independent auditors for 2000, whose report is based in part on the report of Arthur Andersen S.p.A., now called Deloitte & Touche Italia S.p.A..

We have not been able to obtain, after reasonable efforts, the written consent of Arthur Andersen S.p.A., as required by section 7 of the Securities Act for incorporation by reference of its reports on our consolidated financial statements for the year ended December 31, 2000. Rule 437a of the Securities Act, as amended, permits us to include these reports on the financial statements which will be incorporated by reference into our Registration Statement (File No. 333 - 127666) without the consent of Arthur Andersen S.p.A.. Because Arthur Andersen S.p.A. has not consented to the incorporation by reference of its reports therein, your ability to recover for claims against Arthur Andersen S.p.A. may be limited. In particular, you will not be able to recover against Arthur Andersen S.p.A., under Section 11 (a) (4) of the Securities Act for any untrue material fact contained in the financial statements audited by Arthur Andersen S.p.A. or any omission to state a material fact required to be stated therein.

**Risk Factors Relating to the Merger**

***New Telecom Italia's total net financial debt will increase if the Merger of Telecom Italia and Olivetti is successful.***

On April 15, 2003, the Boards of Directors of Olivetti and the Company approved a plan of Merger between Olivetti and Telecom Italia. On May 24 and May 26 the Ordinary and Extraordinary Meetings of the Company's Ordinary Shareholders and the Ordinary and Extraordinary Meetings of Olivetti's Ordinary Shareholders voted in favor of the Merger, respectively. The merged company will be called Telecom Italia. The Merger is expected to become effective in the first half of August 2003, subject to the satisfaction of certain conditions.

From the date on which the Merger becomes effective and as a consequence thereof, New Telecom Italia will assume the rights and obligations of the Telecom Italia Group, continuing its activity. In particular, New Telecom Italia will succeed to Telecom Italia's concessions, licenses and administrative authorizations subject to regulatory approvals, where required. In addition, it will be responsible for the additional businesses currently operated by Olivetti.

See Item 4. Information on the Telecom Italia Group Business Significant Development during 2002 Merger of Telecom Italia into Olivetti .

The debt of New Telecom Italia could be greater than the present total debt of Olivetti and Telecom Italia as a consequence of the Merger although the total amount will depend on the level of acceptances of Telecom Italia's shareholders of the partial cash tender offer for Shares and Savings Shares by Olivetti. Under Italian GAAP, total net financial debt (see Item 3. Key Information Selected Financial and Statistical Information Note 10 ) is expected to be up to approximately 43.6 billion on a pro forma basis following the Merger, a maximum increase of approximately 25 billion from the net financial debt of 18.1 billion at December 31, 2002 of the Telecom Italia Group, of which about 15 billion is existing Olivetti net financial debt and a further 9 billion relates to the maximum amount of funding for the withdrawal rights exercised by certain Olivetti shareholders and the tender offers to be made by Olivetti for a portion of the Telecom Italia Shares and Savings Shares. At December 31, 2002 net financial debt of the Olivetti group was 33.4 billion (including the net financial debt of the Telecom Italia Group).



Net financial debt is projected to decrease and the 9 billion of additional debt which may be incurred is expected to be retired by the end of 2004, partly by using the proceeds of the sale of other non-strategic assets. There can be no assurance that factors beyond New Telecom Italia's control, including but not limited to deterioration in general economic conditions, will not significantly affect New Telecom Italia's ability to reduce such debt. The Telecom Italia Group's business will be adversely affected if it is unable to successfully implement its business plans, particularly in light of the Merger. Factors beyond the New Telecom Italia Group's control may prevent the New Telecom Italia Group from successfully implementing its strategy.

**Table of Contents****RATES OF EXCHANGE**

Beginning with the fiscal year 2001, the Telecom Italia group has published its consolidated financial statements in euros. References to **euro** and **Euro** are to the euro, the currency of 12 member states of the European Union, including Italy and references to **lire**, **lira** and **Lit.** are to Italian lire, the former Italian non-decimal denomination of the euro, and references to **U.S. dollars**, **dollars**, **U.S.\$** or **\$** are to U.S. dollars, the currency of the United States.

For convenience only (except where noted otherwise), certain euro figures have been translated into dollars at the rate (the **Euro/Dollar Exchange Rate**) of 1.00 = U.S.\$1.1843, using the noon buying rate in The City of New York for cable transfers in foreign currencies as announced by the Federal Reserve Bank of New York for customs purposes (the **Noon Buying Rate**) on June 16, 2003. These translations should not be construed as a representation that the euro amounts actually represent such dollar amounts or have been or could be converted into dollars at the rate indicated.

For the purpose of this Annual Report, **billion** means a thousand million.

**Exchange Rates**

Effective January 1, 1999, the following 11 European Union member states adopted the euro as a common currency: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. They also established fixed conversion rates between their respective sovereign currencies and the euro. On January 1, 2001, Greece (together, with the 11 European Union member states referred to in the previous sentence, the **Member States**) joined the European Economic and Monetary Union. The exchange rate at which the lira was irrevocably fixed against the euro is Lit.1,936.27 = 1.00. On January 1, 2002, the Member States began issuing new euro-denominated bills and coins for use in cash transactions. As of March 1, 2002, the Member States withdrew the bills and coins denominated in their respective currencies from circulation, and they are no longer legal tender for any transactions.

The Federal Reserve Bank of New York no longer quotes a Noon Buying Rate for the legacy currencies of any of the Member States.

At the extraordinary stockholders meeting held on May 3, 2001, Telecom Italia's share capital was converted from lire into euros by rounding up the par value of the shares, from Lit. 1,000 (approximately 0.52) to 0.55 partially through the cancellation of 112,998,070 Savings Shares held in treasury.

The following table sets forth, for the year 1998 certain information regarding the Noon Buying Rate for lira expressed in lira per U.S.\$1.

<u>Calendar Period</u>	<u>High</u>	<u>Low</u>	<u>Average(1)</u>	<u>At Period End</u>
1998	1,828	1,1592	1,737	1,654

- (1) Average of the rates for the last business day of each month in the relevant prices.

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The following table sets forth for the years 1999 to 2002 and for the beginning of 2003 certain information regarding the Noon Buying Rate for Dollars expressed in U.S.\$ per 1.00.

<u>Calendar Period</u>	<u>High</u>	<u>Low</u>	<u>Average(1)</u>	<u>At Period End</u>
1999	1.1812	1.0016	1.0588	1.0070
2000	1.0335	0.8270	0.9207	0.9388
2001	0.9535	0.8425	0.8909	0.8901
2002	1.0485	0.8594	0.9495	1.0485
2003 (through June 16, 2003)	1.1870	1.0361	1.1201	1.1843
<b>Monthly Amounts</b>				
December 2002	1.0485	0.9927	1.0194	1.0485
January 2003	1.0861	1.0361	1.0622	1.0739
February 2003	1.0875	1.0708	1.0785	1.0779
March 2003	1.1062	1.0545	1.0797	1.0900
April 2003	1.0621	1.1180	1.0862	1.1180
May 2003	1.1853	1.1200	1.1556	1.1766
June 2003 (through June 16, 2003)	1.1870	1.1686	1.1759	1.1843

- (1) Average of the rates for the last business day of each month in the relevant period except for 2003 for which the date used is June 16, 2003.

Beginning January 4, 1999, the Shares and Savings Shares commenced trading on *Mercato Telematico Azionario* ( Telematico ), managed by Borsa Italiana S.p.A. ( Borsa Italiana ) in euro. Fluctuations in the exchange rate between the euro and the U.S. dollar will affect the U.S. dollar equivalent of the euro price of the Shares and the Savings Shares and the price of the American Depositary Shares ( ADSs ) and the Savings Share American Depositary Shares ( Savings Share ADSs ), on the New York Stock Exchange ( NYSE ). Cash dividends were paid by Telecom Italia in lire until 2001 and in euro starting from 2002. Exchange rate fluctuations will affect the U.S. dollar amounts received by owners of ADSs and Savings Share ADSs upon conversion by the Depositary of cash dividends paid in euro on the underlying Telecom Italia Shares and Telecom Italia Savings Shares. See Item 10. Additional Information Description of American Depositary Receipts .

On completion of the Merger, New Telecom Italia will become a successor registrant to the Company under the Securities Exchange Act of 1934, as amended (the 1934 Act ) and, therefore, become subject to and continue to file periodic reports under the 1934 Act required for a foreign private issuer. New Telecom Italia intends to seek a listing of the New Telecom Italia ordinary shares and savings shares to be issued if the Merger is completed, on the NYSE where such ordinary shares and savings shares will trade in the form of ADSs.

**Table of Contents****SELECTED FINANCIAL AND STATISTICAL INFORMATION**

The selected financial data below should be read in conjunction with the Consolidated Financial Statements and notes thereto included elsewhere in this Annual Report. The selected financial data (other than the 2000 pro forma data) for each of the five years in the period ended December 31, 2002, are extracted or derived from the consolidated financial statements of the Telecom Italia group, which have been audited by the following independent auditors: Reconta Ernst & Young S.p.A. (only for the years ended December 31, 2001 and 2002), PricewaterhouseCoopers S.p.A. (only for the year ended December 31, 2000) and Arthur Andersen S.p.A. (now called Deloitte & Touche Italia S.p.A.) for all other periods. In accordance with Italian law, the financial statements of the parent company Telecom Italia have been approved by the shareholders of Telecom Italia at its Annual Meeting of Shareholders held on May 24, 2003. The Telecom Italia Group's Consolidated Financial Statements included herein have been approved by the Telecom Italia Board of Directors. Unless otherwise indicated, amounts presented are based on Italian GAAP.

	Year ended December 31,					
	2000					
	pro forma					
	1998(1)	1999(1)	2000(1)	(1)(2)	2001(1)	2002(1)
(millions of Euro, except per share and per ADS amounts)						
<b>Statement of Operations Data in accordance with Italian GAAP:</b>						
Operating revenues	25,052(3)	27,104	28,911	27,169	30,818	30,400
Other income	560	516	426	402	417	479
<b>Total revenues</b>	<b>25,612(3)</b>	<b>27,620</b>	<b>29,337</b>	<b>27,571</b>	<b>31,235</b>	<b>30,879</b>
Cost of materials	2,342	2,477	2,259	2,132	1,972	1,779
Salaries and social security contributions	4,992	4,977	5,025	4,745	4,666	4,540
Depreciation and amortization	5,412	5,339	5,647	5,209	6,275	5,877
Other external charges	9,065(3)	9,586	10,790	10,130	12,171	11,949
Changes in inventories	135	(130)	(277)	(255)	58	28
Capitalized internal construction costs	(1,078)	(1,062)	(912)	(831)	(581)	(675)
<b>Total operating expenses</b>	<b>20,868(3)</b>	<b>21,187</b>	<b>22,532</b>	<b>21,130</b>	<b>24,561</b>	<b>23,498</b>
<b>Operating income</b>	<b>4,744(3)</b>	<b>6,433</b>	<b>6,805</b>	<b>6,441</b>	<b>6,674</b>	<b>7,381</b>
Financial income	815	555	847	806	1,076	1,236
Financial expense	(868)	(1,466)	(2,470)	(2,261)	(5,031)	(3,399)
<i>Of which write-downs and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies, net</i>	(178)	(565)	(1,025)	(1,011)	(1,616)	(465)
Other income and expense, net	69(3)	(507)	(214)	(184)	(3,452)	(5,637)
<b>Income (loss) before income taxes</b>	<b>4,760</b>	<b>5,015</b>	<b>4,968</b>	<b>4,802</b>	<b>(733)</b>	<b>(419)</b>
Income taxes	(2,048)	(2,606)	(2,020)	(1,910)	(925)	716
<b>Net income (loss) before minority interests</b>	<b>2,712</b>	<b>2,409</b>	<b>2,948</b>	<b>2,892</b>	<b>(1,658)</b>	<b>297</b>

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Minority interest	(734)	(672)	(920)	(864)	(410)	(619)
Net income (loss)	1,978	1,737	2,028	2,028	(2,068)	(322)
Net income (loss) per Share(4)	0.2634	0.2309	0.2741	0.2741	(0.2858)	(0.0474)
Net income (loss) per Share ADS(4)	2.6339	2.3086	2.7410	2.7410	(2.8581)	(0.4736)
Dividends per Share	0.1446	0.3114	0.3125	0.3125	0.3125	0.3125(5)
Dividends per Savings Share	0.1549	0.3218	0.3238	0.3238	0.3237	0.3235(5)
<b>Amounts in accordance with U.S. GAAP:</b>						
Total revenues	25,612(3)	27,620	27,938		31,017	30,830
Operating income (loss)	4,662(3)	6,153	(1,926)		2,272	4,850
Income (loss) before income taxes	4,419	4,774	7,058		(3,379)	1,357
Net income (loss)	1,526	1,505	3,522		(4,039)	828
Net income (loss) per Share Basic(6)	0.2026	0.1998	0.4731		(0.5553)	0.1103
Net income (loss) per Share Diluted(6)	0.2026	0.1997	0.4717		(0.5553)	0.1103
Net income (loss) per Share ADS Basic(6)	2.0255	1.9982	4.7307		(5.5531)	1.1031
Net income (loss) per Share ADS Diluted(6)	2.0255	1.9966	4.7173		(5.5531)	1.1031

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	Year ended December 31,					
	2000					
	pro forma					
	1998(1)	1999(1)	2000(1)	(1)(2)	2001(1)	2002(1)
(millions of Euro, except per share and per ADS amounts)						
<b>Balance Sheet Data in accordance with Italian GAAP:</b>						
Total current assets	12,186(7)	12,749	16,395	15,673	16,736	15,716
Total fixed assets, net	23,584	23,508	23,425	20,721	21,757	19,291
Intangible assets, net	1,884	2,737	16,037	15,571	16,197	13,052
Total assets	44,870(7)	46,058	65,515	61,985	62,670	52,786
Total short-term debt	4,824	4,969	15,136	14,745	9,114	5,089
Total current liabilities	16,865	17,448	27,482	26,510	21,945	17,616
Total long-term debt	5,598	5,166	8,268	6,733	16,083	15,018
Total liabilities	26,440(7)	26,270	39,986	37,293	43,361	39,959
Total stockholders equity before minority interest	16,346	17,045	18,821	18,821	13,522	9,049
Total stockholders equity	18,430	19,788	25,529	24,692	19,309	12,827
<b>Amounts in accordance with U.S. GAAP:</b>						
Total current assets	12,660	12,984	15,366		16,944	15,331
Total fixed assets, net	23,172	23,150	22,823		23,883	21,277
Intangible assets, net	5,292	5,894	24,084		22,506	18,384
Total assets	48,108	49,263	71,528		72,518	60,822
Total current liabilities	16,865	17,448	26,207		21,487	17,773
Total long-term debt	5,598	5,166	12,466		21,906	20,069
Total liabilities	26,908	26,908	44,848		52,332	46,129
Stockholders equity(8)	19,145	19,659	19,118		12,457	9,215
<b>Financial Ratios in accordance with Italian GAAP:</b>						
Gross operating margin (Gross operating profit/operating revenues)(%)(9)	47.2	45.1	45.4	45.0	44.2	45.9
Operating income/operating revenues (ROS) (%)	18.9	23.7	23.5	23.7	21.7	24.3
Return on equity (ROE) (%)	15.3	12.6	13.0	13.0	n.a.	n.a.
Return on investments (ROI) (%)	18.5	23.6	18.8	18.4	16.0	20.4
Net debt/Net invested capital (debt ratio) (%) (10)	30.7	29.1	42.7	41.1	53.2	58.6
<b>Statistical Data:</b>						
Subscriber fixed lines (thousands)(11)	25,986	26,502	27,153	27,153	27,353	27,142
ISDN equivalent lines (thousands)(12)	1,735	3,049	4,584	4,584	5,403	5,756
TIM lines in Italy (thousands)(13)	14,299	18,527	21,601	21,601	23,946	25,302
Subscriber fixed lines per full-time equivalent employee(14)	332	354	409	409	448	496
Page views Virgilio (millions)		505	2,218	2,218	3,945	5,267
Active Users (at year-end, thousands)		1,104	1,656	1,656	1,804	2,226

- (1) Beginning with the consolidated financial statements for the year ended December 31, 2001, under Italian GAAP, Nortel Inversora and the controlled Telecom Argentina group (Nortel Inversora group), which in 2000 were consolidated proportionally, have been accounted for using the equity method. Prior to 2000 the Nortel Inversora group was accounted for on the equity method. Under U.S. GAAP, the Nortel Inversora group is accounted for using the equity method. These differences in accounting treatment for 2000 did not affect net income and stockholders equity but had an impact on other line items, such as operating revenues and operating expenses, as well as a number of balance sheet line items.
- (2) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.
- (3) Beginning in 1999 the Telecom Italia Group changed the way in which it accounted for revenues from telecommunications services, calculating such revenues gross of interconnection and service charges payable to other operators and service providers and accounting for such interconnection and service charges as an operating expense (other external charges). In prior fiscal years, revenues from





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telecommunications services were accounted for net of interconnection and service charges. Due to this change, operating revenues from telecommunications services and other external charges increased by the same amount: 1,571 million in 1998. This accounting change had no impact on reported net income for 1998. In 1998, the item other external charges also takes into account additional expenses ( 10 million) included in other income and expense, net in the consolidated financial statements in Telecom Italia's 1998 Annual Report on Form 20-F.

- (4) Net income per Share in 1998 is calculated on the basis of 7,421,251,726 Shares and Savings Shares outstanding. Net income per Share in 1999 is calculated on the basis of 7,426,157,226 Shares and Savings Shares outstanding. Net income per share in 2000 is calculated on the basis of 7,321,179,156 Shares and Savings Shares outstanding; Savings Shares are net of 104,978,070 shares of treasury stock acquired during 2000. Net loss per Share in 2001 is calculated on the basis of 7,314,655,506 Shares and Savings Shares outstanding. Net loss per Share in 2002 is calculated on the basis of 7,265,103,156 Shares and Savings Shares outstanding; Shares are net of 5,280,500 shares of treasury stock and Savings Shares are net of 45,647,000 shares of treasury stock acquired during 2002.

The calculations take into account the requirement that holders of Savings Shares are entitled to an additional dividend equal to 2% of the par value of Savings Shares above dividends paid on the Shares. Prior to 2000 the par value of the Savings Shares was Lit. 1,000 per share, while for 2001 and 2002, following the resolution of the extraordinary shareholders' meeting held on May 3, 2001 regarding the re-denomination of Telecom Italia share capital into Euro, the calculations take into account the new par value per share of 0.55. Net income (loss) per Savings Share was 0.2737, 0.2412, 0.2844, (0.2748) and (0.0364) in each of 1998, 1999, 2000 (historical and pro forma), 2001 and 2002, respectively, and net income (loss) per Savings Share ADS was 2.7372, 2.4119, 2.8443, (2.7481) and (0.3636) in each of 1998, 1999, 2000 (historical and pro forma), 2001 and 2002, respectively.

As of December 31, 1998, 1999, 2000 (historical and pro forma), 2001 and 2002, the number of Shares and Savings Shares outstanding was 7,421,251,726, 7,426,157,226, 7,426,157,226, 7,314,655,506 and 7,316,030,656, respectively. The increase in Shares and Savings Shares outstanding in 1999 is due to the issuance of 4,905,500 new Shares in connection with the Stock Option Plan. The decrease in Shares and Savings Shares outstanding in 2001 is due to the cancellation of 112,998,070 Savings Shares of treasury stock following the re-denomination of the share capital into Euro and the issuance of 1,496,350 new Shares in connection with the Stock Option Plan. The increase in Shares and Savings Shares outstanding in 2002 is due to the issuance of 1,375,150 new Shares in connection with the Stock Option Plan.

- (5) In order to ensure shareholders dividends commensurate with those paid out for 2001, in December 2002, reserves were distributed corresponding to a dividend of 0.1357 per Share and a dividend of 0.1357 per Savings Share. Furthermore, the Shareholders' Meeting held on May 24, 2003 approved the pay out of an additional dividend of 0.1768 per Share and 0.1878 per Savings Share, by drawing from the income and capital reserves. Telecom Italia's dividend coupons for the year ended December 31, 2002 were clipped on June 23, 2003, and such dividends for the year ended December 31, 2002 are payable from June 26, 2003.
- (6) In accordance with U.S. GAAP, the Net income (loss) per Share has been calculated using the two class method, since the Company has both Shares and Savings Shares outstanding. Under this method, set forth in Statement of Financial Accounting Standards No. 128, Earnings per Share, Basic earnings per share is computed by dividing income available to shareholders by the weighted average number of shares outstanding, and diluted earnings per share is increased to include any potential common shares and is adjusted for any changes to income that would result from the assumed conversion of those potential common shares. For the purpose of these calculations, the weighted average number of Shares and Savings Shares was 7,421,251,726 for the year ended December 31, 1998, 7,421,660,518 for the year ended December 31, 1999, 7,398,247,829 for the year ended December 31, 2000, 7,314,353,578 for the year ended December 31, 2001 and 7,297,953,685 for the year ended December 31, 2002. The calculations take into account the requirement that holders of Savings Shares are entitled to an additional dividend equal to 2% of the par value of Savings Shares above dividends paid on the Shares. Prior to 2001 the par value of the Savings Shares was Lit. 1,000 per share, while for 2001 and 2002, following the resolution of the extraordinary shareholders' meeting held on May 3, 2001 regarding the re-denomination of Telecom Italia share capital into Euro, the calculations take into account the new par value per share of 0.55. In addition, in accordance with U.S. GAAP, net income (loss) per Savings Share Basic was 0.2129, 0.2101, 0.4834, (0.5443) and 0.1213 in 1998, 1999, 2000 (historical and pro forma), 2001 and 2002, respectively, and net income (loss) per Savings Share ADS Basic, was 2.1288, 2.1015, 4.8340, (5.4431) and 1.2131 in 1998, 1999, 2000 (historical and pro forma), 2001 and 2002, respectively.
- (7) As a consequence of the introduction of the new Italian Accounting Principle for Income Taxes, beginning in 1999, deferred tax assets and liabilities are offset. Due to this change as of December 31, 1998 the

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- amount of current assets was reduced by 114 million, while total assets and liabilities were reduced by the same amount of 379 million.
- (8) Stockholders' equity under U.S. GAAP is calculated after elimination of minority interest. See Note 26 of Notes to Consolidated Financial Statements included elsewhere herein.
- (9) Gross Operating Profit was 11,821 million, 12,226 million, 13,118 million, 12,217 million, 13,619 million and 13,964 million in each of 1998, 1999, 2000 (historical), 2000 (pro forma), 2001 and 2002, respectively. Because Gross Operating Profit includes certain financial statement items and excludes others it is considered a non-GAAP financial measure as defined in Regulation G of the 1934 Act. Telecom Italia believes that Gross Operating Profit provides the best indication of the Telecom Italia Group's operating performance and is meaningful information for investors. In addition the Telecom Italia Group also believes (although other telecommunication operators will calculate such information differently) that Gross Operating Profit permits an adequate comparison of the Telecom Italia Group's performance against its peer group. The following table reconciles operating income to the calculation of Gross Operating Profit by showing the Statement of Operation items included in calculating Gross Operating Profit.

	Year ended December 31,					
	1998	1999	2000	2000 pro forma	2001	2002
	(millions of Euro)					
Operating income	4,744	6,433	6,805	6,441	6,674	7,381
Depreciation and Amortization	5,412	5,339	5,647	5,209	6,275	5,877
Other external charges:						
• Provision for bad debts	364	363	477	394	439	542
• Write-downs of fixed assets and intangibles	950	73	48	48	16	57
• Provision for risk	178	80	119	108	189	109
• Other provisions and operating charges	654	380	382	353	382	436
Other income (excluding operating grants, reimbursements for personnel costs and costs of external services rendered)	(481)	(442)	(360)	(336)	(356)	(438)
<b>Gross Operating Profit</b>	<b>11,821</b>	<b>12,226</b>	<b>13,118</b>	<b>12,217</b>	<b>13,619</b>	<b>13,964</b>

- (10) For purposes of calculating the debt ratio, net financial debt is calculated as follows:

	As of December 31,					
	1998	1999	2000	2000 pro forma	2001	2002
	(millions of Euro)					
Short-term debt, including current portion of long-term debt	4,824	4,969	15,136	14,745	9,114	5,089
Long-term debt	5,598	5,165	8,268	6,733	16,083	15,018
Cash and cash equivalents:						
• Bank and postal accounts	(582)	(668)	(1,299)	(1,281)	(757)	(1,251)
• Cash and valuables on hand	(3)	(9)	(5)	(4)	(5)	(4)
• Receivables for sales of securities		(5)	(1)	(1)	(3)	(55)
Marketable debt securities	(1,252)	(1,265)	(2,020)	(1,869)	(1,935)	(278)
Financial accounts receivable (included under Receivables and Other current assets )	(523)	(144)	(1,110)	(1,110)	(805)	(683)
Financial prepaid expense/deferred income, net and accrued financial income/expense, net	112	95	59	20	250	282

<b>Net Financial Debt</b>	<b>8,174</b>	<b>8,138</b>	<b>19,028</b>	<b>17,233</b>	<b>21,942</b>	<b>18,118</b>
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- (11) Data include multiple lines for ISDN and exclude internal lines.
- (12) Data exclude internal lines.
- (13) Data refer to TACS and GSM services lines, including holders of Prepaid Cards.
- (14) Ratio is based on employees of Telecom Italia only.

**Table of Contents****Dividends**

Telecom Italia has normally paid annual cash dividends on its outstanding Shares and Savings Shares, although the determination of Telecom Italia's future dividend policy, and the amounts thereof, will depend upon a number of factors, including but not limited to the Company's earnings, financial condition and cash requirements, prospects and such other factors as may be deemed relevant at the time.

Telecom Italia's management has publicly stated that in relation to the Merger between Olivetti and Telecom Italia, New Telecom Italia's dividend policy is not expected to change. New Telecom Italia is expected to be able to distribute to the Company's present shareholders an overall dividend corresponding to the dividends presently paid to them.

The dividends per share and per savings share declared by Telecom Italia with respect to each of the last five fiscal years and the aggregate dividend paid in such years are shown below. Actual dividends paid are rounded to the nearest whole cent.

Year ended December, 31	Dividends on Shares			Dividends on Savings Shares		
	Euros per Share	U.S. dollars per	(millions of	Euros per Share	U.S. dollars per	(millions of
		Share(2)	euros)		Share(2)	euros)
1998(1)	0.1446	0.15	759.94	0.1549	0.17	335.61
1999(1)	0.3099(3)	0.29	1,638.10	0.3218(3)	0.30	688.58
2000(1)	0.3125	0.27	1,643.93	0.3238	0.28	664.84
2001	0.3125(4)	0.28	1,644.19	0.3237(4)	0.29	662.33
2002	0.1357(5)	0.13	713.47	0.1357(5)	0.13	273.11

- (1) Dividends for 1998, 1999 and 2000 were paid in lire. The lire amounts were translated into euros at the irrevocably-fixed rate of exchange of Lit.1,936.27 = 1.
- (2) Euro amounts have been translated into U.S. dollars using the Noon Buying Rate in effect on the respective payment dates. See Rates of Exchange.
- (3) The per share amount paid with respect to the fiscal year ended December 31, 1999 includes the distribution to all shareholders of the dividends payable on 26,046,820 Savings Shares held in treasury on the date the dividend was paid. A total of approximately 3.12 million was also distributed from the statutory reserve in order to round up such per share amounts.
- (4) Approved at the Annual Meeting of Shareholders held on May 7, 2002. Telecom Italia's dividend coupons for the year ended December 31, 2001 were clipped on May 20, 2002 and were payable from May 23, 2002. Dividends for the year ended December 31, 2001 were paid also utilizing reserves.
- (5) In order to ensure shareholders dividends commensurate with those paid out for 2001, in December 2002, reserves were distributed and paid corresponding to a dividend of 0.1357 per Share and a dividend of 0.1357 per Savings Share. Furthermore, the Shareholders' Meeting held on May 24, 2003 approved an additional dividend of 0.1768 per Share and 0.1878 per Savings Share, payable from income and capital reserves. Pursuant to Italian Stock Exchange rules, dividends on the Shares and the Savings Shares are payable from the fourth business day after the third Friday of each month, and in any case, at least four business days after the Annual Meeting of Shareholders approving the dividends. Telecom Italia's additional dividend coupons for the year ended December 31, 2002 were clipped on June 23, 2003, and are payable from June 26, 2003.

Payment of annual dividends is subject to approval by the holders of ordinary shares at the annual general shareholders' meeting, which must be convened within six months after the end of the financial year to which it relates. In addition, Article 21 of the Company's Bylaws gives the Board of Directors the power to approve the distribution of interim dividends. Pursuant to Italian law, the distribution may be approved after the final approval of the preceding year's financial statements, and the interim dividends may not exceed the lower of (i) the difference between

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profits from the preceding fiscal year and amounts required to be attributed to legal and statutory reserves and (ii) available reserves. Once paid in compliance with applicable laws, shareholders cannot be required to repay interim dividends to the Company if the shareholders collected such dividends in good faith. Dividends are usually payable within 30 days of the general shareholders' meeting at which they are approved. Dividends not collected within five years from the date they become payable will be forfeited in favour of the Company.

According to the Italian Civil Code, before dividends may be paid with respect to any year, an amount equal to 5% of the net income of the Company for such year must be set aside to the legal reserve until the legal reserve, including amounts set aside during prior years, is at least equal to one-fifth of the par value of the Company's issued share capital. This legal reserve is not available for payment of dividends. Such restriction on the payment of dividends applies, on a non-consolidated basis, to each Italian subsidiary of the Telecom Italia Group. The Company may also pay dividends out of available retained earnings from prior years or other reserves.

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Dividends in respect of Shares and Saving Shares held with Monte Titoli S.p.A ( Monte Titoli ) are automatically credited to the accounts of the beneficial owners with the relevant participant of Monte Titoli, without the need for presentation by such beneficial owners of any documentation. See Item 10. Additional Information Description of Bylaws and Capital Stock .

Arrangements between Euroclear or Clearstream and Monte Titoli permit the shareholders to collect the dividends through Euroclear or Clearstream. Holders of American Depositary Receipts ( ADRs ) are entitled to receive payments in respect of dividends on the underlying Shares and Savings Shares, as the case may be, in accordance with the relevant Deposit Agreement. If profits are not fully distributed, additional reserves are created.

Dividends payable on the Company s Shares and Savings Shares may be subject to deduction of Italian withholding tax. See Item 10. Additional Information Taxation . Italian regulations do not contain any specific restrictions on the payment of dividends to non-residents of Italy. See Item 10. Additional Information Exchange Controls and Other Limitations Affecting Security Holders .

Pursuant to Italian law, in connection with the payment of dividends, participants of Monte Titoli are required to supply to the Italian tax authorities certain information concerning the identity of non-resident shareholders holding Shares or Savings Shares and resident shareholders holding Shares or Saving Shares in registered form provided that such resident shareholders have not exercised the option to receive dividends with the deduction of the withholding tax and to subsequently include such dividends in the annual income statement. Shareholders are required to provide their Italian tax identification number, if any, or alternatively, in the case of legal entities, their name, country of establishment and address, or in the case of individuals, their name, address and place and date of birth, or in the case of partnerships, the information required for legal entities and the information required for individuals with respect to one of their representatives.

In the case of Ordinary Share ADSs and Savings Share ADSs owned by non-residents of Italy, Telecom Italia understands that the provision of information concerning the Depository, in its capacity as holder of record of the Shares and Savings Shares, as the case may be, will satisfy these requirements. However, Telecom Italia will be required to provide information concerning non-resident beneficial owners of Ordinary Share ADSs and Savings Share ADSs, to the extent such owners wish to benefit from reduced withholding tax rates on dividends under an income tax convention, and claims for such benefits therefore must be accompanied by the required information. See Item 10. Additional Information Taxation .

## **Item 4. INFORMATION ON THE TELECOM ITALIA GROUP**

### **BUSINESS**

A glossary of selected telecommunications terms used in the following description of the Telecom Italia Group s business and elsewhere in this Annual Report can be found at the end of Item 4 of this Annual Report.

The legal and commercial name of the Company is Telecom Italia S.p.A. The Company is incorporated as a joint stock company under the laws of Italy. The duration of the Company extends until December 31, 2050.

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On July 18, 1997, the Company's predecessor company was merged with and into STET Società Finanziaria Telefonica per Azioni (STET), its parent holding company, with STET as the surviving corporation. As of the effective date of the merger, STET changed its name to Telecom Italia S.p.A. In November 1997, the Ministry of the Treasury of the Republic of Italy (the Treasury) completed the privatization of Telecom Italia selling substantially all of its stake in the Telecom Italia Group through a global offering, and a private sale to a stable group of shareholders. On May 21, 1999 Olivetti, through a tender offer, obtained control of the Telecom Italia Group when approximately 52.12% of Telecom Italia Shares were tendered to Olivetti. Through a series of transactions which started in July 2001, Olimpia acquired a 28.7% stake in Olivetti which resulted in the replacement of the then Board of Directors. On December 9, 2002 the Treasury sold all its remaining stake in the Company's ordinary and savings share capital. More recently Hopa, the merchant bank led by Emilio Gnutti which participated in the 1999 take-over of Olivetti, gained a 16% stake in Olimpia, leading to a proportional reduction of the other shareholders. Please see Significant Developments during 2002 The Pirelli-Olimpia Transaction .

The registered offices of Telecom Italia is at Piazza degli Affari 2, 20123 Milan, Italy. The corporate headquarters and the principal executive offices of Telecom Italia are located at Corso d Italia 41, 00198 Rome, Italy, the telephone number is +39 06 3688 -1.

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### **Introduction**

At the end of 2002, the Telecom Italia Group was one of the world's largest fixed telecommunications operators, with approximately 27.1 million subscriber fixed-lines installed (including ISDN equivalent lines). Through its subsidiary TIM, the Telecom Italia Group was also the largest mobile telecommunications operator in Italy and one of the largest in the world, with approximately 39.1 million mobile lines (which includes 31.5 million proportionate lines). The Telecom Italia Group also had 6.2 million mobile lines (2.2 million proportionate lines) through companies indirectly owned through Telecom Italia International. In Italy TIM is one of three operators with the right to provide GSM digital mobile telecommunications services and one of three operators with the right to provide DCS 1800 digital mobile telecommunications services (the fourth operator, Blu, was acquired in October 2002 and merged into TIM in December 2002). TIM is one of five entities which have acquired a UMTS license to provide third generation mobile services in Italy.

The Telecom Italia Group also provides leased lines and data communications services. Through SEAT, the Telecom Italia Group is a leading provider of Internet and directory publishing services, although Telecom Italia has recently agreed to sell the directory publishing business of SEAT. The sale is subject to the satisfaction of certain conditions. Please see "Recent Developments SEAT Spin-off and Proposed Sale". Other activities of the Telecom Italia Group include the provision of IT software and services.

The Telecom Italia Group's international portfolio of subsidiaries and investments includes fixed and mobile telecommunications companies which operate mainly in Latin America and certain countries in Europe.

### **Significant Developments during 2002**

#### ***The Pirelli-Olimpia Transaction.***

*The information contained herein on the Pirelli-Olimpia transaction has been taken from publicly available information filed by the parties involved therein with regulatory authorities. So far as Telecom Italia is aware, no facts have been omitted herein which would render the information misleading. No further or other responsibility in respect of such information is accepted by Telecom Italia.*

**Share Ownership.** On July 30, 2001, Pirelli S.p.A. (hereinafter "Pirelli") and Edizione Holding S.p.A. (hereinafter "Edizione") signed an agreement with Bell for the acquisition, through a company to be named, of Olivetti stock owned by Bell, representing about 23.3% of Olivetti's share capital. Edizione is the parent company of the Benetton group and is controlled by the Benetton family.

The agreement called for the acquisition of 1,552,662,120 ordinary shares and 68,409,125 warrants 2001-2002 on ordinary shares of Olivetti (hereinafter the "Olivetti Investment"), at a per unit price, respectively, equal to 4.175 and 1.0875, for a total price of 6,557 million, with a value date at August 31, 2001. The value date was to indicate that the price for the Olivetti Investment would be reduced if the payment was made before August 31, 2001 and increased if made after that date on the basis of the following formula: interest = total price x (1-month Euribor + 0.75%) x the number of days of early or delayed payment / 360.



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The purchase transaction was subject to receipt of the necessary authorizations and in particular from the EU Commission. This authorization was received on September 20, 2001.

On August 3, 2001, Pirelli (80 percent) and Edizione Finance International S.p.A. (20 percent a wholly-owned company of Edizione), set up Olimpia, the company designated for the acquisition of the aforementioned Olivetti Investment.

On August 9, 2001, Kallithea S.p.A. (a subsidiary of Pirelli S.p.A.) sold 147,337,880 Olivetti ordinary shares (equal to about 2.02% of Olivetti's share capital) to Olimpia for a price per share of 4.193, for a total of approximately 618 million. Pirelli Finance Luxembourg S.A. (a subsidiary of Pirelli S.p.A.) and Edizione sold a total of 265,302,250 Olivetti ordinary shares (equal to about 3.64% of Olivetti's share capital) to Olimpia at a total price of approximately 576 million.

On September 19, 2001, an agreement was signed among the majority shareholders of Bell, Pirelli, Edizione and Olimpia which called for a commitment by the majority shareholders of Bell to ensure that the latter, at the same time payment was made by Olimpia for the purchase of the Olivetti Investment, subscribed to bonds issued by Olimpia itself, with the following features: 6-year bonds for an amount of approximately 1,033 million, repayable at maturity, unless the bonds are redeemed in advance by the bondholder, convertible into 263,500,000 Olivetti shares in a ratio of one share for every bond with a face value of 3.92, bearing an annual fixed rate of interest of 1.5%, payable in cash at maturity or at the date of early redemption.

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The agreement also called for the transfer of the Olivetti Investment in two tranches, the first for 552,000,000 Olivetti shares to be carried out on September 27, 2001 and the second for the remaining shares and warrants by October 12, 2001.

In execution of the above agreement, on September 27, 2001, 552,000,000 Olivetti shares were transferred from Bell to Olimpia (for an equivalent amount of 2,315 million), while on October 5, 2001, the remaining 1,000,662,120 Olivetti shares and 68,409,125 warrants were transferred from Bell to Olimpia (for an equivalent amount of 4,199 million and 74 million, respectively). On the same date, October 5, 2001, Bell subscribed to the Olimpia Bonds.

Under the agreements on July 30, 2001, Pirelli and Edizione agreed to purchase a further 54 million Olivetti shares, held originally by Banca di Roma S.p.A., for a price of 225 million, corresponding to a price per share of 4.175. Based on these understandings, on October 31, 2001, with the value date and delivery of the stock on November 2, 2001, Olimpia purchased these shares. This resulted in a holding of approximately 27.7% of the share capital of Olivetti.

On November 20, 2001, in order to hedge the risk on the value of the Olivetti shares to be delivered to the holders of the Olimpia Bonds, Olimpia entered into a forward purchase agreement with UniCredit Banca Mobiliare S.p.A. and Caboto IntesaBci S.p.A. (ex-Caboto Holding Sim S.p.A.), for 263,500,000 Olivetti shares at a price equal to the average purchase price of approximately 1.37 per Olivetti share plus a premium equal to approximately 32% of the average purchase price. Settlement can be made through the physical delivery of the shares against payment of the agreed price or payment of the differentials compared to the market price.

On November 23, 2001, after a capital increase voted by the Board of Directors of Olivetti on October 13, 2001, Olimpia, by exercising its option rights subscribed to 504,825,563 Olivetti shares (for a price of approximately 505 million) and 504,825,562 Olivetti 1.5% 2001-2010 convertible bonds with a premium at redemption (for a price of approximately 505 million).

On December 19, 2002, Olimpia made a proposal to the holders of the Olimpia Bonds to retire them in exchange for either Olivetti shares (as provided under the existing terms of the Olimpia Bonds) or, alternatively, a combination of Olivetti shares and the aforementioned Olivetti 2001-2010 1.5% bonds convertible into Olivetti shares (Olivetti Bonds). On December 19, 2002, Hopa S.p.A. (Hopa) and two companies that Hopa has advised and that are controlled by it, Holinvest S.p.A. (Holinvest) and G.P.P. International S.A., accepted Olimpia's proposal for retirement of the total of 262,533,449 Olimpia Bonds held by them by delivery of a total of (i) 98,975,110 Olivetti shares (representing approximately 1.12% of the 8,845,313,805 Olivetti shares reported to be outstanding on December 31, 2002) effective in January 2003 and (ii) 163,558,339 Olivetti Bonds effective in June 2003.

Also on December 19, 2002, Pirelli, Edizione, UniCredito Italiano S.p.A. (Unicredito) and IntesaBci S.p.A. (IntesaBCI) (collectively, the Former Olimpia Shareholders), Olimpia and Hopa (collectively with the Former Shareholders and Olimpia, the Parties) executed a term sheet (the Hopa Term Sheet). Pursuant to the Hopa Term Sheet, the Parties agreed that, subject to certain terms and conditions, Holy S.r.l. (Holy), a wholly-owned subsidiary of Hopa, would be merged into Olimpia (the Holy Merger). As of the effective date of the Holy Merger, Holy shall own: (i) 163,558,339 million Olivetti Bonds and 99,941,661 Olivetti shares for a total book value of 476,935,000; (ii) a 19.999% equity stake in the capital stock of Holinvest, for a total book value of 385.4 million; (iii) net cash of 98.8 million, plus any dividends for the 98,975,110 Olivetti shares possibly distributed by Olivetti during the period between the date of the Hopa Term Sheet and the effective date of the Holy Merger.

Pursuant to the subsequent agreement signed by the Parties on February 21, 2003 (the Hopa Agreement), the Holy Merger took place on May 9, 2003. As a result of the Holy Merger and the net effect of the early redemption of Olimpia's 1.5% 2001-2007 bonds, Olimpia's holding in Olivetti

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increased to 2,252,094,364 shares, equal to a 28.55 stake in Olivetti's share capital of the same date. As of May 9, 2003, Olimpia also holds 504,825,562 Olivetti 1.5% 2001-2010 convertible bonds with a premium at redemption and 68,409,125 Olivetti 2001-2002 warrants on ordinary shares.

As of the date of this Annual Report, the share capital of Olimpia is fully paid and is equal to 1,562,596,150, consisting of 1,562,596,150 shares of par value 1 each.

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(1) Its current name is Banca Intesa S.p.A. .

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Following the Holy Merger, the share capital of Olimpia is held by Pirelli, Edizione, UCI, IntesaBci and Hopa in the following respective proportions: 50.4%, 16.8%, 8.4%, 8.4% and 16%.

As a result of the Merger, Olimpia's shareholding in New Telecom Italia will be diluted to between 9.94% and 13.27%, depending on certain assumptions, from its current holding in Olivetti of 28.55%. See Recent Developments.

### ***Shareholders' Agreements***

There are shareholders' agreements among Olimpia's shareholders.

In particular, shareholders' agreements were entered into between Pirelli and Edizione on August 7, 2001, as amended on September 14, 2001 and February 13, 2002 (hereinafter the *Agreements*). Shareholders' agreements were entered into also between Pirelli, IntesaBci and UniCredito on September 14, 2001, amended on September 26, 2001 and October 24, 2001 (hereinafter *Agreements with the Banks*).

The *Agreements* and the *Agreements with the Banks* have a duration of three years and can be renewed at each expiration date. The renewal period is three years for the *Agreements* and two years for the *Agreements with the Banks*.

The *Agreements* and the *Agreements with the Banks* deal with the nomination of the Board of Directors of Olimpia, Olivetti, Telecom Italia, TIM and SEAT. They identify the key issues on which the board resolutions of Olimpia, Olivetti, Telecom Italia, TIM and SEAT have to decide in accordance with the *Agreements* and the *Agreements with the Banks*. The *Agreements* and the *Agreements with the Banks* also discuss the rules for the resolution of disagreements among the contracting parties on key issues (the so-called deadlock situations). In addition, the *Agreements* and the *Agreements with the Banks* govern the consequences among the parties of any change in the structure of control of Pirelli (in the *Agreements with the Banks*) and of Edizione or of Pirelli (in the *Agreements*); and grant the parties the right to purchase or sell (puts and calls) Olimpia shares in the event of withdrawal from the agreements themselves.

The provisions relating to the nomination of the members of the Boards of Directors of Olivetti, Telecom Italia, TIM and SEAT are set forth below. In connection with the composition of the Boards of Directors of Olivetti, Telecom Italia, TIM and SEAT, the parties to the Shareholders' Agreements have agreed to use their best efforts, within the limits established by law, in order to cause:

- the nomination by Edizione of one-fifth of the Boards of Directors, without taking into account the directors whose designation is reserved by law or applicable bylaws to the market or other parties;
- the nomination of one director by Intesa;
- the nomination of one director by Unicredito;

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- the nomination of the vice-president of the Boards of Directors from among the directors nominated by Edizione; and
- in the event of the establishment of an Executive Committee, the election of one member of the Executive Committee from among the directors nominated by Edizione. See Item 6. Directors, Senior Management and Employees Directors .

CONSOB in its resolution dated October 30, 2001, which dealt with the matter of the authorization for the publication of the Olivetti prospectus for the offer of options on Olivetti ordinary shares and Olivetti 2001-2010 bonds, asked that the above prospectus indicate, based on CONSOB's evaluation, that de facto control of Olivetti is held by Olimpia and Olimpia is subject to the sole control of Pirelli. CONSOB explained the reasons why this supplementary information was requested in the communication published in the CONSOB Informa Newsletter dated November 5, 2001.

Pirelli did not agree with the reasons expressed by CONSOB and on December 6, 2001 filed a request to review the matter so that the questions surrounding the issue could be reexamined and the comments expressed about Olimpia's control over Olivetti could be revised. On January 8, 2002, under ruling No. RM/2001124, CONSOB gave its decision not agreeing with the request to review the matter of qualifying the holdings between Pirelli and Olimpia and between Olimpia and Olivetti.

Since the rulings were adverse, Olivetti, Pirelli and Olimpia filed an appeal with the TAR of Lazio to obtain their cancellation. The TAR of Lazio, in a ruling released on February 25, 2002, ruled favorably on the appeal, canceling the contested CONSOB rulings.

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The Hopa Agreement provides that, from the effective date of the Holy Merger, Hopa and the Former Olimpia Shareholders are bound by an agreement governing their relationship as shareholders of Olimpia (the Expanded Olimpia Shareholders Agreement).

Under the Expanded Olimpia Shareholders Agreement, Hopa has the right to appoint one Olimpia director and the Former Olimpia Shareholders must use their best efforts in order to cause a director designated by Hopa nominated to the Board of Directors of Olivetti, Telecom Italia, TIM and SEAT (with a corresponding reduction in the number of Pirelli nominees). See Item 6. Directors, Senior Management and Employees Directors.

Hopa does not have the right to veto any decision taken by the board of directors or shareholders of Olimpia. In the event of a disagreement between the former Olimpia Shareholders and Hopa with respect to the passage of a resolution by either the Extraordinary Shareholders Meeting or the Board of Directors of Olimpia concerning certain matters (including (i) the determination as to how Olimpia will vote its Olivetti shares at an Extraordinary Shareholders Meeting of Olivetti, (ii) the purchase or sale of securities exceeding a certain amount and (iii) failure of Olimpia to maintain a debt to equity ratio of 1:1), Hopa may cause the partial demerger of Olimpia, in which event Olimpia may cause the partial demerger of Holinvest S.p.A. (Holinvest), a company jointly owned by Hopa (80.001%) and Olimpia (19.999%). In the event of any such partial demerger transactions, Hopa would receive its proportional share of Olimpia's assets and liabilities (determined in accordance with the Hopa Agreement) and Olimpia will receive its proportional share of Holinvest's assets and liabilities (determined in accordance with the Hopa Agreement). Except under certain extraordinary circumstances (including the failure of Olimpia to hold at least 25% of Olivetti's share capital or to maintain a debt to equity ratio of 1:1 after a specified cure period), no such partial demerger transactions may not be implemented prior to the third anniversary of the Holy Merger.

Hopa is granted certain co-sale rights in the event Pirelli reduces its equity interest in Olimpia.

Hopa, Holy, Holinvest and Hopa controlling companies (the Hopa companies), the Former Olimpia Shareholders and their respective controlling and controlled companies agreed not to acquire any additional Olivetti Shares except (i) in the case of Pirelli, in connection with the exercise of certain existing call options and swap agreements referred to in the Hopa Term Sheet, (ii) in the case of Edizione, Unicredito and Intesa BCI, as currently permitted, respectively, under the Agreements and the Agreements with the Banks, and (iii) in the case of the Hopa companies, as permitted under the Expanded Olimpia Shareholders Agreement.

The Expanded Olimpia Shareholders Agreement will have a three-year term as from the Holy Merger, subject to extension by mutual agreement of the parties thereto. If the Expanded Olimpia Shareholders Agreement is not renewed, the partial demerger transactions will occur and Hopa will receive a premium of at least 0.35 per Olivetti share (or financial instrument).

The Holinvest Shareholders Agreement will have a three-year term, subject to automatic extension if and to the extent the Expanded Olimpia Shareholders Agreement is extended.

The Parties have not sent any notification concerning the possible effects of the Merger on the Agreements, the Agreements with the Banks and the Hopa Agreement.

***Updated Business Plan.***

On February 14, 2002, Telecom Italia announced its 2002-2004 Industrial Plan (the Industrial Plan ) and established its priorities for 2002. The main objectives were to:

- Strengthen its competitive position;
- Improve cost efficiency; and
- Strengthen the Telecom Italia Group s financial structure.

The Telecom Italia Group has sought to strengthen its competitive position in its core domestic market through the introduction of new products and services in its main business areas:

- In *Domestic Wireline*, a new brand and a new range of services for broadband Internet (Alice) was launched, reaching, at the end of 2002, a customer base of 850,000 broadband accesses. New voice packages and innovative integrated solutions for business clients were also introduced;

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- In *Mobile*, a new offering of multimedia services (messaging and videostreaming) and voice portals was developed together with the launching of specialized packages for business; and
- In *Internet & Media*, the directories product range was renewed, a new broadband portal was launched and the programs list of La7 (the Internet and Media business unit television station) was redesigned.

At December 31, 2002, the Telecom Italia Group had achieved 80% of the 2002-2004 announced target of cost reductions of 2 billion through the reduction of both operating expenses and capital expenditures.

With respect to strengthening Telecom Italia Group's financial structure, consolidated net financial debt (see Note 10 to Selected Financial and Statistical Information ) of 18.1 billion as of December 31, 2002, meant that the Telecom Italia Group had fully achieved its target of 18.3 billion established under the Industrial Plan notwithstanding payment of 1.7 billion of dividends paid in advance in December 2002. This level of net financial debt was reached in large part with proceeds from the asset disposal program totaling 5.2 billion from September 2001 to December 2002, which included in 2002 assets such as Auna, Telekom Austria, Mobilkom Austria, Bouygues Decaux Telecom, real estate assets sold in the context of the Tiglio Project (see below Description of Property Tiglio Project ) and other smaller assets. As a result of the Merger, New Telecom Italia's level of indebtedness will increase significantly. See Item 3. Key Information Risk Factors Risk Factors Relating to the Merger New Telecom Italia's total net financial debt will increase if the Merger of Telecom Italia and Olivetti is successful and Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data .

The Telecom Italia Group's Industrial Plan establishes certain financial targets which the Telecom Italia Group has confirmed also apply to the 2003-2005 period and take into account the Merger. These targets are focused on:

- Innovation;
- Leveraging its leadership in its core Italian domestic market;
- Launching new value added services; and
- Leveraging core capabilities to create new opportunities.

The financial targets (based on Italian GAAP) include:

<b>Objectives of New Telecom Italia</b>	
<b>on a consolidated basis CAGR(1)</b>	
<b>2002-2005</b>	
Operating revenues	4 4.5%
Gross operating profit	5 5.5%
Operating income	8 8.5%
Net financial debt ( in billions)	34.3(2)



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- (1) Compound average growth rate.
  - (2) At December 31, 2004.

*Please see Cautionary Statement for Purposes of the Safe Harbor Provisions of the United States Private Securities Litigation Reform Act 1995 at the beginning of this Annual Report for a discussion of factors which could cause New Telecom Italia's actual results to differ materially from the targets discussed above.*

***Reorganization.***

During 2002, the process of reorganizing the Telecom Italia Group's corporate structure continued.

The following new Functions were introduced and remain in place: Latin America Operations and Foreign Holdings, office of the General Counsel and Brand Enrichment.

Some institutionalized meetings such as a Purchasing Committee, which coordinates the purchasing process of the Telecom Italia Group, and the Network Development Committee, which is mandated to optimize the integration of wireline and mobile networks by controlling innovation and technological development, were added to the existing committees formed last year. They included the Business Reviews Committees, which monitor result, plans and projects of each Business Unit monthly, the Investments Committee which approves the

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major investments of the Telecom Italia Group, and the International Steering Committee, which defines the guidelines of the management of all the foreign holdings of the Telecom Italia Group.

As part of the reorganization, the Business Units underwent some further changes in 2002 and, in early 2003 the Telecom Italia Group further reorganized certain of its Business Units. See Item 5. Operating and Financial Review and Prospects Results of Operations General .

## **Disposition and Acquisition of Certain Equity Investments**

### ***Dispositions.***

***Sale of Real Estate Assets.*** On June 20, 2003, the Telecom Italia Group announced that it reached an agreement with Lastra Holding B.V. a company within the Five Mounts Properties group (FMP), for the sale of certain Telecom Italia Group real estate assets. FMP is the real estate arm of BSG (the Beny Steinmetz Group), which is owned and managed by the Geneva based Beny Steinmetz family trusts and foundation.

The value of the agreement, which is expected to be finalized by the end of July 2003, is equal to approximately 355 million.

***Disposal of TI logistics company arm.*** On 27 January, 2003, Telecom Italia announced a transaction with TNT Logistics Italia whereby TNT takes over the stocking and distribution of fixed-line telephony products for customers and Telecom Italia Network assistance and installation. Among other factors, the transaction includes the transfer to TNT Logistics of certain assets of Telecom Italia comprising 6 central warehouses, 100 outlying warehouses and over 4.5 million telephone sets and telephone installation articles annually. Devised to promote a company focus on core business, the agreement became operational on March 5, 2003, upon receipt of clearance from the Italian Competition Authority and completion of union consultation procedures.

***Disposal of GLB Servicios Interativos.*** On January 15, 2003, Telecom Italia Finance disposed of its 28.57% stake held in GLB Servicios Interativos to TIM Brasil for a consideration of U.S.\$ 15 million. At the end of January 2003, TIM Brasil sold such investment to the Globo broadcasting group. As a result of such transaction, the Telecom Italia Group realized a net gain of 4 million (see Note 25 of Telecom Italia s consolidated financial statements included elsewhere in this Annual Report).

***Disposal of Telekom Srbija.*** On December 28, 2002, the Telecom Italia Group announced that it had agreed to sell to PTT Srbija its 29% holding in Telekom Srbija. The deal was finalized on February 20, 2003 and is expected to be completed by the end of June. PTT Srbija is to pay 195 million, of which 120 million is to be paid by June 2003, and the remainder to be settled in six half-yearly installments from January 2006. The shares disposed of shall be placed in escrow with an international bank until payment of the consideration is complete.

***Sale of stake in IMMSI.*** On November 22, 2002, Telecom Italia disposed of its 45% stake in IMMSI to Omnipartecipazioni S.p.A. for consideration of 69 million.

**Sale of Telekom Austria.** In November 2002, Telecom Italia International N.V. sold 75 million Telekom Austria A.G. shares previously held by the Telecom Italia Group. The placement price was 7.45 per share generating gross proceeds of 559 million and a loss of 135 million. After this transaction, the Telecom Italia Group's stake in Telekom Austria decreased from 29.78% to 14.78%.

**Sale of Telespazio.** In November 2002, Telecom Italia finalized its agreement with Finmeccanica for the sale of Telespazio. The total impact on the Telecom Italia Group was to reduce net financial debt by 239 million and a net gain for the Telecom Italia Group of 36 million.

**Project Tiglio.** On October 29, 2002, the transaction envisaged by the framework agreement between the Pirelli, Olivetti-Telecom Italia Groups and The Morgan Stanley Real Estate Funds was finalized. The transaction provided for the integration of certain of the real estate properties of the companies involved, as well as the entities that provide real estate services to the same companies or to their subsidiaries. Under the framework agreement the Telecom Italia Group transferred assets to Tiglio I and Tiglio II in various corporate forms. The market value of these assets was 1,360 million, of which 50 million was related to Seat Pagine Gialle and approximately 1,310 million to real estate from Telecom Italia. The transaction had a net impact on the consolidated statement of operations of approximately 150 million for the Telecom Italia Group.

**Partial sale of Stream stake.** On October 1, 2002, Telecom Italia signed an agreement with the News Corporation group, partner of Telecom Italia in Stream, and Vivendi Universal, current shareholder of Tele+, in order to allow Stream to purchase Tele+ and to subsequently create a single Italian pay-TV company on one platform. On April 30, 2003, following the approval by the competent authorities, the agreement with News Corporation announced in October 2002 was concluded. The new company arising from the integration between Stream and Tele+ has been named SKY ITALIA and Telecom Italia paid approximately 30 million for its stake in the transaction. The company is held by Telecom Italia (19.9%) and News Corporation (80.1%).

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**Solpart Participações.** On August 27, 2002, the Telecom Italia Group reached agreement with the other shareholders in Solpart Participações (which has indirect control of Brasil Telecom) to reduce its own stake in Solpart (from 37.29% to 19% of ordinary share capital) through a sale of 18.29% of the ordinary share capital to Timepart Participações and to Techold Participações. This reduction was carried out to overcome regulatory constraints which had prevented TIM's local subsidiaries from commencing commercial operations of its GSM regulatory 1800 service. As soon as legally possible, the Telecom Italia Group intends to return to its previous investment position. To this extent option rights have been granted to all parties.

**Sale of 9Telecom.** On August 26, 2002, the Telecom Italia Group completed, with the Louis Dreyfus Communication Networks group (LDCom), the sale of the Telecom Italia Group's investment in 9Telecom and the concurrent purchase of approximately 7% of LDCom by the Telecom Italia Group. The net impact on the Telecom Italia Group's result was a loss of 267 million. LDCom is part of the Louis Dreyfus group, a leading French holding company with international operations in telecommunications, energy, oil, maritime and agricultural commodities trading.

**Sale of Auna.** On August 1, 2002, the Telecom Italia Group concluded the sale of Auna to Endesa, Union Fenosa and Banco Santander Central Hispano. The transfer of the entire interest held by the Telecom Italia Group (26.89%) resulted in proceeds of 1,998 million and contributed 1,033 million to the consolidated net result of the Telecom Italia Group.

**Sale of Telemaco Immobiliare.** On August 1, 2002, Telecom Italia sold its 40% interest in Telemaco Immobiliare to Mirtus, an indirect subsidiary of the American real estate fund Whitehall promoted by the Goldman Sachs group, for net proceeds of 192 million. The net gain realized by the Telecom Italia Group was 64 million.

**Sale of Sogei.** On July 31, 2002, Finsiel disposed of its 100% stake in Sogei to the Ministry of Economy and Finance, which reduced Telecom Italia Group's net financial debt by 176 million.

**Sale of stake in Mobilkom Austria.** On June 28, 2002, TIM International N.V. (TIM International), a subsidiary of TIM, disposed of its 25% stake in Mobilkom Austria group to Telekom Austria (a company 14.78% owned by Telecom Italia International as of December 31, 2002), generating proceeds of 756 million and resulting in a gain, which contributed 64 million to the consolidated net result of the Telecom Italia Group.

**Sale of stake in Bouygues Decaux Telecom.** In March 2002, the Telecom Italia Group disposed of its 19.61% stake held by TIM International in BDT (Bouygues Decaux Telecom), parent company of the French operator Bouygues Telecom, generating proceeds of 750 million which contributed 266 million to the consolidated net result of the Telecom Italia Group.

**Sale of stake in Lottomatica S.p.A.** In February 2002, Finsiel S.p.A. accepted the tender offer from Tyche S.p.A. (De Agostini group), for its 18.3% investment in Lottomatica S.p.A. Proceeds for Finsiel were 212 million resulting in a gain which contributed 73 million to the consolidated net result of the Telecom Italia Group.

**Acquisitions.**

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**Agreement for the acquisition of Megabeam.** In March 2003, Telecom Italia signed an agreement to acquire 100% of the share capital of Megabeam Italia S.p.A., the first Italian wireless Internet service provider, for consideration of 11.5 million. Megabeam's acquisition falls under Telecom Italia's broadband strategy, in which wireless technology, such as Wi-Fi, occupies a fundamental role in solutions for families and businesses. Megabeam offers Wi-Fi networking services in private sites and is experimenting the same Wi-Fi service in public places, for example, in significant Italian airports and a hotel chain using Wireless-Lan which operates on the 2,400-2,483.5 frequency. The execution of the agreement is subject to the approval of the Italian Antitrust Authority.

**Purchase of Blu S.p.A.** On October 7, 2002, TIM concluded its agreement to purchase Blu S.p.A. (the fourth mobile operator) from its shareholders. Blu S.p.A. was merged with TIM S.p.A. becoming effective on December 23, 2002. The final purchase price was 84 million.

**Acquisition of the assets of the Pagine Gialle directories.** On September 11, 2002, the Telecom Italia Group reached an agreement with Pagine Italia S.p.A. for the acquisition of the assets of the Pagine Gialle directories, the business segment represented principally by the so-called pocket pages with about 60,000 advertisers. The transaction involves the payment of 214 million Seat Pagine Gialle ordinary shares held by the

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Telecom Italia Group, corresponding to 1.9% of the Seat Pagine Gialle ordinary share capital. The execution of this transaction is subject to the approval of the Italian Antitrust Authority. After the observations formulated by the Italian Antitrust Authority during the inquiry period, on January 16, 2003, Telecom Italia and Pagine Italia S.p.A. agreed to formally withdraw the announcement about the acquisition of the Pagine Utili business segment. The parties further agreed to extend the contract period in order to be able to renegotiate certain aspects of the transaction so that it can eventually be re-submitted to the Antitrust Authority.

**Purchase of stakes in EPIClink.** On August 2, 2002, Telecom Italia purchased 86% of EPIClink S.p.A. for a price of 60.2 million. The shares were sold by Edisontel S.p.A. (30.3%), Pirelli (25.3%), IntesaBci (20%), E\_voluzione (8%) and Camozzi Holding (2.4%). EPIClink specialized in outsourcing services in Information and Communication Technology (ITC) for small and medium-size businesses. After this transaction, EPIClink's shareholder base is as follows: Telecom Italia, 86%, Pirelli, 5%, IntesaBci, 5%, Camozzi, 2% and E\_voluzione, 2%. Telecom Italia is committed to acquire the residual 14% stake for a total consideration of 10 million.

**Purchase of stakes in Stet Hellas.** In August 2002, TIM International purchased, from the Verizon Europe Holding II group, a 17.45% stake in the share capital of Stet Hellas for a price of 108 million. Together with its existing stake of 63.95%, TIM International now holds 81.40% of Stet Hellas's share capital. The transaction, which in effect makes TIM International the only industrial partner and strategic shareholder in the company, falls within the framework of the Telecom Italia Group's strategy to rationalize its international portfolio and consolidate its position in the Mediterranean Basin.

**Investment in Webegg S.p.A.** In June 2002, IT Telecom S.p.A. purchased the 50% investment in Webegg S.p.A. held by Olivetti for consideration of 57.5 million. As of December 31, 2002, Webegg S.p.A. is held by IT Telecom S.p.A. (69.8%) and Finsiel S.p.A. (30.2%). The Webegg group is an Internet Consulting company offering its own solutions as well as those deriving from partnerships with the world's leading Internet solutions companies.

**Acquisition of Consodata shares.** On February 12, 2003 Seat Pagine Gialle acquired 1,108,695 ordinary shares in the French subsidiary Consodata S.A. listed on the Paris Nouveau Marché stock exchange after the founding shareholders' exercised their option to sell, which was extended to them under an agreement made with previous Seat Pagine Gialle management on July 31, 2000. This transaction, undertaken at an agreed consideration of 44 per share for a total of approximately 48.8 million resulted in Seat Pagine Gialle acquiring a further 8.17% of the company share capital and voting rights, thereby raising its stake in Consodata S.A. to 98.60%.

**Lisit Informatica.** On February 4, 2003, Telecom Italia, in a temporary association of companies with Finsiel and Lutech (Lucchini group), won the bid held by the Lombardy Regional Authority for the supply of the goods and services needed to disseminate and manage the Regional Services Card throughout the Lombardy Region. The total value of the bid won by the association led by Telecom Italia, scheduled to last until 2009, is approximately 350 million. Within the framework of the obligations undertaken, Telecom Italia and Finsiel acquired 35.2% of the share capital of LISIT, for a total of 54 million.

**Early purchase of leased assets.** On January 27, 2003, procedures were completed for the early purchase of 12 property units (approximately 300,000 square meters) from Teleleasing S.p.A. that are used by Telecom Italia S.p.A. and other Telecom Italia Group companies under financial leasing contracts. The deal involved a total financial payment of approximately 369 million for the entire Telecom Italia Group. Certain of these assets were recently agreed to be sold. See Dispositions above.

**Other Developments**

**Nortel Inversora S.A.** As per the decision of the Shareholders meeting of April 25, 2002, the Preferred A shares of Nortel Inversora S.A. have the right to vote (one vote per share), as a consequence of the default by Nortel Inversora in repaying the amortization plan related to those shares. Moreover, following Nortel Inversora first quarter 2002 results, Telecom Argentina Total Liabilities/Net Equity ratio exceeded 1.75, giving a voting right also to Preferred B shares, that was officially established during the Shareholders meeting of September 13, 2002. As a result Telecom Italia International and Telecom Italia voting rights have been respectively diluted from 17.5% to 11.86% and from 32.5% to 22.03%, respectively.

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### Recent Developments

#### *Merger of Telecom Italia into Olivetti*

On March 11, 2003, the Boards of Directors of Telecom Italia and Olivetti met to discuss the proposed merger of Telecom Italia with Olivetti (the Merger), in which Olivetti would be the surviving company, changing its name to Telecom Italia S.p.A. upon the Merger becoming effective. At that time each of the Telecom Italia Board and Olivetti Board agreed that the proposed Merger transaction should be explored, and established a proposed exchange ratio of seven Olivetti Ordinary Shares for each Telecom Italia Ordinary Share and seven Olivetti Savings Shares for each Telecom Italia Savings Share. Telecom Italia was advised by Lazard & Co. S.r.l. and Goldman Sachs SIM S.p.A. and Olivetti by JPMorgan Chase Bank.

The Telecom Italia Board and the Olivetti Board reconvened on April 15, 2003 and in each case concluded to proceed with the Merger and fixed the exchange ratios as described above. As a result, the plan of merger was agreed upon and the shareholders' meetings of both companies were convened and such shareholders' meetings were held on May 26, 2003 and May 24, 2003, on second and first call, respectively. At such meetings each of the Olivetti Ordinary shareholders and the Telecom Italia Shareholders approved the Merger transaction. The effectiveness of the Merger is conditioned upon the savings shares of New Telecom Italia being accepted for listing on the automated screen-based trading system (Mercato Telematico Azionario) of Borsa Italiana.

In addition to the Merger, the following transactions are also contemplated:

- Olivetti shareholders who either voted against the Merger or did not attend the shareholders' meeting benefit from a withdrawal right of 0.9984 per share (which is the mean of the daily official prices of the Olivetti shares in the six months preceding the date the merger resolution was adopted on May 26, 2003). Olivetti shareholders were entitled to such a right by law due to the change in the corporate objectives of New Telecom Italia. As of June 12, 2003, the end of the withdrawal right period, Olivetti shareholders had exercised such right with respect to 10,958,057 Shares representing 0.12% of the outstanding Ordinary Shares. Olivetti shareholders will receive an aggregate payment of 10,940,525 when the Merger becomes effective.
- Voluntary cash tender offers by Olivetti for a portion of the outstanding Telecom Italia Shares and Savings Shares, to be made in connection with the Merger and before its completion (although the cash tender offer is not being made to Savings Shareholders in the United States). The tender offers for the Telecom Italia Shares and the Telecom Italia Savings Shares will commence on June 23, 2003, with Olivetti tendering for approximately 17.3% of the shares in the respective classes.

In connection with financing the withdrawal right and the cash tender offers, Olivetti has entered into a term loan facility pursuant to which it will borrow up to 9 billion (assuming that the tender offers are fully subscribed) with respect to the above transactions. Any such payments for withdrawal rights and for the cash tender offers will only be made at the time the Merger becomes effective. See Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data. The total amount of the facilities is 15.5 billion, with the remaining 6.5 billion as a senior revolving credit facility available to refinance Telecom Italia's existing 7.5 billion facility providing for working capital and general corporate purposes for Telecom Italia and, following the Merger, New Telecom Italia.

*The tender offer for the Savings Share is not being made, directly or indirectly, in or into the United States and is not capable of being accepted, directly or indirectly, in or from the United States.*



The Merger is expected to become effective in the first half of August 2003, subject to certain conditions required under Italian law. As a result of Olivetti being the surviving company (and changing its name to Telecom Italia S.p.A. ), New Telecom Italia will, on completion of the Merger, succeed to the 1934 Act registration of Telecom Italia and become subject to the foreign private issuer reporting requirements of the 1934 Act. It is the intention of New Telecom Italia to apply for a listing, and complete such listing, on the New York Stock Exchange by the time of the effectiveness of the Merger.

*Reasons for the Merger.*

- *Principal Business Rationales*

The purpose of the Merger is to merge the operations, assets and liabilities of Olivetti and Telecom Italia into a single company, a substantial majority of whose share capital and voting rights will be held by

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shareholders unaffiliated with Pirelli or Olimpia. The Telecom Italia Board believes that the Merger will produce a simplified, more transparent corporate, capital and financial and ownership structure, which will benefit the shareholders of both Telecom Italia and Olivetti. The principal benefits include the following:

- *Improved ownership structure: Majority ownership by shareholders unaffiliated with Pirelli or Olimpia.*

As a result of, and immediately after, the Merger, shareholders unaffiliated with Olivetti, Pirelli or Olimpia will see their proportionate ownership of New Telecom Italia's share capital increase substantially. Currently, Olivetti S.p.A. owns approximately 54.94% of the Telecom Italia Shares. The exact percentage of New Telecom Italia's share capital that shareholders unaffiliated with Pirelli or Olimpia will hold immediately after the Merger depends on a number of factors, such as:

- the number of Olivetti shares which may be issued upon conversion of Olivetti's outstanding convertible bonds or exercise of Olivetti's outstanding warrants (a portion of which are held by Olimpia and its affiliated entities);
- the number of Olivetti shares issued pursuant to the exercise of outstanding stock options held by officers of Olivetti (Telecom Italia has suspended the exercise of outstanding stock options until after the Merger becomes effective); and
- the number of Telecom Italia Shares and Savings Shares tendered in response to Olivetti's cash tender offer for a portion of Telecom Italia's Shares and Savings Shares.

As a result of the Merger it is expected that Olimpia will be the largest shareholder in New Telecom Italia. The exact percentage of Olimpia's interest in New Telecom Italia's share capital immediately after the Merger can not currently be determined and depends on the factors discussed above but is expected to be in a range of 9.94% to 13.27%.

The Telecom Italia Board believes that the expected new ownership structure will facilitate the market's valuation of New Telecom Italia based on New Telecom Italia's business, financial condition and prospects and eliminates any negative effect that Telecom Italia's current ownership structure may have on valuation. The Telecom Italia Board also believes that the absence of a controlling shareholder will produce a corresponding increase in the liquidity of the New Telecom Italia shares compared to the current liquidity of Telecom Italia Shares and that this has the potential to enhance market valuations of New Telecom Italia shares.

- *Improved corporate structure.*

The Merger will simplify and make more transparent the Telecom Italia Group's corporate structure. Instead of having Olivetti, an intermediate holding company with few operations of its own, between Olimpia and Olivetti's other shareholders on the one hand and Telecom Italia on the other, all of Olivetti's and Telecom Italia's respective operations will be combined in a single entity with a single Board of Directors and a single Board of Statutory Auditors. In New Telecom Italia, Olimpia, Olivetti's other shareholders and Telecom Italia's minority shareholders will have direct ownership interests. This, and the integration of Olivetti's and Telecom Italia's respective corporate support functions, is expected to simplify and improve the corporate governance, management and decision-making process of New Telecom Italia compared to the current situation.

- *Rationalized capital and financial structure.*

The Merger is intended to optimize financial and income flows within the New Telecom Italia Group through a more efficient management of the New Telecom Italia Group debt and more effective use of financial leverage. The Merger as a whole will also make it possible to attain a more efficient financial structure, with an increase in debt capital, which currently has a lower net cost than equity capital. It is also likely that these effects will lead to an improvement in the creditworthiness of New Telecom Italia, which, in turn, could lead to a more favorable rating and a reduction in the cost of future debt.

The Telecom Italia Board also believes that the Merger will produce a more unified approach to debt management (for example, with respect to extending maturities and co-ordinating with the needs of the businesses) than is currently the case for Olivetti and Telecom Italia on a stand-alone basis.

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### *SEAT Spin-off*

On April 1, 2003, the Board of Directors of SEAT approved the proposed proportional spin-off of substantially all of the Directories, Directory Assistance and Business Information business segments of SEAT into a newly incorporated company which will assume the current name of SEAT ( New SEAT ). Effective as of the date of spin-off, the corporate name of SEAT will be Telecom Italia Media S.p.A. (hereinafter referred to as Telecom Italia Media ). The spin-off plan was approved by the SEAT extraordinary shareholders meeting held on May 9, 2003.

The spin-off plan provides for a spin-off on a proportional basis. The allocation of the shares of, respectively, New SEAT and Telecom Italia Media, is based on the net assets of each company as of December 31, 2002. Consequently, for every 40 ordinary (or savings, as applicable) shares currently owned, the present shareholders of SEAT will receive:

- 11 new ordinary (or savings, as applicable) shares of Telecom Italia Media, and
- 29 new ordinary (or savings, as applicable) shares of New SEAT.

The shares of both companies will be listed on the automated screen-based trading system (Mercato Telematico Azionario) of Borsa Italiana: the effectiveness of the spin-off is conditioned upon the shares of New SEAT being accepted for listing.

The spin-off plan contemplates the creation of two independent companies, each focused on its core businesses. It is SEAT management's view that SEAT operates in two broad market sectors that have increasingly developed separate and distinct characteristics in terms of strategy, operations and competitive landscape. The first sector is that of targeted advertising and telephone services, in which SEAT operates through its Directories, Directory Assistance and Business Information segments, providing answers to queries via printed, online and telephone products and services.

The second sector is that of traditional advertising and the Internet, in which SEAT operates through its Internet, TV and other business segments, primarily providing access and content services. In SEAT management's view, both sectors present interesting development prospects (including broadband access and digital TV).

The strategic objective of the spin-off plan is to allow SEAT's businesses in each of the two sectors to more rapidly respond to market developments and exploit market opportunities, with a more focused management and a resource allocation consistent with the development prospects of each business line.

The spin-off plan provides for the transfer to New SEAT of the following companies within the Directories, Directory Assistance and Business Information business segments of SEAT:

Directories: Directories Italia Seat Pagine Gialle S.p.A. division, Annuari Italiani S.p.A., Euredit S.A., TDL group, Euro Directory S.A.

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Directories Assistance: Directories Assistance Seat Pagine Gialle division, Telegate group, Telegate Holding GmbH, IMR S.r.l.  
Business Information: Consodata S.A., Consodata group Ltd (including Netcreations Inc., Pan-Adress).

The other companies and business segments will remain in SEAT, which, as noted above, will be known as Telecom Italia Media.

For a further discussion of these businesses, please see [Internet and Media](#).

The spin-off, subject to certain conditions of Italian law, is expected to become effective at the end of July 2003.

### *Potential Sale of Telecom Italia's stake in New SEAT*

On June 10, 2003 Telecom Italia and a consortium of investors formed by BC Partners, CVC Capital Partners, Investitori Associati and Permira entered into a sale and purchase agreement for the sale of approximately 61.5% of the share capital of New SEAT which will be received by the Telecom Italia Group after the spin-off transaction creating New SEAT (including the shares resulting from the expected exercise of the J.P.Morgan Chase put option). The parties agreed on a sale price of 0.598 per New SEAT ordinary share, representing an enterprise value of approximately 5.65 billion.

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The completion of the sale will be subject to the proportional spin-off becoming effective, the admission to listing of New SEAT, that is expected to occur by the beginning of August, and the approval of the relevant anti-trust authorities. Telecom Italia will receive approximately 3.03 billion for its stake. The buyers will also assume the estimated 708 million of debt of New SEAT at the closing.

The transaction will allow New Telecom Italia to reduce its net financial debt by approximately 3.74 billion.

See also Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data .

### ***Telecom Italia Hewlett-Packard deal.***

On February 21, 2003, Telecom Italia and Hewlett-Packard agreed to a five-year management services and outsourcing agreement worth a total of 225 million. The agreement became effective on April 16, 2003 following receipt of clearance from the Italian Antitrust Authority and completion of labour union consultation procedures. Under the agreement, Hewlett-Packard will supply asset management, help desk, maintenance and workstation management services to the Telecom Italia Group, while IT Telecom will manage the Hewlett-Packard's Italian operational activities in the SAP environment and house the systems in its Data Centers. The agreement also contemplated the sale by IT Telecom of the Desktop Management Services business (100%-owned by Telecom Italia) to the new Hewlett-Packard's entity HP DCS (Hewlett-Packard Distributed Computing Services).

### ***Restructuring of the Telecom Argentina group's debt obligations.***

On February 12, 2003, Telecom Argentina STET-France Telecom S.A. (controlled by Nortel Inversora) (Telecom Argentina) and its subsidiaries, Telecom Personal S.A. and Publicom S.A. announced their intention to launch a cash tender offer for a portion of their financial debt obligations and to make partial interest payments on their financial debt obligations. Having obtained any necessary authorizations, the offer started on April 16, 2003 and represents the beginning of the process to restructure the Telecom Argentina group's debt obligations.

In June 2003, Telecom Argentina and its subsidiaries Telecom Personal S.A. and Publicom S.A., pursuant to a tender offer, repurchased U.S.\$ 292 million principal amount of their financial debt obligations at a price of U.S.\$ 160.6 million (55% of the face value).

### ***Telecom Italia share buyback.***

Under the buyback plan authorized by the Ordinary Telecom Italia Shareholders' Meeting of November 7, 2001, the Company in March 2002 began to buy-back treasury shares on the market according to the terms and in the manner established by existing laws and the above shareholders' resolution. During the period between January 1 and May 7, 2003, 8,662,500 savings shares were acquired at an average price of 4.73 per share, corresponding to an investment of 41 million, plus 915,000 ordinary shares at an average price of 6.83 per share, corresponding to a 6 million investment. The above authorization expired on May 7, 2003 and at such date, 54,309,500 savings shares had been acquired at an average price of 5.24 per share, corresponding to an investment of 285 million, plus 6,195,500 ordinary shares at an average price of 8.00 per share, corresponding to a 50 million investment. As a result of the merger of Telecom Italia with and into Olivetti, the Telecom Italia Ordinary

and Savings Shares treasury stock will be cancelled.

***Telecom Italia Group Results for the First Quarter Ended March 31, 2003.***

For a discussion of first quarter results for 2003 see Item 5. Operating and Financial Review and Prospects Recent Developments Telecom Italia Group Results for the First Quarter Ended March 31, 2003 compared to March 31, 2002 .

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**Overview of the Telecom Italia Group s Major Business Areas**

The following is a chart of Telecom Italia Group s business units as of March 31, 2003:

- 
- (1) Mobile South America.
  - (2) Previously included in the International Operations Business Unit.



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The table below sets forth certain key data for each Business Unit.

		Domestic Wireline		South America	Internet and Media	IT Market	IT Group	Sub Total	Other activities and eliminations	Consolidated Total
		(1)	Mobile	(1)(2)		(3)	(3)		(4)	
(millions of Euro, except number of employees)										
Gross operating revenues	2002								(3,016)	
	2001								(2,487)	
	2001	17,022	10,867	1,409	1,991	912	1,215	33,416		30,400
		17,168	10,250	1,534	1,957	1,198	1,198	33,305	(2,710)	30,818
	2000 (pro forma)(5)	17,419	9,418	312	263	1,135	1,332	29,879		27,169
	2000	17,419	9,418	2,100	263	1,135	1,332	31,667	(2,756)	28,911
Gross operating profit(6)	2002				593				(327)	
	2001				444				(216)	
	2000 (pro forma)(5)	7,965	5,039	450		104	140	14,291		13,964
		7,750	4,760	527	(35)	166	188	13,835	(109)	13,619
		7,403	4,447	172		136	203	12,326		12,217
	2000	7,403	4,447	1,073	(35)	136	203	13,227	(109)	13,118
Operating income	2002						(21)		(1,095)	
	2001				232					
					31		22		(1,186)	
	2000 (pro forma)(5)	4,700	3,358	146		61		8,476		7,381
		4,361	3,136	187	(73)	123	(15)	7,860	(567)	6,674
		3,904	2,988	99		105		7,008		6,441
	2000	3,904	2,988	473	(73)	105	(15)	7,382	(577)	6,805
Capital expenditures	2002					30				
	2001				81	30				
					175					
	2000 (pro forma)(5)	2,462	1,715	216			158	4,662	180	4,842
		2,801	3,151	406	34	37	162	6,725	265	6,990
		2,710	4,206	68			159	7,214	161	7,375
	2000	2,710	4,206	592	34	37	159	7,738	161	7,899
Number of employees at the year end	2002									
	2001									
	2000 (pro forma)(5)	53,682	18,702	5,461	7,715	4,493	7,327	97,380	4,333	101,713
		57,895	16,721	5,746	9,264	6,441	6,844	102,911	7,045	109,956
		62,366	15,257	1,087	7,515	7,400	6,385	100,010	7,161	107,171
	2000	62,366	15,257	8,585	7,515	7,400	6,385	107,508	7,161	114,669

(1) The data relating to 2001 and 2000 have been reclassified and presented consistent with the 2002 presentation.

(2) The data refer to Entel Chile Group, Entel Bolivia group, the company Telecom Italia America Latina and the business segment South America of Telecom Italia.

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- (3) In early 2002, the IT Services Business Unit was split into two distinct units: Information Technology Market and Information Technology Group. Beginning January 1, 2002, Saritel S.p.A. was consolidated in the Information Technology Group Operating Activity instead of the Domestic Wireline Business Unit.
- (4) The data presented include the operations of the Foreign Holdings Corporate Function and the Business Unit Satellite Services (the Telespazio group) which was disposed of during the 4th quarter of 2002 and consolidated in the statement of operations only for the first nine months of 2002.
- (5) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.
- (6) See Item 3. Key Information Selected Financial and Statistical Information Note 9 .

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The following table sets forth, for the periods indicated, certain selected statistical data for the Italian fixed-line, mobile and internet businesses.

	Year ended December 31,		
	2000	2001	2002
<b>Subscription and Customers:</b>			
Subscriber fixed-lines at period-end (thousands)(1)	27,153	27,353	27,142
Subscriber fixed-line growth(%)	2.5	0.7	(0.8)
Subscriber fixed-lines per full-time equivalent employee at period-end(2)	409	448	496
ISDN equivalent lines at period-end (thousands)(3)	4,584	5,403	5,756
TIM lines at period-end (thousands)	21,601	23,946	25,302
TIM lines growth per annum(%)	16.6	10.9	5.7
Average revenue per mobile line per month( ) (4)	30.5	29.1	28.8
Cellular penetration at period-end (TIM lines per 100 inhabitants)(%)	37.5	41.6	43.9
Cellular market penetration at period-end (lines for the entire market per 100 inhabitants)(%)	73.3	89.0	95.0
<b>Retail Traffic(5):</b>			
Average minutes of use per fixed-line subscriber during period(6)	4,722	4,739	4,292
Of which:			
Local traffic during period (in average minutes)(7)	3,621	3,575	3,198
Long-distance traffic during period (domestic and international) (in average minutes)	1,101	1,163	1,094
Growth in international incoming and outgoing traffic in minutes(%) (8)	5.4	12.1	5.7
Total mobile outgoing traffic per month (millions of minutes)	1,569	1,795	1,960
<b>Internet and Media:</b>			
Directories (units)	474	477	477
Of which SEAT Pagine Gialle	304	304	304
Of which Thomson (TDL Infomedia Ltd.)	170	173	173
Page Views Virgilio (millions)	2,218	3,945	5,267
Active Users (at year-end, thousands)	1,656	1,804	2,226

- (1) Data include multiple lines for ISDN and exclude internal lines.
- (2) Ratio is based on employees of Telecom Italia only.
- (3) Data exclude internal lines.
- (4) Including Prepaid Customers revenues and excluding equipment sales and including non TIM customer traffic.
- (5) Retail traffic consists of traffic from Telecom Italia customers for local calls, long distance national and international calls (including calls to mobile phones).
- (6) Includes total fixed outgoing traffic (including international outgoing traffic and fixed outgoing traffic to the mobile networks).
- (7) Including district and internet dial-up traffic.
- (8) Data include incoming and outgoing wholesale traffic and retail outgoing traffic.

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**Strategy**

***General***

Telecom Italia Group's strategic priorities include:

- consolidating its leadership in the domestic wireline market by increasing customer loyalty through innovative offers and stimulating the market for value added and broadband services, with special reference to ADSL technology; in the mobile market, to increase traffic volumes and develop value added services in line with user expectations (MMS, community videotelephony), in part through the introduction of UMTS technology; and, in the Internet and Media sector, to continue the development of broadband services and portals;
- expanding the Telecom Italia Group's presence abroad in markets where it can capitalize on its marketing and technological know-how: in the mobile business, in Latin America and especially in Brazil and, in the wireline business, through the development of the pan-European broadband network;
- continuing to manage the Telecom Italia Group according to rigorous criteria of efficiency, relying on synergies deriving from the organizational model based on so-called "professional families" and service centers, cost control systems, and the careful selection of investment projects, aimed primarily at fostering innovation and growth.

Industrial investments will be directed towards reinforcing the following strategy:

- focus on innovation;
- continuing leadership in the domestic market; and
- development of value added services.

The industrial investments planned for the three years 2003-2005 will be between 14 billion and 16 billion, more or less in line with the forecast for the three years 2002-2004. The breakdown by sector of activity is shown in the table below.

	<b>Approximate % of Industrial Investments</b>
Domestic Wireline	45%
Mobile	40%

Internet and Media	2%
Other	13%

### *Domestic Wireline*

The Telecom Italia Group's wireline strategy will be driven by defense of market share in voice traffic, strong emphasis on data/internet growth and broadband development, and focus on obtaining continuing efficiencies and levels of capital expenditures.

In particular, the Telecom Italia Group intends to:

- maintain its domestic leadership in its core business (voice services, internet access, data transmission services for businesses, national and international wholesale services);
- consolidate its operational capabilities with the objective of offering best in class service levels to its customers and leverage opportunities to retain its client base by enhancing customer loyalty (through billing, CRM and customer contact);
- concentrate on developing value added services, both for corporate and residential customers, to sustain revenue and margin levels, building, in particular, on the increasing penetration of internet and broadband services, but also on innovation in voice services and terminals, equipped with new facilities, similar to mobile phone functions;
- run efficient operations and continue its cost-cutting program (personnel, real estate, general and administrative, network); and
- maintain competitive services and focus investment on enhancing network evolution and innovation (optical transport, IP services, etc.).

*There can be no assurance that these objectives and targets will actually be achieved.*

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### ***Mobile***

TIM's strategy is focused on maintaining its leadership in the wireless market, in particular:

- defending its share of the voice and SMS market;
- developing a new GPRS and UMTS Mobile Data generation;
- developing GSM services in Brazil and acquire leadership in the GSM Latin American market; and
- completing the start-up phase of some subsidiaries.

The main strategic tools for the achievement of such objectives are:

- focus on the customer, to be achieved through caring, segmentation of the offer, focus on high spending clients and leadership on customer acquisition;
- premium positioning, guaranteed by the development of a consistent on-net community, by providing a high quality of service, by the maintenance of a price premium and by avoiding handsets subsidies;
- technological innovation and leadership, characteristics associated with the TIM brand, to be maintained through: GPRS/UMTS development, launching innovative value added services, maintenance of high standards of quality for the Network and IT services and the progressive migration from a TDMA network to a GSM network for some controlled companies;
- excellence in human resources, through recruitment, development and retention of key human resources, analysis and selection of methods for increasing flexibility of resources and the management of internal innovation process; and
- profitability and cash flow generation, through maintenance of high efficiency levels on its network, IT and back-office, investments and working capital control and a prudent capital allocation policy.

*There can be no assurance that these objectives and targets will actually be achieved.*

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### **The Organizational Structure**

The following diagram highlights the organizational structure of the Telecom Italia Group as of June 16, 2003.

- 
- (1) Consortium company which carries out Internal Auditing activities in the Telecom Italia Group and Olivetti.
  - (2) Beginning April 1, 2003, the company Telecom Italia Lab, which was the Research & Development function, was merged by incorporation into Telecom Italia S.p.A. At the same time, this function took the name of Telecom Italia Lab.
  - (3) Latin America Operations coordinates the activities of the Telecom Italia Group in Latin America. Beginning February 2003, Latin America Operations report directly to the CEO Carlo Buora for wireline TLC and to the head of the Mobile Business Unit Mobile for Mobile TLC.
  - (4) As of June 16, 2003, Domestic Wireline took the name Wireline. At the same time, Giuseppe Sala was appointed General Manager directly reporting to the Telecom Italia CEO and Head of Wireline Riccardo Ruggiero. Beginning July 1, 2003, Luca Luciani is appointed Assistant of the Chairman.
  - (5) As of June 18, 2003 the new central function, International Affairs, was established which reports directly to the CEO Carlo Buora. On the same date the central Function Foreign Holdings merged into International Affairs and the International Steering Committee was disbanded. Head of International Affairs is Giampaolo Zambelletti.

Telecom Italia Group's organizational structure includes:

- Central Functions, which are responsible for the Telecom Italia Group's operations;
- Operational Activities, which are responsible for the synergies of Intra-Group activities and for the supply of common services; and
- Business Units, which are responsible for business development and managing operations for the external markets.

**Table of Contents****BUSINESS UNITS****Domestic Wireline**

The Domestic Wireline Business Unit accounted for gross operating revenues of 17,022 million in 2002, 17,168 million in 2001 and 17,419 million in 2000. The organizational structure of the Domestic Wireline Business Unit as of December 31, 2002 was as follows:

(1) On December 31, 2002 International Wholesale Services was moved to Telecom Italia Sparkle.

As a result of the 2002 Reorganization, Saritel (a company specializing in Internet operations and value added services for fixed and mobile telecommunications such as Internet hosting, e-business solutions, on-line services and vocal recognition software) was moved to the Information Technology Group Operating Activity and Intelcom San Marino S.p.A. is now included as part of the Domestic Wireline Business Unit.

Domestic Wireline operates on a national level as the consolidated market leader in wireline telephone and data service and call centers, for consumers and other operators. On an international level, Domestic Wireline develops fiber optic networks for wholesale customers, mainly in Europe and Latin America.

**Subscribers.** The table below sets forth, for the periods indicated, certain subscriber data of Domestic Wireline.

	As of December 31,				
	1998	1999	2000	2001	2002
Subscriber fixed-lines at period-end (thousands)(1)	25,986	26,502	27,153	27,353	27,142
Subscriber fixed-line growth %(2)	1.1	2.0	2.5	0.7	(0.8)
Subscriber fixed-lines per full time equivalent employee at period-end(3)	332	354	409	448	496
ISDN equivalent lines at period-end (thousands)(4)	1,735	3,049	4,584	5,403	5,756

(1) Data include multiple lines for ISDN and exclude internal lines.

(2) For each of the years ended December 31, the percentage growth figure represents growth per annum over the prior year's end.

(3) Ratios are based on employees of Telecom Italia.

(4) Excluding internal lines.

At December 31, 2002, Domestic Wireline had approximately 27.1 million fixed subscriber lines, including approximately 18.9 million residential lines (including multiple lines for ISDN), approximately 8.0 million business lines (including multiple lines for ISDN), and approximately 230,000 public telephones lines (including ISDN equivalent lines). Italy has 48 subscriber lines per 100 inhabitants.



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At December 31, 2002, Domestic Wireline had approximately 5.8 million ISDN equivalent lines. The number of subscribers is expected to continue increasing although marketing focus is on ADSL lines which

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provide greater speed on the Internet. This is evidenced by significant growth in broadband access: at December 31, 2002, Domestic Wireline had contracts for approximately 850,000 broadband points of access (390,000 at the end of 2001) with approximately 220,000 wholesale points of access (143,000 at the end of 2001) and 630,000 retail market points of access (247,000 at the end of 2001). The growth is attributable to the success of various tariff structures geared to the Mass Market, and to business customers. At the end of 2002 Domestic Wireline had contracts for 390,000 Mass Market and Soho broadband access and 240,000 business broadband access.

At December 31, 2002, 62% of the public telephones in service were equipped with phone card readers. The density of public telephones in Italy is among the highest in the world, with one public telephone per square kilometer and approximately 4.2 public telephones for every 1000 inhabitants. During 2002, ISDN technology was introduced to approximately 45% of public telephones in order to support the launch of innovative services (104,635 basic ISDN equivalent lines in public telephony architecture; unlike residential and business ISDN lines, each ISDN public telephone line is linked to only one phone).

**Domestic Traffic**

The table below sets forth, for the periods indicated, certain traffic data for Domestic Wireline.

	Year ended December 31,				
	1998	1999	2000	2001	2002
Average minutes of use per fixed line subscriber during period(1)	4,259	4,298	4,722	4,739	4,292
of which:					
Local traffic during period (in average minutes)(2)	2,628	2,767	3,621	3,575	3,198
Long distance traffic during period (domestic and international) (in average minutes)	1,631	1,531	1,101	1,163	1,094

- (1) Includes total fixed outgoing traffic (including international outgoing traffic and fixed outgoing traffic to mobile networks); excludes traffic for special services.
- (2) Data for the years 1998 and 1999 include internet dial-up traffic and exclude district traffic which is accounted for in long distance traffic; data for the years 2000, 2001 and 2002 include district and internet dial-up traffic.

**Domestic Fees and Tariffs.** Since November 1, 1999, the Telecom Italia Group's traffic tariffs have been based on a per second billing system with an initial fixed charge (the call set up). The tariff per call set up varies depending on the kind of call: 0.0619 for local calls, 0.0787 for long distance calls (including calls to mobile) and 0.3098 for international calls. The tariff per second varies according to the kind of call, the time of day, the day of the week and, for long distance calls only, the distance. Since December 1997, the Telecom Italia Group has introduced tariff packages for residential and business customers which provide for discounts on national and international traffic tariffs and additional rental charges.

Traffic packages mainly consist of Teleconomy offers for Mass Market and Small office/home office (Soho) customers. Further customized offers are provided to business customers.

Teleconomy was launched as a brand in June 2000. The Teleconomy offers include tariff packages with targeted discounts and customized programs for residential and business customers. Teleconomy offers were revised in 2002 to further support retention efforts and to win back

customers.

Penetration of Teleonomy offers and ADSL lines are key strategic priorities for Domestic Wireline.

New Teleonomy offers, which Domestic Wireline introduced in 2002, include:

- for Mass Market customers: Teleonomy Forfait (no payment for national calls, excluded calls to mobile, for an additional fee) and Teleonomy Zero (fixed price for any national calls, excluded calls to mobile, for an additional fee); and
- for Business customers: new offers as Teleonomy Professional (which provides a volume of no payment traffic minutes for an additional fee) and Teleonomy Zero Business (similar to Teleonomy Zero).

For Business customers Domestic Wireline has introduced specific offers for companies with high volumes of traffic, allowing companies to choose among a variety of price plans. In addition, Domestic Wireline has launched in two steps *Ricomincio date*, a standard offer for residential (February 2002) and business customers (second half 2002) which provide an amount of free national traffic minutes with no additional fees.

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**Domestic Tariff Rebalancing.** The Telecom Italia Group commenced rebalancing its tariffs in 1991 and made various adjustments until 1997. Since December 1998, the National Regulatory Authority has been responsible for tariff regulation. On July 28, 1999, the National Regulatory Authority introduced a price cap mechanism designed to promote productivity and efficiency for the Telecom Italia Group, as the incumbent operator in markets with a low level of competition. The price cap was applied until December 31, 2002 to a whole basket of public voice telephone services composed of activation fees, basic charges, long distance and international tariffs.

The table below sets forth, for the periods indicated, initial connection fees, bimonthly subscription fees and the average cost of a three-minute local call and a three-minute peak rate call for the four different domestic long distance regions (exclusive of value-added tax) and the percentage change since 1998.

	Year ended December 31,					Percentage
						change since
	1998(1)	1999(1)	2000(1)	2001(1)	2002	1998(2)
			( )			(%)
Connection fee	103.29	103.29	103.29	103.29	100.00	-3.2
Bimonthly subscription fee:(3)						
Residential subscribers	16.84	18.59	19.32	21.38	24.28	44.2
Business subscribers	26.24	27.27	27.27	29.23	30.40	15.9
Basic ISDN connection fee	103.29	103.29	103.29	103.29	100.00	-3.2
Basic ISDN bimonthly subscription fee:						
Residential subscribers	33.05	33.05	33.05	33.05	33.05	0.0
Business subscribers	51.65	51.65	51.65	51.65	54.74	6.0
Three minute local call:						
Standard	0.0930	0.0992	0.0992	0.0992	0.0992	6.7
Higher(4)	0.0930	0.0992	0.0992	0.0992	0.0992	6.7
Three minute call in the same District at higher rate(5)(6)		0.1312	0.1312	0.0992	0.0992	
Three minute domestic long distance call at higher rate(7)(8):						
Region 1	0.2231	0.2231	0.2231	0.2205	0.2205	-1.2
Region 2	0.3610	0.3610	0.3610	0.3522	0.3522	-2.4
Region 3	0.5903	0.4772	0.4065	0.3522	0.3522	-40.3
Region 4	0.5903	0.4772	0.4065	0.3522	0.3522	-40.3

- (1) The fees and costs for 1998, 1999, 2000 and 2001 were in Lire. The lire amounts have been converted to euros at the irrevocably fixed exchange rate of Lit. 1,936.27 = 1.
- (2) Data are not adjusted for inflation.
- (3) In February 2001, the residential and business subscription fees increased to 20.45 and 27.89, respectively.
- (4) For the year 1999, the introduction of per second billing resulted in an increase in the cost of a three minute call, while leaving unchanged the overall spending of the customers.
- (5) Long distance calls within the same area code. This tariff was introduced in November 1999.
- (6) In February 2001, district rates for three minute calls decreased by 24.4%.
- (7) In February 2001, the week-end flat tariff ( 0.1431 for three minutes call) was introduced.
- (8) Since July 2001, Region 3 charge (applied to calls over 30 Km) was combined with the former Region 2 charge (applied to calls between 15 and 30 km), with the result that current Region 2 tariffs apply to all long distance calls over 15 km.

**International Traffic**

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The table below sets forth, for the periods indicated, information with respect to incoming and outgoing traffic, including direct dial and operator assisted calls and mobile traffic.

	Year ended December 31,				
	1998	1999	2000	2001	2002
Total outgoing traffic (millions of minutes)	2,339	2,390	2,706	3,015	3,405
Growth in outgoing traffic (%) <sup>(1)</sup>	5.89	2.18	13.2	11.4	13.0
Total incoming traffic (millions of minutes)	2,950	3,419	3,415	3,845	3,842
Growth in incoming traffic (%) <sup>(1)</sup>	12.64	15.90	-0.1	12.6	-0.1

(1) For each of the years ended December 31, the percentage growth figures represent growth per annum over the prior year's end.

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Growth in the volume of international traffic from 1998 to 2002 has resulted mainly from macroeconomic factors such as growth in foreign demand and import/export activities, immigrants and new subscribers. The decline in gross operating revenues from 2001 to 2002 has resulted mainly from the impact of continuing tariff reductions and increasing competition. International traffic is mostly concentrated in communications with Germany, France, Romania, United Kingdom, Switzerland, United States, Spain and Albania, which together accounted for approximately 52% of toll minutes of outgoing international traffic in 2002.

Incoming international traffic is divided into two general categories: traffic incoming on the fixed network and traffic incoming, or deemed to be incoming, on the mobile network. With respect to the mobile network, the distinction between incoming or deemed to be incoming is that incoming traffic is the one generated abroad and directed to the mobile network in Italy, while traffic which is deemed to be incoming is traffic generated in Italy through the use of international calling cards. Because of the use of international calling cards, by the use of ITFN, such traffic is deemed to be incoming from an international network although the call may be generated in Italy.

In 2002, the traffic directed to the fixed network increased by 11%, growth that was offset by a decrease in the traffic directed to the mobile network. The traffic directed to the mobile network decreased because the component of the traffic deemed to be incoming registered a 61% decline due to the introduction of a surcharge for calls directed to the mobile network with a consequent increase in the price of the international calling cards.

**International Tariffs.** International calls utilize the same per second billing as domestic calls, with the price per minute depending upon the country called and, beginning July 2002, for certain countries also on the type of connection (the price will vary depending on whether the destination number called is fixed or mobile). See Domestic Traffic Domestic Fees and Tariffs .

The table below sets forth, for the periods indicated, the average cost of a three-minute international call to a fixed line at standard rates (exclusive of value-added tax) for selected countries for outgoing traffic with destination to fixed line and the percentage change since 1998.

	As of December 31,					Percentage
	1998(1)	1999(1)(2)	2000(1)	2001(1)	2002(3)	change since
						1998(4)
			( )			(%)
Germany, France	1.43	1.03	0.88	0.88	0.71	-50.3
United Kingdom	1.15	1.03	0.88	0.88	0.71	-38.3
Spain	1.43	1.03	0.88	0.88	0.71	-50.3
Russia	2.09	2.09	1.65	1.65	1.50	-28.2
Canada and United States	1.42	1.03	0.88	0.88	0.71	-50.0
Australia	3.29	2.64	2.43	2.43	2.38	-27.7
Japan	3.29	2.64	2.43	2.43	2.38	-27.7
Brazil	4.29	3.29	3.05	3.05	2.74	-36.1
Chile	5.45	5.45	4.91	4.91	2.74	-49.7

(1) All amounts for 1998, 1999, 2000 and 2001 were converted to Euro at the fixed exchange rate of Lit. 1,936.27 = 1.

(2) Rates became effective on November 1, 1999.

(3) Since July 2002, price per minute of traffic into some countries is differentiated on the basis of the termination of the call (fixed network or mobile network).

(4) Data are not adjusted for inflation.

**International Tariff Rebalancing.** During the last three years there has been a meaningful reduction in the total cost for international traffic with overall international traffic tariffs falling by an average of 23%. In particular, the reduction in the international traffic tariffs to Western Europe, the USA and Canada was an average of 25% (approximately 70% of the international traffic is represented by the volume with these countries).

**International Settlement Arrangements.** The Telecom Italia Group derives revenues from foreign telecommunications operators for incoming calls which use the Telecom Italia Group's network. The Telecom Italia Group has bilateral settlement arrangements with other international telecommunications operators under the general auspices of the ITU. Because incoming and outgoing international traffic are relatively equal, the

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Telecom Italia Group's net payments on international accounting rates are negligible. This has the effect of limiting the Telecom Italia Group's exposure to changes in currency exchange rates. The exposure to changes in currency exchange rates has also been reduced due to the adoption of the euro.

### ***Leased Lines***

At the end of 2002 gross operating revenues from leased lines, from retail and wholesale customers, including international leased lines, was 1,400 million (approximately equal to the level of gross operating revenues in 2001). With revenues from international services of approximately 75 million relatively stable, there has otherwise been a significant change in the revenue mix, with revenues from business customers falling, and revenues from other local operators growing significantly.

Leased lines services consist of offering to a customer-subscriber a permanent connection for telecommunication services between two geographically separate points. This kind of connection can be used to handle high volume voice, data or video transmission. During 2002 leased lines continued growing in connections between the Telecom Italia Group's network and other telecommunication operators network, resulting in an increase in revenues from approximately 800 million in 2001 to approximately 870 million in 2002.

Revenues from business customers continued to decline in 2002 as business customers migrated towards broadband connections. As of December 31, 2002, there were approximately 320,000 (in points of entry of data network) lines leased to business customers (approximately 342,000 in 2001) and approximately 132,000 digital leased lines (152,000 in 2001).

During 2002 migration from low speed lines to high speed lines continued as customers favor the convenience of this kind of connection. Retail revenues for leased lines decreased from approximately 500 million in 2001 to approximately 440 million in 2002.

### ***Interconnection with Other Operators***

On February 6, 2003, the National Regulatory Authority approved, subject to certain technical and economic amendments, the 2002 Reference Offer (RO) originally submitted by the Telecom Italia Group in April 2002. The Telecom Italia Group's Reference Offer includes the conditions for FRIACO (Flat-Rate Internet Access Call Origination) service, partial circuits provisions, shared access and sub-loop unbundling, thus enabling a competitive development of internet access and broadband services.

The offer presents, in comparison with the 2001 RO, a simplification of the interconnection planning process, includes a significant improvement of SLAs (Service Level Agreement) as well as further overall price reductions. Moreover, new elements are included such as double local exchange, transit at the level of local exchange, partial circuit offer, including new data speed and distances (more than 5 km).

Economic conditions have been defined according to the principle of non discrimination, transparency, objectivity and cost orientation. The RO will be retroactively applied to January 1, 2002. Pursuant to the recent decision of the National Regulatory Authority issued in March 2003 to adopt a network cap system, starting with the 2003 RO the market will have greater visibility over the arrangements relating to interconnection



services, allowing operators to rely on stable economic values in preparing their own business plans.

The Telecom Italia Group offers a comprehensive range of network access services which allow other telecommunications companies access to its fixed-telephony network, including:

- FRIACO: the Telecom Italia Group has been offering this service since 2001 but the 2002 RO provides for a 13% price reduction for local exchange, a 6.2% decrease at the metropolitan level and a 6.5% reduction for interconnection at the transit level.
- Partial circuits: represent partial circuits from customer premises to the Other Licensed Operators' Point Of Presence ( POP ), as a segment of an end-to-end leased line. The National Regulatory Authority determined that economic conditions are to be set according to the price ceiling methodology that was established by the European Commission Recommendation C(1999) 3863 of November 24, 1999, and introduced the price ceiling into national legislation with Order 10/00/CIR. For speeds and distances of partial circuit different from those included in the Recommendation, the prices are based, according to national as well as European accounting requirements, on Telecom Italia's own costs, evaluated according to the fully allocated current costs model.

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- Billing and bad debt service: the Telecom Italia Group also offers billing to Other Licensed Operators ( OLOs ) who decide not to bill the customers (*i.e.* customers that are connected to the network through indirect access service) accessing their non geographic services. The Telecom Italia Group, as required by the National Regulatory Agency, fixed the level of charge for the billing service at 2.9% calculated on the total revenues of each OLOs non geographic service. With respect to bad debt, the level of risk and insolvency is subject to negotiation between Telecom Italia and the other Licensed Operators.

The 2002 RO includes a detailed and complete Local Loop Unbundling ( LLU ) offer (physical LLU, sub loop unbundling and shared access) and the Telecom Italia Group has satisfied all National Regulatory Authority requests. To date, the Telecom Italia Group has equipped more than 90% of the sites requested by OLOs.

Economic conditions for LLU are lower than the one proposed in the 2001 RO (monthly rental of copper pair for POTS/ISDN decreased by 5.9%, for ADSL decreased by 11.5%, shared access decreased by 61.8% and sub loop unbundling decreased by 9.3%). With regard to implementation, on December 31, 2002 Italy had 131,000 fully unbundled lines compared with approximately 3,000 at the end of 2001.

Finally, law 59/02 of April 8, 2002 requires that Internet Service Providers have access to the RO of the notified operators with reference to internet traffic origination (both for metered and unmetered interconnection) and termination on 70x codes (dedicated in Italy to Internet access) and Partial Circuits. On June 26, 2002 the National Regulatory Authority issued an Order to define the criteria for ISPs to gain access to the RO economic conditions that the Telecom Italia Group has implemented on the 2003 RO issued on April 11, 2003.

## ***Data Services***

Data services consist primarily of data transmission and network services for business customers and residential customers. Revenues from data services are included primarily in fixed subscription and connection fees.

Domestic Wireline provides a broad range of data transmission and web application services supported by a wide spectrum of technological platforms ranging from traditional to advanced platforms based on broadband access (SDH and xDSL).

Domestic Wireline's strategy consists of large penetration of the Mass Market and SOHO segments with ADSL connections, supported by Alice and Smart . Domestic Wireline focuses on switching from traditional to innovative technologies to enlarge IP services and the applications market. This strategy has had a significant success with 850,000 broadband points of access sold to the retail and the wholesale market (390,000 at the end of 2001); of which 630,000 access have been sold to retail customers.

During 2002 Domestic Wireline introduced several innovative offers for the data transmission networks and Internet access, including:

- new solutions with fiber optic technologies for SMEs, mainly for IP services;
- revised solutions for security and for full outsourcing services for SMEs;

- new web services offers for secured storage for Internet Data Center; and
- customized solutions for e-learning applications.

Revenues from Data Services amounted to 916 million in 2002 and increased by 14.2% over 2001 ( 802 million in 2001). Revenues from Data equipment were substantially in line with 2001 figures (approximately 220 million in 2002). Growth in services revenues has been driven mainly by innovative data services increasing by more than 50% ( 387 million in 2002; 253 million in 2001); web services continued to increase strongly (30%) and amounted to 130 million in 2002.

Revenues from traditional Data Services decreased from 450 million in 2001 to 400 million in 2002 due to customer migration to broadband services.

#### *Fixed Network*

Since 1988, the Telecom Italia Group has installed high levels of fiberoptics, intelligent nodes, digital switching, satellite connections and high speed data transmission technology. The technologically advanced

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nature of its fixed network permits the Telecom Italia Group to offer a variety of advanced services such as toll free numbers, call waiting and call forwarding, VPNs, premium charges and charge splitting.

### *Domestic Network*

**Fixed Network.** The Telecom Italia Group's domestic fixed network includes 66 transit switches and 628 main local switches. The long distance fixed network includes 3.7 million circuits, while the distribution fixed network includes 104 million kilometers of pairs over copper cable.

In 2002, the Telecom Italia Group set up interconnections with the networks of 5 additional operators, making a total of 65 operators at December 31, 2002. In the same period 19 operators have disconnected.

During the year 2002, the following contracts were also signed or renewed:

- 7 new interconnection agreements (adding to the 77 interconnection agreements previously agreed);
- 8 additional reverse agreements, terminating calls on the network of another operator, for a total of 64, since 1998;
- 6 agreements to supply high-speed access services using ADSL technology for a total of 29 since 2000;
- 11 carrier preselection contracts, 1 district carrier selection agreements, 7 number portability agreements;
- 7 contracts for the local loop unbundling service on the local network; and
- 18 contracts to supply Digital Data Circuits for a total of 83 from 1998.

**Digitalization and ISDN.** At December 31, 2002, 100% of the Telecom Italia Group's domestic telecommunications lines were connected to digital telecommunications exchanges. The digitalization of the long distance fixed network was completed in 1994 and the level of digitalization of the local fixed network has been 100% since 2000. Since the end of 1999, ISDN services have been accessible to substantially all of Italy. The Telecom Italia Group has one of the largest ISDN networks in Europe. ISDN allows subscribers to use their existing access lines for a number of purposes, including high speed data transmission, video-conferencing, high speed fax and faster Internet access. The Telecom Italia Group expects to continue to make investments in its fixed network to permit the expansion of ISDN and IN services.

**SDH and ATM.** The Telecom Italia Group introduced SDH advanced transmission technology into operation in the long distance fixed network in 1996 and introduced such technology into operation for its local fixed network during 1997. These transmission systems are operating on fiberoptics from 155 Mbit/s up to 2.5 Gbit/s. Moreover, in 2002 we started using transmission systems with speed up to 10 Gbit/s. Work on the development of the Arianna network which, by use of the latest generation of SDH technologies and the new optical DWDM technology (Dense Wavelength Division Multiplexing) constitutes the basis for a new transport network with a high transmission capacity

capable of covering the entire Italian territory, continued during 2002. The network will be used to transport flows with a high requirement for quality and availability, both in terms of incremental requirements and migration away from the current transit network. Arianna is based on a structure with SDH rings; since 2000, in order to reduce the number of fibers, DWDM systems have been used to multiply by a factor of 12 up to 40 the available optical fiber band and the current transmission capacity, thus increasing the transport capacity of the connections. The network will be operated by the same system that is currently used for regional networks. The DWDM systems provide the natural link between current transport networks and the future optical OTN (Optical Transport Networks), multiplexing and exchange entirely within the optical domain, without any need for optical-electric conversion. In November 2002 Domestic Wireline introduced a new generation Optical Digital Cross Connect on Domestic Wireline transmission backbone in order to progress with the transition towards a new generation meshed ASTN (Automatically Switched Transport Network) optical backbone which will start during 2003. By using the ASTN approach it is possible to build a multiservice platform with a high level of integration with the IP network. First applications of Metro DWDM systems were developed in Rome and Milan metropolitan areas.

The evolution of the transport network towards the optical network will make it possible to increase the operational capacity of all types of traffic, from phone calls to Internet traffic.

ATM switching technology, introduced in 1996, allows the transfer of information combining data, video and other services over public and private networks both domestically and internationally. Telecom Italia ATM

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(Atmosfera) and Frame Relay (Business Frame) networks are overall networks that work together as a multiservice network, using SDH transmission systems as physical layer. The ATM Network allows for the provision of ATM native services with access rates ranking from 2Mbit/s up to 155 Mbit/s. It also acts as a backbone for both the Frame Relay Access network (with access rates ranking from 64 kbit/s up to 2 Mbit/s), and for the DSL network, used for the provisioning of xDSL services (ADSL, HDSL and SDSL). The ATM/Frame Relay networks allows for access to IP and MPLS customers with access rate ranking from 64 kbit/s to 155 Mbit/s.

**Network Quality and Productivity.** Telecom Italia Group's investment in its domestic service network has enabled it to continue to reduce the average time required for the installation of new lines. The effectiveness rate of the fixed network is defined as the ratio of successful calls to the total number of call attempts, not including failures caused by the calling party's behavior, in a specified time period. A successful call is a call attempt to a valid number, properly dialed, where the called party's busy tone, ringing tone, or answer signal is recognized on the access line of the calling user.

To reduce costs and improve efficiency, the Telecom Italia Group undertook in 2001 and continued in 2002 an extensive program to reengineer its network operation and maintenance organization, which will permit a more effective use of human resources.

Beginning in 1999 operating systems were, in turn, developed with the aim of ensuring the offering of new services, optimizing operational activities and pursuing objectives of total quality. Procedures were developed for systems dedicated to supervising traffic for verifying levels, the immediate management of measurements and constant monitoring of the quality of the service provided. In systems that operate the flexible network for data transmission, features were activated which reduce activation and connection time, permit the timely recognition of customers who have experienced malfunctions in services and augment the availability of the connections themselves. Moreover, operating systems have been equipped with new features for marketing new services.

**Broadband Network/ADSL.** The Telecom Italia Group's broadband network is capable of supporting advanced telecommunications services and multimedia applications and, to this end, the Telecom Italia Group has installed significant levels of fiber optic cables in its fixed network. In 1998, the Telecom Italia Group began introducing ADSL systems over copper pairs to deliver interactive services (e.g., fast-Internet). ADSL allows the Telecom Italia Group to fulfill in the short-term, market driven needs to provide services like fast-Internet, multimedia, video conferencing and teleworking either for business or residential customers. Furthermore, ADSL together with other existing infrastructure and satellite services allows the Telecom Italia Group to focus the commercialization of its broadband network services on a market basis and to tailor investments to the growth of the market. With reference to access services using ADSL technology, in 1999, the technical and commercial trials with fast Internet access for residential and Soho customers, begun in Rome and Milan at the end of 1998, were concluded. In 2002, commercial services with access to ADSL technology for business customers and Internet Service Providers had been extended to 1,300 cities (approximately 700 at the end of 2001). The commercial services for business customers include the use of ADSL technology in urban areas to supply access to IP and ATM services of the Telecom Italia Group's data networks. The services for ISPs supply ATM access based on ADSL technology to the public, leaving the commercial interface with the final customer to the Service Provider. At the end of 2002, the local exchange areas covered by ADSL technology numbered 2,120; in 2003, 3,000 local exchange areas are expected to be served.

**Fiber optic Cables.** At December 31, 2002, the Telecom Italia Group had installed approximately 3.6 million kilometers of optical fiber for access and transfers, of which approximately 0.99 million kilometers were installed on long distance fixed-lines. Fiber optic cables significantly increase the capacity of the network and permit the Telecom Italia Group to provide new advanced services based on the simultaneous transmission of several kinds of signals, such as voice, data and video. To enable the offer of such services, the Telecom Italia Group is planning to introduce fiber optics in its local access network.

In 2002, a project which started in the second half of 2000, consisting of the creation of an optical fiber ring between Milan and Palermo (T-Bone), was completed with the installation of about 6,000 kilometers of cable with 96 optical fibers on two backbones and the laying of two

submarine links under the Strait of Messina.

**Flexible Data Network.** The Telecom Italia Group also operates a flexible network equipped with a centralized system that makes it possible to establish dedicated data links from a work station. At December 31, 2002, 600,000 direct digital line access points and 166,500 direct analog line access points had been installed.

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### *International Network*

Since 1997, the Telecom Italia Group has rationalized its international fixed network and enhanced international transmission capacity.

The Telecom Italia Group owns capacity in a number of international cable links and its international network includes fiber optic cables to several countries. During 2002 major implementations in this traditional area were related to the upgrade of Catania (Italy) - Malta submarine cable, for supporting international voice traffic and IP connectivity, and to the completion of the Palma (Spain) - Algiers submarine link, for improving its capabilities to deliver traffic to Algeria.

On December 31, 2002, there were 9 exchanges utilized for voice services and digitalization of the international network exceeded 98%. In the aggregate, the Telecom Italia Group owns capacity on more than 360,000 kilometers of submarine cables.

In addition, the Telecom Italia Group has developed a new strategy building a number of proprietary networks in Europe, Latin America and in the Mediterranean area. These multiservice backbones are optical fiber rings with ring-topology protection that use the DWDM (Dense Wavelength Division Multiplexing) technology for transmission, while, for access and delivery, the POPs (Point of Presence) use multiservice platforms (voice, data and IP). These platforms complete the switching functions for voice and routing for data with packet/cell switching IP/ATM technology.

In 2002, three completely integrated multiservice backbones have been operating and supporting Telecom Italia's international services. In particular, the main activities included:

- *Pan European Backbone.* Fully activated cross-border services are available for wholesale customers: Managed Bandwidth, IP Connectivity, International Private Leased Circuit, Global Voice Services, .GRX (GPRS Roaming eXchange for Mobile Operator). The European fiber optic network (Pan European Backbone) 2 fiber pairs, 400 Gbit/s each is laid in the main industrialized European countries: Italy, France, U.K., Netherlands, Belgium, Germany, Switzerland and Austria with a total length of 9,100 km. (an extension of the Pan European Backbone to Madrid and Barcelona in Spain is planned for the second quarter of 2003).
- *Mediterranean Nautilus.* Mediterranean Nautilus Ltd., a company controlled by Telecom Italia, has built a new submarine optical ring, in a high-availability network configuration, with a total length of 7,000 km 6 fiber pairs, 64 lambda (10 Gbit/s each) per fiber pair. Such system will link the main markets of the Central-Eastern Mediterranean area: Italy, Greece, Turkey and Israel. Presently, the optical ring that links Catania, Athens, Chania-Crete, Haifa and Tel Aviv has been completed.
- *LAN (Latin American Nautilus).* The final network configuration of Latin America Nautilus has been activated. The Latin American Nautilus is a new high capacity backbone, previously utilized in Latin America and now integrated with the transatlantic and European networks. The backbone is an optical fiber ring network both on earth and under sea, 30,000 km long, including the Miami-New York City link. The ring, having optical automatic traffic protection and a bandwidth up to 320 Gbits, links the most important cities of South America to Central and North America.

Furthermore, Telecom Italia of North America (TINA), a wholly owned subsidiary of Telecom Italia, has implemented two POPs in Newark (NJ) and Miami to offer Voice and IP/Data services. In order to improve the capabilities between such POPs, the Pan European Backbone and Latin American Nautilus, Telecom Italia together with TINA signed contracts to purchase capacity on the Flag Atlantic-1 transatlantic cable and



TINA on the Middle Atlantic Crossing submarine cable.

***Mobile***

The Mobile Business Unit accounted for gross operating revenues of 10,867 million in 2002, 10,250 million in 2001 and 9,418 million in 2000.

The Mobile Business Unit (TIM group) operates in the sector of national and international mobile telecommunications. Its international operations are concentrated in Latin America and in the Mediterranean Basin.

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As of December 31, 2002, the business unit was organized as follows:

In May 2002, the International Operations (IOP) Operating Activity was disbanded. As a result of this reorganization, all the companies based in Latin America are now coordinated by Latin America Operations (LAO). Beginning February 2003, Latin America Operations reports directly to the CEO Carlo Buora for wireline telecommunication and to Marco De Benedetti, the CEO of the Mobile Business Unit, for mobile telecommunication.

Among the large mobile telecommunications operators in Europe at the end of 2002 TIM has the largest number of lines in its domestic market (source: Mobile Communication magazine) and has been the fastest growing area of the Telecom Italia Group's business for the past several years. Line growth was 17% in 2000, 11% in 2001 and 6% in 2002. Gross operating revenues from TIM totaled 7,929 million, 8,357 million and 9,022 million (8,915 million net of Blu merger effect) in 2000, 2001 and 2002, respectively.

### ***Holdings of International Operations***

As a result of a corporate reorganization completed at the end of 2000, TIM acquired 100% of STET Mobile Holding (SMH), the international holding company of the Telecom Italia Group holding substantially all of the Telecom Italia Group's wireless investments outside of Italy. On December 28, 2001, SMH merged with TIM International, the holder of stakes in Digitel and Is TIM. TIM International is managed by TIM and the international results have been fully consolidated with TIM's results since January 1, 2001. In January 2001, TIM Brasil, a wholly owned subsidiary of TIM International, was formed to act as a sub holding company for the subsidiaries which acquired PCS licenses in Brazil (TIM Celular Centro Sul, TIM Sao Paulo and TIM Rio Norte). In November 2001, TIM International's stake in Bitel (the majority shareholder of Tele Nordeste Celular and Tele Celular Sul) was contributed to TIM Brasil. TIM Brasil currently owns 100% of Bitel's share capital. In December 2002 within the framework of the corporate reorganization process, TIM Sao Paulo was merged with TIM Celular Centro Sul and TIM Rio Norte and, in January 2003, changed its name to TIM Celular.

Corporacion Digitel and Maxitel, whose controlling stake was acquired at the end of 2000 have been fully consolidated with TIM's results since January 1, 2001.

At December 31, 2002, the overall number of TIM lines calculated on a proportionate basis, in Italy and internationally was approximately 31.5 million. There are approximately an additional 2.2 million equity mobile lines calculated on a proportionate basis that are part of the Telecom Italia Group.

The following tables list the countries in which TIM (through TIM International) currently has operations, the ownership interest in each operator and the number of lines for each operator. Beginning in May 2002, all the Latin America companies owned by TIM International are coordinated by Latin America Operations. The mobile operations in Austria, France and Spain were sold during 2002.

**Table of Contents****Controlled Operations**

<u>Country</u>	<u>Operator</u>	Percentage	Total Wireless lines
		interest of TIM	per operator at
		<u>International</u>	<u>December 31, 2002</u>
(millions)			
<b>Europe</b>			
Greece	STET Hellas	81.40(1)	2.5
<b>Latin America(2)</b>			
Brazil	Maxitel	100.00(3)	1.4
	Tele Nordeste Celular(*)	21.18	1.9
	Tele Celular Sul(*)	20.68	1.7
	TIM Celular (formerly TIM Sao Paulo)	100.00	0.3(4)
Perú	TIM Perú	100.00	0.4(5)
Venezuela	Digital	66.56(6)	0.9

(\*) Represents total of shares held; these entities are consolidated as the Group owns over 50% of the voting common stock.

**Affiliated Companies**

<u>Country</u>	<u>Operator</u>	Percentage	Total Wireless lines
		interest of TIM	per operator at
		<u>International</u>	<u>December 31, 2002</u>
(millions)			
<b>Europe</b>			
Czech Republic	Radiomobil	4.35	3.5
Turkey	Is TIM	49.00	1.2(7)

- (1) In August 2002, TIM International acquired a 17.45% stake in STET Hellas from Verizon. As a consequence of this acquisition the stake owned by TIM International in STET Hellas increased from 63.95% to 81.40%.
- (2) Pursuant to the 2002 Reorganization the activities of the Latin American companies are now coordinated by Latin America Operations.
- (3) In February 2002, TIM Brasil acquired 10% of ordinary shares of Maxitel, corresponding to 3.33% of the total capital.
- (4) Operations started October 18, 2002.
- (5) Operations started January 25, 2001.
- (6) In December 2002, TIM International increased its interest in Digital, through a share capital acquisition, by 10%.
- (7) Operations started March 21, 2001.

**Services Italy.** TIM offers both digital and analog mobile services. The GSM digital service, which commenced operations in April 1995, uses digital technology and is the standard throughout Europe. GSM generally provides higher quality transmission than analog service and may be used by customers to make and receive mobile calls throughout Europe and certain other countries. As of June 11, 2003, roaming agreements have been reached with 319 operators in over 180 countries, allowing customers to make and receive calls abroad. See **Mobile Tariffs** below.

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The analog service is based on the TACS 900 standard and began operation in 1990. See Cellular Network .

The table below sets forth, for the periods indicated, geographic and population coverage data for TIM s TACS and GSM services.

	Year ended December 31,			
	1999	2000	2001	2002
	(%)			
TIM Italian geographic coverage				
TACS	83	83	83	83
GSM	89	92	94	94
TIM Italian population coverage				
TACS	98	98	98	98
GSM	99	100	100	100

**Customers and Lines.** The penetration of mobile telecommunications service in Italy is above the Western European average at approximately 95 lines per 100 inhabitants and growth rates have been substantially higher than the European average. This compares to a penetration rate of 73 and 89 lines per 100

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inhabitants at the end of 2000 and 2001, respectively. The increase is due to innovative services and an increase in customers with multiple lines and operators. TIM's customer base consists of TACS subscribers, customers holding TACS prepaid services, ( TACS Prepaid Customers ), GSM subscribers and customers holding GSM TIM Cards ( GSM Prepaid Customers ), and together with TACS Prepaid Customers, Prepaid Customers ). In 2002, TIM added 48.5% of the net additional GSM lines, with 2.1 million net additions compared to 1.6 million for Vodafone Omnitel and the remaining 0.6 million attributable to Wind. At December 31, 2002, the number of lines for TIM's TACS and GSM mobile service was approximately 25.3 million (of which 24.3 million were GSM lines, consisting of 2.7 million GSM subscribers and 21.6 million GSM Prepaid Customers). As of March 31, 2003, TIM's customer base had increased to 25.7 million lines.

The table below sets forth, for the periods indicated, selected customer data for TIM's domestic business.

	Year ended December 31,				
	1998	1999	2000	2001	2002
	(number of customers in thousands)				
Lines at period end(1)	14,299	18,527	21,601	23,946	25,302
TACS subscribers	1,563	832	495	304	180
TACS prepaid lines	2,001	2,344	1,950	1,430	815
GSM subscribers(2)	2,453	2,442	2,485	2,538	2,685
GSM TIM Prepaid Lines	8,282	12,909	16,671	19,674	21,622
	(in %)				
Customer growth	54.1	29.6	16.6	10.9	5.7
Churn(3)	16.8	12.7	15.7	15.6	18.0
TIM penetration(4)	25.1	32.5	37.5	41.6	43.9
Cellular market penetration(5)	35.9	53.1	73.3	89.0	95.0
	( ) (6)				
Average revenue per line per month(7)	40.0	34.9	30.5	29.1	28.8

(1) Includes lines of TACS and GSM services, including Prepaid Customers.

(2) Commenced GSM services in April 1995.

(3) In 1998 net of internal migration between TACS and GSM networks; since 1999 data refers to total lines. The churn rate for any given period represents the number of TIM customers whose service was discontinued during that period due to a payment default or who voluntarily gave up a mobile telephony service during that period, expressed as a percentage of the average number of customers during that period.

(4) TIM customers per 100 inhabitants.

(5) Customers per 100 inhabitants for the entire market.

(6) The data for the years ended December 31, 1998, 1999 and 2000 was in lire and was translated into euros at the irrevocably-fixed rate of exchange of Lit. 1,936.27 = 1.

(7) Including Prepaid Card revenues and excluding equipment sales and, since 1999, including non-TIM customer traffic revenues.

The significant growth in TIM's mobile lines since October 1996 has resulted almost entirely from the marketing success of the GSM TIM Card, a prepaid card which permits the customer to make outgoing calls up to the limit on the card for the 12 months following issuance of the card or the last recharge of the card and receive an unlimited number of calls for the 13 months following issuance of the card or the last recharge of the card. If a GSM TIM Card is not recharged within this 12-month period, the customer will not be able to make outgoing calls but for one additional month such customer will be able to receive incoming calls. The GSM TIM Card can be recharged at any time to permit additional outgoing calls. The GSM TIM Card offers several advantages, including elimination of bad debt charges and lower administration costs, as no statements are sent to customers. The TACS prepaid service, which was introduced in December 1997, functions the same way as the GSM TIM Card and has successfully reduced the decline in usage of the TACS network. Approximately 89% of TIM's lines at December 31, 2002 are prepaid.

**UMTS License.** The Italian government awarded five UMTS licenses in Italy in November 2000. TIM, together with Omnitel S.p.A. (now Vodafone Omnitel N.V.), WIND S.p.A., Andala S.p.A. (now H3G S.p.A.) and IPSE S.p.A., were awarded licenses to provide third-generation mobile services. TIM has committed to pay 2,417 million for its license, with approximately 117 million, 117 million and 2,066 million having been paid in November 2002, November 2001 and December 2000, respectively. The remaining 117 million will be paid in 2003. The licenses are valid for 20 years starting January 1, 2002. In 2001, TIM began an experimental UMTS service in its service center in Padoa, and a gradual roll-out of the UMTS network has begun. Transition toward third generation services will be gradual with a broad launch of the service expected in 2004.

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**Traffic.** The table below sets forth, for the periods indicated, selected traffic data for TIM's business.

	Year ended December 31,				
	1998	1999	2000	2001	2002
	(millions of minutes)				
Total outgoing traffic per month	839	1,219	1,569	1,795	1,960
Total incoming and outgoing traffic per month	1,473(1)	1,989(2)	2,479(3)	2,815(4)	3,036(5)
	(% of total)				
Of which:					
TACS(6)	33.3	19.5	10.3	5.4	3.0
GSM(6)	66.7	80.5	89.7	94.6	97.0

- (1) Includes domestic mobile incoming and outgoing traffic (96.2% of total mobile traffic in 1998 compared to 96.9% in 1997), international traffic (2.3% in 1998 compared to 2.1% in 1997) and roaming traffic (1.5% in 1998 compared to 1.0% in 1997). These data include fixed outgoing traffic to the mobile network.
- (2) Includes domestic mobile incoming and outgoing traffic (93.9% of total mobile traffic in 1999 compared to 96.2% in 1998), international traffic (3.2% in 1999 compared to 2.3% in 1998) and roaming traffic (2.9% in 1999 compared to 1.5% in 1998). These data include fixed outgoing traffic to the mobile network.
- (3) Includes domestic mobile incoming and outgoing traffic (90.4% of total mobile traffic in 2000 compared to 93.9% in 1999), international traffic (2.9% in 2000 compared to 3.2% in 1999) and roaming traffic (6.7% in 2000 compared to 2.9% in 1999). These data include fixed outgoing traffic to the mobile network.
- (4) Includes domestic mobile incoming and outgoing traffic (92.8% of total mobile traffic in 2001 compared to 90.4% in 2000), international traffic (2.7% in 2001 compared to 2.9% in 2000) and roaming traffic (4.5% in 2001 compared to 6.7% in 2000). These data include fixed outgoing traffic to the mobile network.
- (5) Includes domestic mobile incoming and outgoing traffic (94.5% of total mobile traffic in 2002 compared to 92.8% in 2001), international traffic (2.3% in 2002, compared to 2.7% in 2001) and roaming traffic (3.2% in 2002 compared to 4.5% in 2001). These data include fixed outgoing traffic to the mobile network.
- (6) Includes traffic from Prepaid Customers.

**Mobile Tariffs.** TIM's mobile customers (other than Prepaid Customers) are charged a one-time connection fee, a monthly basic charge and traffic fees for calls, as well as a monthly government tax. Prepaid Customers are charged an initial connection fee of 26 for the GSM TIM Card and TACS prepaid service and are required to pay a fee ranging from 5 to 1 to the dealer for each recharge, according to the cost of each recharge. No other connection or subscription fees or taxes are payable by Prepaid Customers. Mobile customers (including Prepaid Customers) must purchase their own mobile telephone handsets. TIM does not subsidize the cost of mobile telephone handsets to its customers and does not intend to do so in the foreseeable future. In 2002, approximately 76.8% of revenues from TIM mobile services (net of access charge) were derived from traffic charges, 5.7% from sales and rental of equipment, 8.4% from VAS and 9.1% were miscellaneous revenues (subscription and connection fees).

TIM offers its customers a variety of different pricing packages which are tailored to address different usage patterns. Such packages include offerings to TIM's GSM customers of free minutes packages which are available in various options. TIM also offers packages such as, TIM Menù, a dedicated TACS and GSM pre-paid card. The customer can choose a rate suited to his or her own needs, combining the various items on a menu. The objective is to simplify the service offer and at the same time make them more flexible.

TIM also offers innovative services, such as an offering called AutoRicarica. The AutoRicarica formula has proven to be particularly successful: according to this formula, TIM gives a bonus of 3.7 (VAT included) for each 100 minutes of calls received.

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TIM also offers certain discount packages, which include TopTim, a discount plan for professionals that rewards both length of subscription and volume of traffic, and TimClub, a 15% discount on the three most frequently called wireless numbers (which is only available after the free bonus minutes have been used).

At the beginning of 2002, TIM launched the first exclusive service which allowed TIM customers to reverse billing charges to a rechargeable or contract TACS or GSM TIM mobile, or to Telecom Italia fixed network numbers.

In May 2002 TIM introduced the following new tariff plans: Unica and Unica10; customers can personalize their own tariff choosing between two options: SuperAutoricarica (self recharge from all numbers) and Trio, a special tariff for three TIM numbers or two TIM numbers and a Telecom Italia fixed network number.



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GSM and TACs customers are charged on the basis of a per-seconds billing system paying for the actual duration of the call plus a call setup charge of 0.1 (which is not charged when free minutes are being used). At the end of 1997 TIM also introduced local tariffs. From time to time, TIM offers promotional packages to attract additional customers.

**Value Added Services.** TIM has been building its brand as a platform for content providers by entering into partnerships and developing business synergies. TIM has offered WAP since May 2000 and has over 200 partnerships and commercial agreements with primary content and service providers, such as SEAT-Tin.it, Yahoo!Europe, Sonera Zed, Caltanet, Kataweb, Sit.com and Excite. TIM also has agreements with leading Italian banks and financial institutions to provide on-line trading and mobile banking. In August 2000, TIM launched GPRS services in the areas of Rome and Milan and GPRS national coverage was completed in December 2000. The GPRS service has been available to corporate customers since the first quarter of 2001 and was extended to consumer segments starting May 2001. GPRS services represent the transition between the evolution of second (GSM) to third (UMTS) generation mobiles.

The introduction of GPRS allowed TIM to launch other initiatives. All GSM lines are able to handle GPRS traffic, which has become a fundamental service for the professional market. TIM was the first provider to market GPRS in Italy, consolidating its technological leadership in the domestic market.

TIM also introduced M-Services, which represents a combination of multimedia services on its GSM and GPRS networks. M-Services allows customers to use their mobile phones to send photographs and images accompanied by written or musical messages and to access a WAP page simply by pressing a button (WAP Push). TIM has been the first in Europe to introduce the PhotoMessage service, a major step towards multimedia message services. In June 2002 these services became available with the new MMS (Mobile Multimedia Services) and will be available on UMTS in the future.

**Billing.** TIM's customers (other than Prepaid Customers) are billed in a staggered bimonthly billing cycle. TIM endeavors to minimize bad debts by implementing a credit check on each customer at the time of sign-up and by requiring certain customers to post a security deposit. In addition, if payment is not received, the customer is notified accordingly and his or her ability to place outgoing calls is interrupted. If no payment is received, all services are terminated. The average rate of innovative payments (credit cards, Banco Posta) made by customers (other than Prepaid Customers) rose, in 2002, to 66% of the total payments.

**Marketing and Distribution.** TIM believes that its active marketing programs, extensive customer service and distribution network (primarily a nationwide network of independent dealers) and responsiveness to customer needs provide it with a significant competitive advantage. At December 31, 2002, there were 1,509 distribution partners, with 4,650 sales points (including 69 Telecom Italia Group outlets marketing TIM products and 24 shops directly owned by TIM). As of December 31, 2002, 4,143 TIM employees (about 40.4% of its total workforce) were involved in customer service activities.

**Cellular Network.** TIM's TACS network consists of 2,730 radio base stations and 60,291 radio channels. TIM has reduced the level of investment in its TACS network as the number of TACS customers has decreased. TIM's GSM network consists of 11,750 radio base stations and 629,600 radio channels (an increase of 7.4% over 2001). The Telecom Italia Group believes that as a result of TIM's enhancement of the GSM service and increased coverage, TIM's network is in line with the best European GSM networks.

**Services International.** TIM continued to consolidate its role as a global player during 2002. TIM International's presence is now primarily concentrated in Latin America and in the Mediterranean Basin. In December 2002 TIM had 13.8 million lines attributable to customers abroad, 6.2 million represented proportionate lines. 52.0% of TIM's international lines are European mobile lines while 48.0% are Latin American

mobile lines. See Companies Controlled by TIM International .

In-Europe , TIM s pan-European tariff, introduced in 2001, combines the preferential roaming agreements among TIM, its foreign subsidiaries and other European partners, allowing TIM customers to roam in 30 countries using the same tariff. As part of its international roaming service, TIM offers its customers the possibility of making calls from abroad with a simplified rate plan. Subscribers are allowed to use the same rates twenty-four hours a day and prepaid customers to charge the cost directly to their remaining credit rather than to a credit card. See Companies Controlled by TIM International .

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On April 7, 2003, TIM signed a cooperation agreement with Telefonica Moviles and T-Mobile International to set up an alliance to provide their customers with a unified and superior offering of products and services in the countries where the three operators are present, thereby strengthening their ability to compete in cross-border markets. Initially the partners plan to develop, through roaming agreements, joint offers in voice, data and mobile internet, in order to gain new customers, both private users as well as multinational companies and corporate users interested in maintaining their level and quality of services, regardless of the country or the operator. The benefits to customers will include simplified tariff schemes and the capacity to access the same service offering on a global scale, as easily as at home. Additional services will include recharging a prepaid account abroad, sending photos via MMS, accessing Customer Care in the client's home language or the use of the same short code for SMS services. Another aim of the alliance would be to join forces to obtain synergies, economies of scale and greater sales potential, as well as equipment and handsets development, in order to meet the demand for new products and services. All these elements will lead to an improved service offering to customers.

TIM is focusing its efforts on becoming a technological and marketing partner for its affiliates. Examples of synergies implemented among TIM and affiliated companies are represented by the commercial launches of TIM Celular (formerly TIM Sao Paulo) in 2002 and TIM Perú in 2001. TIM's strategy for international development focuses on consolidation in countries where new markets have greater growth potential. Targeted countries include Brazil (for GSM services), Perú and Venezuela where TIM's affiliates have been awarded licenses and services have recently been started. These markets currently have low penetration rates and dense populations made up of young consumers who are more oriented toward value added services. See [Companies Controlled by TIM International](#).

**Companies Controlled by TIM International****Europe*****Greece***

The Telecom Italia Group's first international investment in Western Europe was the establishment of STET Hellas. STET Hellas was awarded one of two GSM licenses granted in Greece, in the 900 Mhz frequency band, and commenced commercial services in June 1993.

In July 2001, the company was awarded a UMTS license at the price of 145 million and a DCS 1800 license for 26 million. At December 31, 2002, STET Hellas had approximately 2.5 million lines. In 2002, operating revenues were 689 million against 523 million in 2001, gross operating profit was 255 million compared to 188 million in 2001 (a 35.6% increase) and operating income was 131 million against 89 million in 2001 (an increase of 47.2% compared to 2001).

STET Hellas was listed on NASDAQ and on the Amsterdam Stock Exchange in June 1998 through an initial public offering of American Depositary Shares on NASDAQ and of Dutch Depositary Receipts on the Amsterdam Stock Exchange. After completion of the initial public offering, the Telecom Italia Group's stake through TIM International was reduced from 74.8% to 58.14%. In February 2001, a stake of 1.14% was acquired by TIM International. In October 2001, TIM International subscribed to a capital increase to finance the acquisition of its new business, and its stake rose to 63.95%. In August 2002, TIM International acquired the 17.45% stake of Verizon, its original joint venture partner. Consequently, as of December 31, 2002, the TIM group's interest in STET Hellas was 81.40%.

**Latin America**

***Brazil***

In 2001, TIM Brasil (a wholly owned subsidiary of TIM International) was incorporated to act as a sub holding company for TIM Celular Centro Sul, TIM Sao Paulo and TIM Rio Norte. In November 2001, TIM International's stake in Bitel (the majority shareholder of Tele Nordeste Celular and Tele Celular Sul) was contributed to TIM Brasil. Consequently, TIM Brasil is actually the holding company for all the Brazilian subsidiaries.

*Tele Nordeste Celular Participacoes group.* A controlling interest in Tele Nordeste Celular, a supplier of mobile telephone services in the regions of Alagoas, Cearà, Paraiba, Pernambuco, Piaui and Rio Grande do Norte, was acquired in 1998. At the end of 2002, in a market with a penetration level of 12%, Tele Nordeste had more than 1.9 million lines (an increase of 9.6% compared to 2001), corresponding to a market share of approximately 59%.

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In 2002, Tele Nordeste Celular reported operating revenues of Brazilian reais 984 million ( 355 million), an increase of 12.3% in local currency compared to 2001; gross operating profit of Brazilian reais 523 million ( 189 million), an increase of 25.7% in local currency compared to 2001; and operating income of Brazilian reais 271 million ( 98 million), an increase of 26.0% in local currency compared to 2001.

*Tele Celular Sul Participacoes group.* A controlling interest in Tele Celular Sul Participações, a mobile telephone operator in the states of Paraná, Santa Catarina and in the city of Pelotas, was acquired in 1998. In 2002, Tele Celular Sul had 1.7 million lines (an increase of 7.5% compared to 2001) representing an overall market share of 61%. In 2002, Tele Celular Sul reported operating revenues of Brazilian reais 1,010 million ( 364 million), an increase of 13.6% in local currency compared to 2001; gross operating profit of Brazilian reais 422 million ( 152 million), an increase of 12.2% in local currency compared to 2001; and operating income of Brazilian reais 192 million ( 69 million), an increase of 3.8% in local currency compared to 2001.

*Maxitel.* In November 2000, TIM, through Bitel Participações, acquired from UGB Participações S.A. and Vicunha S.A., respectively, 19.43% and 18.53% of the ordinary and preferred shares of Maxitel, the Brazilian mobile telephony operator licensee in the states of Minas Gerais, Sergipe and Bahia in which it already held a 58.7% interest (43.15% of ordinary share capital). The transaction involved a total investment of approximately U.S.\$240 million.

In February 2002, TIM International, through its wholly owned subsidiary TIM Brasil S.A., acquired from the minority shareholders UGB Participações S.A. and Vicunha S.A. the remaining 10% of Maxitel ordinary shares for the equivalent of 27 million by exercising a call option.

In 2002, Maxitel reported operating revenues of Brazilian reais 755 million ( 273 million), an increase of 29.7% in local currency compared to 2001, due to an increase in traffic; gross operating profit of Brazilian reais 293 million ( 106 million), an increase of 61.9% in local currency compared to 2001. Operating income was Brazilian reais 74 million ( 27 million).

*TIM Celular.* On February 13, 2001 TIM's subsidiaries TIM Sao Paulo and TIM Celular Centro Sul acquired PCS licenses in Brazil respectively in the regions of São Paulo and in the Distrito Federal, in the middle/west and south region. On March 13, 2001, TIM Rio Norte acquired PCS licenses in the Northern and in the Rio de Janeiro and Espirito Santo states. On October 18, 2002, the three companies launched GSM services. In December 2002, within the framework of the corporate reorganization process, TIM Sao Paulo merged the other two companies and, in January 2003, changed its name to TIM Celular.

The company operates mobile network services using GSM technology in the north of Brazil, in the middle/west and south region and in the states of São Paulo, Rio de Janeiro and Espirito Santo and in the Distrito Federal.

At the end of 2002, TIM Celular had 293 thousand lines. In 2002, TIM Celular reported operating revenues of Brazilian reais 108 million ( 39 million); a loss in gross operating profit of Brazilian reais 472 million ( 170 million) compared to a loss of Brazilian reais 33 million in 2001; and an operating loss of Brazilian reais 521 million ( 188 million) compared to a loss of Brazilian reais 34 million in 2001.

## *Perú*

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In March 2000, TIM Perú was awarded the third mobile PCS license in the country at a cost of US\$180 million. The license has a duration of 20 years, is renewable, and provides for the supply of mobile telecommunications service on the 1900 MHZ frequency band. The license permits TIM Perú to request licenses for supplementary services, including basic and long distance telephone services. These licences were obtained in March 2001 and October 2001.

The Telecom Italia Group has elected to use GSM technology for its mobile services in Perú consistent with the development of a Latin American platform and GSM roaming worldwide.

In 2002, TIM Perú reported operating revenues of 308 million Nuevo Soles ( 93 million), a loss in gross operating profit of 95 million Nuevo Soles ( 29 million) and an operating loss of 201 million Nuevo Soles ( 61 million) against an operating loss of 238 million Nuevo Soles ( 76 million) in 2001.

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***Venezuela***

In December 2000, TIM acquired a 56.6% stake in Corporacion Digitel S.A., a Venezuelan mobile operator. The amount paid for this acquisition was approximately US\$363 million (of which approximately US\$107 million was in the form of a capital increase and the balance was in the form of a share purchase). In December 2002, TIM International acquired a further 10% of Corporacion Digitel's share capital for 32 million. Consequently, TIM group's interest in Digitel increased to 66.56%. Corporacion Digitel was awarded a 900 MHZ 20-year renewable GSM license in January 1998 and is operating in the Venezuelan Central Region, which, including Caracas and other major cities, is the most important economic region of Venezuela, with 60% of the national GDP.

In 2002, Corporacion Digitel changed its network architecture with the choice of Nokia as a main supplier, updated its technologies for prepaid services and launched GPRS and MMS services. At the end of 2002 Corporacion Digitel's market share was 15%.

In 2002, Corporacion Digitel reported: operating revenues of 260 billion Bolivares ( 177 million), an increase of 50.2% in local currency against operating revenues of 173 billion Bolivares in 2001; gross operating profit of 51 billion Bolivares ( 35 million) compared to 10 billion Bolivares in 2001; and an operating loss of 30 billion Bolivares ( 20 million), an increase in loss of 40.1% compared to 2001.

As a consequence of the recent devaluation of the Venezuelan currency against the U.S.\$, Corporacion Digitel's 2002 operating loss was equal to approximately 120% of its share capital. According to Venezuelan law, this situation would cause the winding-up of the company unless the General Shareholders' Meeting, while approving the financial statements, provides for a replenishment of the losses. Under Venezuelan law losses can be offset through direct contributions by shareholders, without increasing the company's share capital. Any shareholder not contributing pro-rata to the replenishment of losses could lose its investment in Corporacion Digitel.

In order to avoid participating in the loss replenishment, as well as to avoid losing their investment, some minority shareholders have initiated legal actions against Corporacion Digitel and TIM International, including the request for issuance of cautionary injunctions aimed at preventing the approval and/or the implementation of the replenishment of losses.

Most of the aforesaid legal actions have been rejected by the competent courts, so that on June 6, 2003, Corporacion Digitel's annual Shareholders' Meeting finally approved with the contrary vote of the minority shareholders present at the Meeting the 2002 financial statements and a loss replenishment in an amount suitable to bring Corporacion Digitel out of the situation envisaged in the Venezuelan Civil Code as to losses and necessary remedies. TIM International contributed to such replenishment with a financial credit it had towards the same Corporacion Digitel, of U.S.\$45 million.

**Other investments held by TIM International**

***Czech Republic***

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The Telecom Italia Group holds a 7.16% interest in C-Mobil B.V., a company which owns a 60.76% interest in Radiomobil, a mobile telecommunications operator, which in March 1996 won a GSM license in the Czech Republic. As of December 31, 2002, the penetration rate in the Czech Republic had reached almost 85% and Radiomobil had approximately 3.5 million customers. Radiomobil had operating revenues of 705 million and net income of 88 million in 2002.

### *Turkey*

In line with its expansion strategy in the Mediterranean Basin, in April 2000, the Telecom Italia Group was awarded a mobile GSM 1800 license in Turkey. This license was acquired, at a price of US\$ 2,525 million, through a special consortium (49% owned by Telecom Italia and 51% by Is Bank, the leading private bank in Turkey, in compliance with restrictions imposed by local laws about foreign investments). The second license was awarded to the fixed network operator (Turk Telekom) at the same time, according to the terms of the bid.



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In September 2000, the Telecom Italia Group and Is Bank formed Is TIM, that, under the brand name *Aria*, launched GSM services in March 21, 2001. According to the agreements with Is bank, TIM was responsible for the technical and commercial operation of Is TIM. In December 2000, 49% of Is TIM was transferred to TIM International B.V. (now TIM International N.V.)

At the end of 2002, Is TIM had a customer base of approximately 1.2 million lines and it reported operating revenues of 141,276 billion Turkish lire ( 83 million) and an operating loss of 715,735 billion Turkish lire ( 420 million). These results are due to the consequence of the difficulties faced by Is TIM in developing its mobile business, because of the Turkish regulatory scenario. In fact beginning with the award of the license, some measures which should have fostered effective competition and permitted a new entrant to compete against incumbent operators (roaming arrangements in particular), did not effectively take place. These measures are essential in the light of international experience to foster competition and pursuant to applicable legislation in Turkey. Is TIM and its shareholders made repeated and formal efforts to have the situation rectified but was *de facto* prevented from entering the Turkish mobile telephony market, thereby infringing the terms and conditions of the tender.

From a financial standpoint, at the end of 2002 Telecom Italia, in conjunction with TIM, concluded that the competitive conditions which would permit TIM to earn a return of investment did not exist. Facing this situation Telecom Italia and TIM have completely written off their investment in Is TIM. The investment held in Is TIM was written down (extraordinary loss of 1,491 million) and a provision was added to the reserve for risk and charges related to Is TIM ( 850 million) against the guarantees provided by the Telecom Italia Group to financial institutions and suppliers as creditors of Is TIM and the loans to Is TIM by the Telecom Italia Group.

On May 13, 2003 TIM International signed a Term Sheet with Turk Telekom (the fixed line operator) outlining a set of guidelines for the integration of Is TIM and Aycell (the 4<sup>th</sup> Turkish mobile operator wholly owned by Turk Telekom). The agreement aims at obtaining significant operating and financial synergies through the combination of the two companies. Both the two telecoms operators, TIM and Turk Telekom will hold 40% of the shares of the new entity respectively; the remaining 20% will be held by Is Bank. The closing of the operation is expected by the end of June 2003.

## ***Other Countries***

During 2002 TIM disposed of its mobile investments in Austria, France and Spain. In Austria, TIM International sold its 25% stake in Mobilkom Austria to Telekom Austria. The sale was completed on June 28, 2002. In France, Telecom Italia sold its 19.61% stake in BDT, the company controlling 55% of French mobile company Bouygues Telecom, to Bouygues S.A. The sale was completed in March 2002. In Spain, TIM International sold its 3.81% stake in Auna. See *Significant Developments during 2002 Disposition and Acquisition of Certain Equity Investments*.

## **South America**

All the activities conducted by the Latin American subsidiaries (whether controlled by Telecom Italia International or by TIM International) are currently coordinated by Latin America Operations (LAO) and are developed in accordance with the Telecom Italia Group's overall strategic plan. LAO reports to the International Steering Committee, composed of the Chairman and CEO. Permanent invitations to the Steering Committee meetings are extended to those in charge of the Domestic Wireline and Mobile Business Units. Beginning February 2003, Latin America Operations reports directly to the CEO Carlo Buora for Wireline telecommunication, and to Marco De Benedetti for Mobile telecommunication.



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As of December 31, 2002, LAO was organized as follows:

A description of the companies providing mobile services (TIM Brasil group, TIM Perù and Corporacion Digitel) is provided under Mobile Companies Controlled by TIM International Latin America .

### **International Strategy in Latin America**

The Telecom Italia Group s international strategy in Latin America has the following objectives:

- consolidate the Telecom Italia Group s presence in mobile and in the fixed-mobile integrated business;
- maximize return on investments and focus on sustainable growth;
- invest in high-growth market segments, such as wireless, data and broadband, through the creation of a common GSM platform and through the launch of VAS services based on state-of-the-art technologies that provide synergies to the Telecom Italia Group;
- enhance the value of shareholdings, maximizing efficiency and cash cost control particularly on legacy services;
- strengthen its role of strategic partner in the current operations by increasing the transfer of the Telecom Italia Group s technological expertise and marketing know-how; and
- divest investments in the existing Latin American portfolio where the Telecom Italia Group does not have control, in non-core businesses or divest minority participations in non-strategic geographical markets.

### *Significant Developments During 2002*

During 2002 the Telecom Italia Group, through its wholly owned subsidiary Telecom Italia International N.V. (the primary vehicle by which the Telecom Italia Group holds its international wireline and integrated mobile/fixed-line investments), continued pursuing its targets, supporting the growth of its majority owned subsidiaries and focusing on rationalization of other investments.

The following key transactions were finalized during 2002:

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- Telecom Italia Group sold part of its stake in Solpart Participacoes S.A. (indirect parent company of Brasil Telecom) to other shareholders reducing the Telecom Italia Group's stake in ordinary share capital from 37.29% to 19.0%. As a result, the regulatory restrictions preventing the TIM group from launching a mobile telephone service based on GSM technology throughout Brazil were removed. Within the framework of this transaction, both parties have an option which can be exercised in the event certain conditions are met that will restore the previous shareholder positions; and
- the Telecom Italia Group, as a result of the Nortel Inversora Shareholders' Meeting on April 25 and September 13, 2002 which gave voting rights in the shareholders' meeting to the preferred shareholders and the right to appoint their own representative on the Board of Directors, has reduced its voting percentage in the shareholders' meeting to 33.89%. The percentage holding of ordinary share capital has remained unchanged at 50%, as well as the economic rights thereto.

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Finally, as part of the plan to restructure debt, on February 12, 2003, Telecom Argentina and its subsidiaries Telecom Personal S.A. and Publicom S.A. announced the intention to launch an offer for a portion of its financial debt for cash and to effect a partial payment of the interest due. Having obtained any necessary authorizations, the offer started on April 16, 2003 and represents the beginning of the process for restructuring the Telecom Argentina group's debt obligations.

In June 2003, Telecom Argentina and its subsidiaries Telecom Personal S.A. and Publicom S.A., pursuant to a tender offer, repurchased U.S.\$292 million principal amount of their financial debt obligations at a price of U.S.\$160.6 million (55% of the face value).

## **Latin America Companies Controlled by Telecom Italia International**

### ***Chile***

Telecom Italia International has a 54.76% stake in Entel Chile. Entel Chile is the largest long distance international telecommunications operator in Chile and the second largest national telecommunications operator. Through its mobile and two PCS licenses, Entel Chile is the largest wireless telecommunications operator with nationwide coverage with almost 2.3 million subscribers at the end of 2002 (a 18% increase compared to 2001).

Despite weaker demand and the strong Chilean Peso's volatility, the Entel Chile group reported consolidated operating revenues of approximately 1,223 million in 2002 (an increase of 12.3% in local currency compared to 2001), gross operating profit of 381 million in 2002 (an increase of 17% in local currency compared to 2001) and an operating income of 151 million in 2002 (an increase of 37.5% in local currency compared to 2001, due to the increase of wireless operations). Entel Chile has been fully consolidated with Telecom Italia since the first quarter of 2001.

In 2002, the Company focused its efforts on reducing costs and capital expenditures levels, implying lowered funding requirements and increased its cash generation, and on growing to profitable mobile business (the wireless subsidiary has improved its Return on Sales (ROS) level from 18% in 2001 to 25% in 2002).

During 2002 Entel Chile launched a WLL (Wireless Local Loop) business in the Chilean broadband market and long distance operations in Peru and Venezuela. At the end of August, Entel Chile reduced staff levels (468 employees of both staff and outsourced workers were laid off) which has affected the 2002 results with a provision of approximately 10 million.

In September 2002, Entel Chile group restructured its debt through the refinancing of a US\$ 300 million syndicated loan at a rate of Libor + 0.875%, which is lower than the 1.25% implicit spread of the older loan. The loan has a 5 year term with a 3 year grace period.

### ***Bolivia***

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Telecom Italia International holds indirectly a 50% stake in Entel Bolivia, the Bolivian national long distance and international telephony operator, which it acquired in 1995. Entel Bolivia is a leader in the mobile market and owns a license to provide CATV services. Local regulations established that until November 2001, when liberalization of the market began, long distance telecommunication services would be provided by Entel Bolivia under a monopoly system. In 2001 complete deregulation of the telecommunication market took place, carrier selection was introduced and local access, previously in the exclusive hands of cooperatives, was liberalized.

Due to the increasing competition in the wireline segment (6 long-distance operators), together with the strong impact attributable to the volatility of the Bolivian currency, operating revenues were approximately 186 million in 2002, a decrease of 4.5% in local currency compared to 2001. Mobile growth partially compensated for a decline in wireline revenues. The competition resulted in lower profitability and gross operating profit was 72 million in 2002 (down 10.3% in local currency compared to 2001), while operating income was 2 million in 2002 (a decrease of 83.5% in local currency compared to 2001).

As of December 31, 2002, Entel Bolivia had 462,000 mobile customers, up 26% compared to the end of 2001, reaching a market share of 52% (45% in 2001). Subscriber fixed-lines were 50,000 at December 31, 2002, a 6% decrease compared to the end of 2001. Internet clients were approximately 15,000 as of December 31, 2002 (an increase of 23% compared to the end of 2001).

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### **Latin America Affiliated Companies**

#### ***Nortel Inversora***

The current interest of 50% the Telecom Italia Group holds in the Nortel ordinary share capital is the result of an initial share of 32.5% acquired in 1990 for approximately U.S.\$33 million and an additional share of 17.5% acquired in August 1999 for approximately U.S.\$265 million. Nortel currently owns 54.74% of Telecom Argentina, which until October 1999 operated the telecommunications network in the northern part of Argentina (including Buenos Aires) among others, fixed-line and mobile telecommunications operations, international services, data transmission services, value-added services and directories publishing. Since October 1999, the Argentinean market has been progressively liberalized, and as a consequence Telecom Argentina has expanded its operations to the entire national territory. In June 1999, Telecom Argentina also expanded its mobile telecommunications services, by acquiring new licenses in the PCS technology, for a total amount of U.S.\$327 million.

At the end of 2002, Telecom Argentina had accumulated 3.3 million fixed-line network subscribers corresponding to a 45% market share. Its subsidiary Telecom Personal (including Nucleo) which is a leading company in the wireless segment, accumulated more than 2.7 million mobile customers (80% with prepaid cards), with a market share of 33% in Argentina. In the Internet sector, there were approximately 177,000 subscribers (147,000 access clients and 30,000 Broad Band clients with a market share of 19%).

As a result of the financial crisis in Argentina, Telecom Argentina has seen a decline in the number of fixed lines and a migration from postpaid lines to prepaid lines in the mobile segment. There has also been a strong traffic fall in both mobile and fixed telephony. The situation can largely be attributed to the economic crisis the country is presently undergoing.

Argentina's economy is in its fourth straight year of recession. In January 2002, the Argentine government removed the peg of the Argentine peso to the U.S.\$, resulting in a significant devaluation of the peso against the U.S.\$ and against other major currencies. The Argentine government has also defaulted on the payment of its debt obligations. Whether companies doing business in Argentina will default on their obligations depends upon their own financial condition, and, in the case of U.S.\$ obligations, continued access to the foreign exchange markets. The default by the Argentine government and its decision to devalue the currency have resulted in considerable uncertainty about the government's political stability, its management of the economy and the current exchange rate regime. Economic activity declined 10.9% in 2002. The GDP per capita decreased from U.S.\$7,458 to U.S.\$ 2,700.

In February 2002, Telecom Argentina hired Morgan Stanley as financial advisor in order to explore the possibility of restructuring and consequently reducing its debt. The Company declared its financial default on April 2, 2002, and in 2002 has not made payments on its debt since then. In 2002, payment of interest was also frozen starting from June 24, 2002. Currently Telecom Argentina is working on the restructuring of the debt. In 2002, Telecom Argentina continued to implement a cost and investment optimization process in order to improve cash flow. The use of this strategy is expected to go on in future years.

In 2002, the Telecom Argentina group recorded consolidated operating revenues of Argentine Pesos 3,983 million ( 1,127 million). The gross operating profit was Argentine Pesos 2,417 million ( 684 million) and the operating income was Argentine Pesos 2 million ( 1 million).

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On April 22 and April 24, 2002 the Board of Telecom Internet and Telecom Argentina approved the merger of Telecom Internet with Telecom Argentina.



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### **Internet and Media**

The Internet and Media Business Unit consists of the SEAT group. As of December 31, 2002 the Business Unit was organized as follows:

The Telecom Italia Group operates in the Internet and publishing services sector through Seat Pagine Gialle S.p.A. Telecom Italia acquired control of Seat Pagine Gialle S.p.A. in 2000 pursuant to the SEAT/TIN.IT transaction. As of December 31, 2002 Telecom Italia holds, directly and indirectly, approximately 55% of Seat's ordinary share capital.

Through the combination of SEAT and Tin.it in 2000 and a number of key acquisitions in 2000 and 2001 (Telegate, Consodata, Netcreations, Holding Media e Comunicazione, the former Cecchi Gori Communications), SEAT has evolved into a leading multiplatform directory and business information provider, targeting small and medium-sized enterprises.

### ***SEAT Spin-off***

On April 11, 2003, the Board of Directors of SEAT approved the proposed proportional spin-off of substantially all of the Directories, Directory Assistance and Business Information business segments into a newly incorporated company ( *New SEAT* ). The spin-off plan was unanimously approved by SEAT's Board of Directors on April 11, 2003, and was approved by the SEAT extraordinary shareholders' meeting held on May 9, 2003.

The spin-off plan contemplates the creation of two independent companies, each focused on its core businesses. It is SEAT's management's view that SEAT operates in two broad market sectors that have increasingly developed separate and distinct characteristics in terms of strategy, operations and competitive landscape. The first sector is that of targeted advertising and telephone services, in which SEAT operates through its Directories, Directory Assistance and Business Information segments, providing answers to queries via printed, online and telephone products and services.

The second sector is that of traditional advertising and the Internet, in which SEAT operates through its Internet, TV and other business segments, primarily providing access and content services. Both sectors present interesting development prospects (including broadband access and digital TV).

The strategic objective of the spin-off plan is to allow SEAT's businesses in each of the two sectors to more rapidly respond to market developments and exploit market opportunities, with a more focused management and a resource allocation consistent with the development prospects of each business line.

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The spin-off plan provides for the transfer to New SEAT of the following companies within the Directories, Directory Assistance and Business Information business segments of SEAT:

Directories:	Directory Italia Seat Pagine Gialle S.p.A. division, Annuari Italiani S.p.A., Euredit S.A., TDL group, Euro Directory S.A.
Directories Assistance:	Directories Assistance Seat Pagine Gialle division, Telegate group, Telegate Holding GmbH, IMR S.r.l.
Business Information:	Consodata S.A, Consodata group Ltd (including Netcreations Inc., Pan-Adress).

SEAT's other companies and business segments will remain in SEAT, which, as noted above, will be known as Telecom Italia Media.

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Effective as of the date of the Spin-off, the beneficiary company will be called SEAT Pagine Gialle S.p.A. The spin-off, subject to certain conditions of Italian law, is expected to become effective at the end of July 2003.

### ***Potential Sale of Telecom Italia's stake in New SEAT***

On effectiveness of the spin-off, Telecom Italia will retain its current interest in the share capital of New SEAT and Telecom Italia Media.

On June 10, 2003 Telecom Italia and a consortium of investors formed by BC Partners, CVC Capital Partners, Investitori Associati and Permira entered into a sale and purchase agreement for the sale of approximately 61.5% of the share capital of New SEAT which will be received by the Telecom Italia Group after completion of the spin-off transaction creating New SEAT (including the shares resulting from the expected early exercise of the J.P.Morgan Chase put option). The parties agreed on a sale price of 0.598 per New SEAT ordinary share, representing an enterprise value of approximately 5.65 billion.

The completion of the sale will be subject to the proportional spin-off becoming effective, the admission to listing of New SEAT, that is expected to occur by the beginning of August, and the approval of the relevant anti-trust authorities. Telecom Italia will receive approximately 3.03 billion for its stake. The buyers will also assume the estimated 708 million of debt of New SEAT at the closing.

The transaction will allow New Telecom Italia to reduce its net financial debt by approximately 3.74 billion.

See also Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data .

### ***Business***

The Internet and Media Business Unit is responsible for the whole chain of value in the media sector, satisfying the public's need for information and entertainment, and the communication requirements of the business sector, through the production of traditional products on paper, and innovative products through the media of Internet, the telephone and television.

The Telecom Italia Group is a leader in the field of telephone publishing and is the second largest telephone publishing group in the United Kingdom. Furthermore, in Italy, SEAT Pagine Gialle is the top company in the marketing of services and products for the office and is present in the television sector with La7 and MTV Italia.

SEAT's business activities are currently organized in six business segments:

- directories;
- directory assistance;
- Internet;
- office products & services;
- business information; and
- television and other.

In the Internet sector, SEAT Pagine Gialle promotes the development of all internet services for residential customers and for small and medium-size companies: access, portals and web services. In Directory Assistance, the group handles the 89.24.24 Pronto Pagine Gialle 24-hours service in Italy.

#### *Directories and Directory Assistance*

SEAT's principal revenue generating activity is the sale of advertising in the telephone directory products that it publishes. SEAT's principal publishing products are business-to-business Yellow Page directories (*PagineGialle® Lavoro*), business-to-consumer Yellow Page directories (*PagineGialle® Casa*) and the White Pages (*PagineBianche®*).

SEAT also publishes business-to-business Yellow Page directories with regional coverage (*Pagine Gialle Professional*) and national subscriber-only business-to-business directories, segmented by industry (*Annuario SEAT PG*), provides an operator-assisted talking Yellow Pages directory service accessible 24 hours a day, 365

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days a year (*Pronto Pagine Gialle*) and publishes city maps and information about local public services (*Tutto Città*) to be inserted into certain editions of the Yellow Pages.

SEAT also provides on-line directory Yellow Pages service (*PagineGialle.it*) and White Pages service (*PagineBianche.it*).

In October 2002, SEAT launched a new edition of *PagineBianche*<sup>®</sup> that replaces the traditional directories and contains the telephone numbers of the other operators' customers.

SEAT also participates in the European telephone directory advertising and services market through shareholdings in:

- TDL Infomedia, which is the second largest directories publisher in the United Kingdom, through Thomson Local Directories;
- EURÉDIT, a French company, which publishes and distributes Europages; and
- Telegate, the second largest operator of directory assistance services and vocal portal services in Germany, with operations in Italy, Spain and the United States became part of the directory assistance business unit.

## ***Internet***

SEAT offers a full range of Internet services, consisting of:

- Internet access services;
- portal services;
- on-line advertising services; and
- web services.

*Internet Access Services.* Through Tin.it, SEAT provides Internet access services to residential, SOHO and SME Internet users. The small office/home office, or SOHO, market consists of businesses that use telephone lines to connect to the Internet, as opposed to dedicated lines, and is made up of small businesses, generally with one or two employees, and businesses conducted out of the home. The small- and medium-sized enterprise, or SME, market consists of businesses having between 3 and 50 employees.

Tin.it offers two principal access subscription plans:

- free access (tin.it Free); and
- premium access (dial-up, ISDN and ADSL access).

At December 31, 2002, Tin.it's subscriber base amounted to approximately 6.6 million registered users and 2.2 million active users (defined as users who connect to the Internet at least once every 45 days).

<u>Million users</u>	<u>2002</u>	<u>2001</u>
Registered users	6.6	5.0
Active users	2.2	1.8

During 2002, SEAT re-launched its Tin.it brand and completely reviewed the range of products, introducing, in particular, an ADSL connection based on usage. This innovation marked an increase in the customer base (Alice, ADSL of Telecom Italia, +Tin.it).

*Portal Services.* SEAT provides portal services through Matrix, which operates the Virgilio portal.

*Virgilio* is a leading Italian portal, with approximately 5.3 billion web page views in 2002 and approximately 3.9 billion web page views for 2001, that caters to the Italian speaking community on the Internet. Management believes that *Virgilio*, which has been on-line since July 1996, is one of the most complete Italian portals. It contains a search engine and a websites index, and it centralizes services in various interest areas such as stock quotes, weather forecasts, TV guides, games, chats advertisements and shopping. In order to simplify the use of information, *Virgilio* offers personalized, interactive services that correspond to the requirements of individual customers.

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In 2002, SEAT launched the pay version (Virgilio Più) on its Virgilio portal with services and exclusives contents for customers. The continued innovation of products is one of the most important basis for future evolution of Virgilio and it represented the primary focus for investment during 2002.

In particular, SEAT revised the range of text products proposed by the Virgilio portal. In detail, PG Net product, launched in July 2002, generated a more effective use of its search engine by offering outgoing priority and listing on the results of searches. In only a few months, almost 33 thousand on-line customers (22% of total clients) subscribed to this new product.

*On-line Advertising Services.* Matrix's division *Active Advertising* is a leading on-line advertising agency in Italy and has arrangements with approximately 20 Italian websites to provide advertising services.

*Web Services.* SEAT provides web services through Tin.It and Matrix's division Matrix Communication.

Tin.It provides different packages, which enable SME and SOHO customers to establish a presence on the Internet or provide e-commerce services. In particular, Tin.It's Easy and Village packages provide SME and SOHO customers with solutions to build an Internet site, to advertise the site with a pre-assembled banner advertising campaign and to establish and manage e-commerce capabilities on the Internet.

Matrix Communication provides a wide range of web services, including communication consultancy, website construction and maintenance, housing and hosting services and technical assistance.

### ***Office Products & Services and Business Information.***

Through SEAT's control of Gruppo Buffetti S.p.A. (Buffetti), SEAT is a leading distributor of office products and business solutions in Italy. Through certain controlled companies (Consodata and Databank) it also offers direct marketing and database services.

During 2002, SEAT repositioned towards products with greater added value, with the introduction of print on demand and the digital signature and the development of software and the ADSL subscription plan.

### ***Television and other.***

- SEAT provides television services through Holding Media e Comunicazione S.p.A. which holds the broadcasting licenses for La7 and MTV Italia.

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La7 is providing news information on a 24-hour basis, and is currently interacting with the Internet Services business segment in order to provide on-line news information through the use of video-streaming technology. La7 started broadcasting under the new format on March 18, 2002.

MTV Italia is a television channel providing music programs on a 24-hour basis. The brand MTV is a well known brand in the music industry and in the television network business. MTV Italia started broadcasting its programs on May 1, 2001.

In 2002, the main activities were:

- repositioning of the television broadcasting channel La7 with new programming and programs starting March 2002, and significant development of MTV Italia;
  - consolidation of geographical coverage and the percentage of the population served by the signal distribution network ;
  - agreement with Cairo Communication to collect advertising business with a guaranteed minimum on channel La7 with effect from 2003; and
  - collaboration with the Virgilio portal for news.
- 
- Through Giallo Professional Publishing, SEAT has interests in companies publishing specialized information in the hotel, restaurant and entertainment industry, in electronics, information technology and audiovisual communication and in ceramics, architecture and urban design sectors.

### **Information Technology Market**

The Information Technology Market (ITM) Business Unit was created in early 2002 with the aim of focusing the activities previously concentrated in the Information Technology Services Business Unit by type of



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customer. The ITM Business Unit includes the Finsiel group and is responsible for the information technology activities of the Telecom Italia Group for local and central government entities, as well as for banks, insurance companies, manufacturers and service companies. This Business Unit is also the supplier of system integration and IT consulting to the Italian government and local government authorities. As of December 31, 2002, ITM was organized as follows:

In order to reflect the new strategic guidelines, the Business Unit's internal structure has been subdivided in accordance with the following functions and provides services in the field of IT and related activities, including the design, management and maintenance of software and information products and services for each-area:

### **Main Subsidiaries**

#### **Finsiel S.p.A.**

Finsiel is held 77.92% by the Company, 14.38% by the Bank of Italy and 7.70% by other shareholders.

Finsiel provides services in the field of information technology and related activities, including services for local and central government entities. In addition, Finsiel provides management consulting and services related to company automation. Finsiel is the leading Italian firm in the systems integration and information technology consulting market, and one of the largest European companies of this type. Finsiel is the principal supplier of systems integration and information technology consulting to the Italian government and local government authorities, typically under long term exclusive arrangements.

During 2002, Finsiel increasingly focused new offerings of customized web-based solutions.

#### **Banksiel S.p.A.**

Banksiel, held 55.5% by Finsiel, is part of the Finsiel group's Finance sector operations. Italy's top banking industry IT player, in 2002, gained one of the first important customers in the insurance field, the Cattolica Assicurazioni group.

#### **Insiel S.p.A.**

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Insiel, held 52% by Finsiel S.p.A., provides services in the field of information technology and related activities for local government entities. During 2002, Insiel acquired new contracts in government and healthcare.

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### **Tele Sistemi Ferroviari S.p.A. (TSF)**

TSF, held 61% by Finsiel, is the ICT partner for the Ferrovie dello Stato group companies, for which it designs and develops both systems for passenger and freight transport, management and administration systems. TSF also offers e-ticketing and electronic fleet monitoring systems to local transport companies.

### **Information Technology Group**

The Information Technology Group ( ITG ) Operating Activity is responsible for the information technology activities of the Telecom Italia Group and covers the entire range of information services. It is oriented towards increasing efficiency and quality of service activities directed at all the Business Units of the Telecom Italia Group.

The Operating Activity was established in early 2002, completing a plan to integrate various companies.

As of December 31, 2002, IT Telecom S.p.A., the main company of the ITG Operating Activity, was organized as follows:

In June 2002, Telecom Italia contributed its shares in Netsiel S.p.A. (68.65%), Telesoft S.p.A. (60%), Sodalìa S.p.A. (100%) and Netikos S.p.A. (25%) to IT Telecom S.p.A. (a wholly owned subsidiary of the Company). IT Telecom also purchased the remaining stake of Netsiel S.p.A. (31.35%), Telesoft S.p.A. (40%) and Netikos S.p.A. (75%) from Finsiel S.p.A., through a capital contribution received from the Company.

On June 27, 2002, IT Telecom S.p.A. (100% owned by Telecom Italia) bought Olivetti's 50% stake in Webegg S.p.A. The price paid by IT Telecom was 57.5 million and was agreed on the basis of independent evaluations carried out by KPMG Corporate Finance for Telecom Italia and IT Telecom and by UBM for Olivetti. Following this operation, Webegg is owned by IT Telecom (69.8%) and Finsiel (30.2%).

In December 2002, Netsiel, Saritel, Sodalìa and Telesoft, 100% owned by IT Telecom S.p.A., were merged into IT Telecom. The merger was carried out to obtain more efficiency and effectiveness in the information technology services rendered to the Telecom Italia Group and to focus consistently on innovation, services and products.

As of December 31, 2002, the Information Technology Group Operating Activity also included the Netikos group, the Webegg group and the TILAB group (100% owned by the Company) and was organized as follows:

The Netikos group was created by the Company to meet the increasing needs of Internet and wireless services solutions, as one-stop-shop partner to different corporations and institutions.

The Webegg group is focused on spreading the use of internet by commercial entities. It is mainly a supplier of CRM systems and a software factory for several different customers, such as banks and insurance companies.

TILab was established in March 2001 to combine the Telecom Italia Group's venture capital and innovation activities, the *Centro Studi e Laboratori Telecomunicazioni S.p.A.* (or CSELT) research laboratories in Turin and the Future Centre in Venice and the Consumer Lab in Rome. The Technology Observatory in San Francisco collaborates, on an exclusive basis, with TILab. Telecom Italia Lab was formed to enhance the Telecom Italia Group's competitive position, promoting and managing innovation and by identifying and developing business opportunities. Telecom Italia Lab's strongest assets are its rich and consolidated R&D activities, its ability to

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promote corporate venture capital activities in emerging technology and to identify internal research areas through the development of new ideas.

Pursuant to the 2002 Reorganization, the venture capital activities of TILab became part of a separate venture capital central function and TILab became part of the Information Technology Group.

The Group spent 269 million, 138 million and 121 million on research and development in 2000, 2001 and 2002 respectively. The Group also receives grants from research and development national and international programs.

The purposes of the Group's research and development activities are mainly the development of innovative services and applications, to meet the increasing demand from the market. Some R&D activities are also devoted to support the manufacturing sector outside the Group.

Development of innovative services is pursued through both the introduction in the network infrastructure of new platforms and systems that enable the provision of a wide range of services, and the use of state-of-the-art information and communications technologies for the development of highly innovative applications, tested on selected customers' sites. Such activities are mainly carried out by TILab, the corporate research center of the Group. TILab performs both strategic research and research specifically requested by Group Companies.

The following main operations and developments that occurred in 2002 were:

- acquisition of the minority associates' share of Loquendo;
- the development of an Interactive TV service;
- the support of the evolution on the XDSL services; and
- restructuring of the partnership with SVP FUND, realized through the departure of the USA Ramius Capital group and reduction of the Capital Committed.

The management activity, focused in the field of research and development with collaborative projects together with Pirelli Lab, has involved:

- the study of enabling techniques in the mobile and fixed sectors;
- the definition of network design, planning and management tools;
- the definition and testing of local access techniques;

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- the development of solutions, products and architectures suitable for silicon integration;
- the development of modular products, obtained as software and capable of being turned into firmware for specific solutions or for hardware components; and
- the implementation of the interactive TV service.

In 2002, TILab's basic research involved different sectors within both fixed and mobile telecommunications, with reference to services, infrastructures and technology.

For Internet and mobile applications, it was oriented towards integrated application and technological solutions for the multimedia offering, to the definition of content access modes and management of broadband customers, to the implementation and assessment of advanced solutions for the user environment (terminals, home wiring, application platforms).

Activities in the field of switching and networking were aimed at developing IP networks, developing Content Delivery Network architectures for an efficient distribution of multimedia contents and defining IPv6 introduction strategies, also assessing their impact on networks and services. Particular attention was also devoted to Wireless LAN and to the corporate solutions for the PABXless Company. Within this context, new telephony solutions were also developed, using innovative solutions for packet network telephony.

Within the mobile network field, techniques for the efficient management of radio resources were developed, along with tools for assessing Quality of Service in different network and traffic situations. Research in the network intelligence field, which, though it does have implications on the fixed network as well, is currently more closely linked with the evolution of the mobile network, was oriented to the study and definition of the set of functionalities and architectures that constitute the enabling middleware for the new services.

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Research on network infrastructures involved the urban and transport network, experimenting with new optical network architectures with automatic switching, as well as the access network, proposing innovative solutions based on copper and fiber optics connections. New operational and strategic planning tools were also developed for fixed networks, to allow the operator to carry out technical/economic evaluations of the various network development options.

As a result of the new policy within the Telecom Italia Group to exploit intellectual property, the research activities described above led, in 2002, to the filing of 45 patent applications, up about 13% over the previous year.

## **Other Telecom Italia Group Activities**

### ***Real Estate and General Services***

The Real Estate and General Services Function provided an interface for the various corporate Functions/Business Units to satisfy the needs of the real estate and general services area. In particular, the activities performed by the Real Estate and General Services Function concerned planning of sites and locations of the Telecom Italia Group, the design and construction of civil works, the maintenance of the properties and technological plant, in addition to providing real estate and general services.

This Function operated through the internal structures of Telecom Italia mainly for the activities conducted on behalf of the Telecom Italia Business Units/Functions and through the subsidiary Emsa Servizi S.p.A., which, for the most part, geared its activities towards the other companies in the Telecom Italia Group.

In February 2003, the Real Estate and General Services Operating Activity was disbanded; its activities and resources were reassigned to other corporate functions of the Telecom Italia Group.

### ***Foreign Holdings Corporate Function***

In May 2002, the companies and business segments of the Telecom Italia Group which formerly reported to the International Operations (IOP) Operating Activity were transferred to Domestic Wireline and the Foreign Holdings Corporate Function, while all the companies based in Latin America are now coordinated by Latin America Operations (LAO).

The corporate function Foreign Holdings, operating under the corporate control structure, is responsible for the companies Telecom Italia International, 9Telecom group, the BBNed group, the Telekom Austria group, Telekom Srbija, Etec S.A., Netco Redes and the residual segment of the former IOP.

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Foreign Holdings Corporate Function reports to the CEO, Mr. Carlo Buora, in order to strengthen the relationship with other Central Functions and, in particular, with Mergers & Acquisitions with whom Foreign Holdings Corporate Function will evaluate opportunities to reorganize or restructure participations held by Telecom Italia operating in the fixed and integrated fixed-mobile telecommunication business.

During the course of 2002 the Telecom Italia Group, through the wholly owned company Telecom Italia International N.V., continued to pursue its targets under the Business Plan, focusing on reorganizing and rationalizing its international presence. The principal corporate transactions which took place in 2002 were the following:

- on August 1, 2002, the Telecom Italia Group finalized the sale of the investment in Auna and Multimedia Cable to Endesa, Union Fenosa and Banco Santander Central Hispano;
- on August 26, 2002, the French group 9Telecom was sold to LDCOM with the simultaneous purchase on the part of Telecom Italia International of a 7.22% stake in LDCOM. At December 31, 2002, the stake was reduced to 6.99% after the company effected a reserved capital increase in November;
- Telecom Italia International, following the agreement reached in June with OIAG, in the month of November, sold 75,000,000 Telekom Austria shares at a price of euro 7.45 per share, reducing its investment from 29.78% to 14.78%. Under such agreement, the sale of the remaining part of the shares held by the Telecom Italia Group can be initiated as from January 1, 2004;
- on December 28, 2002, the Telecom Italia Group announced that it had reached an agreement for the sale of its 29% stake in Telekom Srbija to PTT Srbija (the local state owned partner). The agreement for the sale was finalized on February 20, 2003 and the closing is scheduled to take place by the end of



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June. PTT will pay 195 million, 120 million of which will be paid by June 2003. The remaining amount will be paid in six semi-annual installments beginning January 2006. The shares disposed of shall be placed in escrow with an international bank until payment of the consideration is complete.

### **The Netherlands**

BBNed, established in July 2000, is 97.56% owned by Telecom Italia International. BBNed is an alternative carrier in the Netherlands, providing broadband local access to ISPs and business clients. Its commercial operations are based on unbundled local loop and co-locations services acquired from the local incumbent operator. During 2002 the company finalized the roll out of a nationwide DSL network with 300 points of presence, and experienced a large growth in its portfolio and revenues. As of December 31, 2002 BBNed had 15,800 ADSL lines and 11.7 million of revenues, compared to 462 lines and 0.6 million revenues in 2001. In 2002 BBNed had a gross operating loss and an operating loss of 14.9 million and 21.7 million, respectively.

### **Cuba**

Telecom Italia International has a 29.29% interest in Empresa Nacional de Telecomunicaciones de Cuba S.A. ( ETEC S.A. ), the exclusive operator for national and international wire telecommunications services in Cuba. In order to fulfill the long term objectives related to its license, ETEC S.A. increased the number of lines from 555,000 in 2001 to 646,000 in 2002 (an increase of 16%), while the digitalization rate rose to 76% from 69% reached in 2001. Further development of telecommunication infrastructure includes the near completed fiber optic national backbone, and capacity doubling of the ATM/Frame Relay Network. In 2002, ETEC S.A. focused on Internet and data transmission commercial development, achieving a 35% growth compared to revenues of 2001 (from approximately U.S.\$10 million in 2001 to U.S.\$13.4 million in 2002). In 2002, total operating revenues were U.S.\$294 million compared with U.S.\$281 million in 2001, an increase of 4.6%. Gross Operating profit increased from U.S.\$185 million in 2001 to U.S.\$202 million in 2002 (an increase of 9.2%) and operating income was U.S.\$139 million compared with U.S.\$137 million in 2001 (an increase of 1.5%). Net income was U.S.\$132 million in 2002 compared to U.S.\$137 million in 2001 (a decrease of 3.6%).

### ***Telespazio***

The Satellite Services Business Unit (consisting of the Telespazio group, which was sold in November 2002, and Telecom Italia's Satellite Telecommunications business segment) was responsible for developing satellite communication systems for phone and data, radio and television broadcasting and earth-observation.

Telespazio (a wholly owned subsidiary of Telecom Italia) designed, developed and managed satellite telecommunications systems for a variety of commercial uses and managed such systems for the Telecom Italia Group, including the public network utilized by Telecom Italia.

### **Other Subsidiaries**

#### **Telecom Italia Finance S.A.**

Under the reorganization of the Telecom Italia Group companies in Luxembourg, in October 2002, Sogerim S.A. was absorbed by its sole shareholder Softe S.A., and Huit II was absorbed by its sole shareholder TI Media S.A. On December 16, 2002, Softe S.A. incorporated TI Media S.A. and the new company was merged with TI WEB S.A., which, on the same date, changed its name to Telecom Italia Finance. All the rights and obligations of the merged companies are vested in Telecom Italia Finance.

Following the merger, TI Finance, a subsidiary of Telecom Italia, took over responsibility of the international treasury function operating in support of the financial needs of the foreign companies of the Telecom Italia Group, a task previously carried out by Softe.

The company ended the year 2002 with a loss of 85 million, due principally to write-downs of 80 million. The write-downs specifically refer to a 24 million mark-to-market adjustment of third-party bonds in the portfolio, a 56 million mark-to-market adjustment of investments and the adjustment of the investment in GLB Serviços Interativos S.A. (Globo.com) to the sale price.

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### **Saiat S.p.A.**

The company, held 100% by Telecom Italia, carried out support services for the Telecom Italia Group, in the financial area and in investment management.

In 2002, in particular, the company continued to provide services under the program for the securitization of the Telecom Italia Group trade accounts receivable. Under the Tiglio Project, the company sold its interest (99.42%) in TELIMM to MSMC Immobiliare and, as part of the reorganization of the Luxembourg companies of the Telecom Italia Group, sold its stakes in Softe (0.01%) and Sogerim (0.05%).

### **T.I. Learning Services S.p.A.**

The company operates in the training sector with the aim of achieving a leadership position in the market of learning and knowledge management. Due to the technologies at its disposal and the experience gained in this field, the company is able to design complex and customized training systems that can be used by large numbers of people. Its product range includes more than 1,000 courses for continuous training, particularly on topics associated with ICT and Business Management.

At December 31, 2002, the conferral of the Training business segment of the Telecom Italia Group was completed, concluding the project to rationalize the companies of the Telecom Italia Group operating in the field of traditional and web-based training approved by the Board of Directors of Telecom Italia on December 18, 2001.

### **Other Investments**

#### ***Multimedia Services***

Stream, a wholly owned subsidiary of Telecom Italia, was formed in 1993 with the objective of establishing and promoting a wide range of multimedia services and applications for the Italian and other international markets.

On May 29, 1999, Telecom Italia, News Corporation, Cecchi Gori group and SDS (an Italian company that sells broadcast rights for the exploitation of Italian football games) signed an agreement to develop the second digital TV platform, pursuant to a memorandum of understanding signed by the parties on April 27, 1999. Following such agreement, on June 7, 1999 Telecom Italia sold 65% of Stream's shares to News Corporation, Cecchi Gori group and SDS for a total of 67 million. On May 16, 1999, SDS and Stream signed an agreement for the cable broadcast by Stream of sports events for the 1999-2000, 2000-2001 and 2001-2002 seasons. Stream has an option to renew the agreement for an additional three-year term. Stream will pay SDS an annual fee of 124 million.

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On April 18, 2000, Telecom Italia and News Corp agreed to acquire the stakes owned by Cecchi Gori and SDS in Stream. Through the above mentioned transaction Telecom Italia and News Corp increased their respective stakes in Stream to 50%. The total cost to Telecom Italia and News Corp was approximately 196 million.

In 2000, Stream acquired broadcasting rights, for new television channels and programs and for Italian and European soccer championships. Interactive and Internet applications were developed and in December 2000 an e-mail service via the television set was launched.

Stream's main activities in 2001 were:

- enhancing its offer packages by including the Calcio channel and three new theme-oriented channels (MT Channel, Stream Verde and Fox News);
- the acquisition of the broadcasting rights for all the football matches of the UEFA Champions League for seasons 2001-2002 and 2002-2003, and the rights of Bologna Calcio starting from the season 2001-2002; and
- creation of the single decoder a machine which allows the customer to purchase the subscription to both Stream and Stream's main competitor, Telepiu without installing two separate decoders.

On October 1, 2002, Telecom Italia signed an agreement with the News Corporation group ( News ), partner of Telecom Italia in Stream, and Vivendi Universal ( Vivendi ), current shareholder of Tele+, in order to allow Stream to purchase Tele+ and to subsequently create a single Italian pay-TV company on one platform.

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On April 30, 2003, following the approval by the competent authorities, the agreement with News Corporation announced in October 2002 was concluded. The new company arising from the integration between Stream and Tele+ has been named SKY ITALIA and Telecom Italia paid approximately 30 million for its share in the transaction. The company is held by Telecom Italia (19.9%) and News Corporation (80.1%).

## **Competition**

### *Domestic Fixed-line and International Telecommunications Services*

Pursuant to the Telecommunications Regulations, fixed-line public voice telephony services and the operation of the fixed-line network for the provision of such services was liberalized effective January 1, 1998. Until January 1, 1998, the Telecom Italia Group was the sole provider of fixed-line public voice telephony services, which consist of local, long distance and international telecommunications services, in Italy. In addition to fixed-line public voice telephony services, over the last five years there has been increasing liberalization of all other business areas in which the Telecom Italia Group operates. The operation of telecommunications infrastructure for the provision of all telecommunications services other than fixed-line public voice telephony services was opened to competition by the Telecommunications Regulations and the Maccanico Law during 1997. As a result of the complete liberalization of the market for telecommunications services, the Telecom Italia Group has faced increasingly significant competition since 1998 in the Italian domestic market, including competition from foreign telecommunications operators, particularly with respect to medium-sized and large business customers.

On December 31, 2002, the number of licenses for the provision of both fixed voice telephony service and building public telecommunications networks granted by the Ministry of Communications and the National Regulatory Authority was approximately 163. See Regulation .

The Telecom Italia Group faces increasing competition in international and domestic telecommunications services from, among others Albacom and Wind, TISCALI and Tele2. International telecommunications services and long distance domestic services as well as mobile telecommunications services are the areas of its business which are attracting substantial competition, based mainly on pricing.

Since the beginning of 2001 there has been increased competitive pressure with respect to local calls.

Although increased competition (including the need to adjust tariffs in response to competition) has affected the Telecom Italia Group's operations, management believes that it will be able to increase traffic and revenue from domestic telecommunications services as a result of (i) the introduction and continued growth of new telecommunications services (in particular, non-voice services), capitalizing on the Telecom Italia Group's advanced fixed network, (ii) growth in traffic due to increased Internet and data usage, (iii) increased interconnect traffic as a result of the growth of other mobile telecommunications operators and alternative telecommunications operators in Italy, (iv) continued growth of the Telecom Italia Group's mobile telecommunications businesses, (v) continued focus on customer service quality and marketing initiatives, and (vi) growth of the Italian economy. The Telecom Italia Group expects its revenue mix to continue to change for domestic fixed telecommunications due to regulatory and competitive reasons, and the new business opportunities driven by data and Internet services and broadband access. On voice services, the Telecom Italia Group will seek to implement a strategy based on greater efficiency for its internal structure and competitive offerings in its services portfolio aimed at reducing market share losses.

The legal framework for regulation in the telecommunications sector in Italy was completely transformed, as a consequence of the adoption of the Maccanico Law (effective August 1, 1997), the Presidential Decree No 318/97 (the Telecommunications Act ) (effective September 22,

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1997) and a series of Orders issued by the National Regulatory Authority (see Regulation ) which have been important to the Telecom Italia Group as it has faced increasing competition. To date the regulatory environment has been characterized by an intensive implementation process in order to complete liberalization. The trend continued in 2002 as additional steps were taken regarding tariff rebalancing, interconnection charges and the further signing of contracts to permit the unbundling of the local loop. See Regulation .

Although management has taken steps over the last several years in response to increased competition, as management expected it has lost fixed-line telephony services market share, in particular, with respect to domestic fixed long distance traffic (including fixed to mobile traffic) and outgoing fixed-line international traffic. In 2001, revenues from fixed-line telecommunications services were primarily affected by increased competition due to the development of carrier selection operators. Any decline in market share is expected to be

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offset in part by increased interconnection revenues as new competitors utilize Telecom Italia's domestic fixed-line network. Telecom Italia maintained its subscriber lines volume in 2002, as the unbundling of the local loop did not have a significant impact in this year.

With respect to domestic fixed traffic, as a result of increasing competition and to limit market share losses, in particular for long distance traffic, Telecom Italia introduced a number of innovative tariff and loyalty packages, (such as Teleonomy and Ricominicio da te ). About 24% of Telecom Italia Group's customer base has subscribed to a loyalty package.

The Telecom Italia Group's overall strategy is to focus on pricing, customer service and loyalty, and new offers to achieve customer retention in order to stop or slow further losses in market share. For the year ended December 2002, Telecom Italia was able to maintain its market share on total traffic volumes compared to December 2001.

In the domestic wireline telecommunications services market, the Telecom Italia Group is also continuing to pursue the new opportunities offered by the Internet (about 850,000 broadband access lines at the end of 2002) and data services that have offset, in part, the continuing decline in voice revenues.

The Telecom Italia Group believes it is in the best position to capture the potential benefits to be derived from E-value. The Telecom Italia Group intends to develop broadband networks in order to offer customers more bandwidth and convergent services.

### ***Mobile Telecommunications Services***

**The Italian Mobile Market.** The mobile telephone market continued to grow in Italy in 2002, but at a slower pace (7% in 2002 compared to 21% in 2001 and 40% in 2000). By December 31, 2002, the number of cellular phone lines reached 54.8 million, corresponding to a penetration rate of around 95% of the population.

After several year of strong growth, the demand growth curve has reached its inflexion point and the remaining potential market will be smaller than the one already acquired. In addition, the increasing saturation means that new customers to be acquired are likely to result in lower revenues per customer as has been the case in recent years. Competition for mobile telecommunications services remained strong in 2002. Consequently TIM's strategy has been focused on strengthening its leadership through innovative offers, CRM actions, quality performance, reinforcement of the core voice business and marketing VAS.

By the end of 2002, TIM was the leading Italian operator with a market share of 46.1%. Vodafone Omnitel had 34.6%, while Wind obtained 15.7%. The remainder (3.6%) was held by Blu, the fourth operator that was acquired by TIM, with its customers transferred to Wind.

### ***The Regulatory Framework***

In a scenario of increasing liberalization, the decisions taken by the National Regulatory Authority have greater impact. The most significant measures taken by the National Regulatory Authority were the designation of TIM and Omnitel as providers with considerable market strength in terms of cellular service, interconnection, the definition of new pricing scheduled for fixed-to-mobile communications, and the introduction of mobile number portability.

**TIM's role in the New Economy.** The opportunities offered by new technologies will accelerate the Information and Communication Technology (ICT) convergence process, linking the two currently fastest growing businesses: mobile communications and the Internet. TIM's strategic choice with respect to this convergence is the open model. TIM will not focus on Internet content but, rather, it will create alliances with the best content producers in order to provide its customers with the most innovative and the widest range of opportunities, while guaranteeing customers transaction security through TIM's authentication center. This is the context in which the strategic partnership with SEAT and agreement with YAHOO Europe in May 2000 operates.

**Traditional Business and Value Added Services.** The development of new advanced services will necessarily lead to changes in TIM's revenue structure. Value Added Services have and will continue to account for a rising proportion of revenues compared to those generated by voice traffic. TIM's growth will be increasingly dependent on its ability to develop data traffic and innovative services.



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Technological development in data transmission (GPRS, UMTS) and platforms (MMS) will generate new business models based on the capability of offering information, entertainment and advertising through mobile phones and of executing an increasing number of complete commercial and banking transactions.

This means the mobile economy will play a fundamental role in the new economy as a whole, and it is one of the segments with the highest potential growth rates and profitability.

TIM will seek out commercial synergies with web-oriented companies in the market, which will increasingly demand mobile services (information and media, on-line banking and trading, geographic positioning information system). A further objective will be the consummation of partnerships with prime content and service providers to develop m-commerce.

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### REGULATION

#### Overview

The legal framework for the regulation of the telecommunications sector in Italy has been extensively revised in recent years. This revision includes the liberalization of all telecommunications services including the provision of fixed-line public voice telephony services and the operation of networks to support the provision of such services, which were opened to competition as of January 1, 1998. Most importantly, the legal framework for regulation of the telecommunications sector in Italy has been completely transformed through the formation of the National Regulatory Authority in accordance with the Maccanico Law, which implemented the Framework Law, and the adoption of the Telecommunications Regulations by the Italian Government pursuant to Law No. 650 of December 23, 1996 ( Law 650 ) and Law No. 189 of July 1, 1997 ( Law 189 ) to implement a number of EU directives in the telecommunications sector, the general objective of which was to create a framework for a fully competitive telecommunications market. Effective August 1, 1997, the former Ministry of Posts and Telecommunications changed its name to the Ministry of Communications pursuant to the Maccanico Law. The Telecommunications Regulations (Presidential Decree no. 318 of September 19, 1997) became effective on October 7, 1997, and have been implemented by specific regulations. The Framework Law in general aimed at:

- ensuring the improvement of competition and efficiency in the telecommunications sector;
- establishing adequate quality standards;
- ensuring access to telecommunications services in a homogeneous manner throughout Italy;
- defining a clear and transparent tariff system based on the price cap method which, pursuant to the Maccanico Law, applied to the Telecom Italia Group's fixed public voice telephony services for up to two years starting on August 1, 1997. The National Regulatory Authority applied the price cap to Telecom Italia fixed public voice telephony from August 1, 1999 to December 31, 2002; and
- protecting consumers and users' interests.

The Telecommunications Regulations completed the liberalization of the provision of all telecommunications services and the operation of all telecommunications networks in Italy, effective from October 7, 1997, except for the provision of fixed public voice telephony services and the operation of telecommunications networks to support provision of such services, which were liberalized as of January 1, 1998. Restrictions on other operators providing telecommunications services, other than fixed-line public voice telephony services and the operation of telecommunications networks, had been lifted by several previous measures, including the National Telecommunications Plan referred to in a Ministerial Decree of April 6, 1990 (the NT Plan), Law Decree No. 55 of February 11, 1997 (satellite communications) and Law Decree No. 103 of March 17, 1995 ( Decree 103 ) and its implementing decrees and regulations (data communications, voice telecommunications for closed user groups and Value Added Services).

The Telecommunications Regulations contain provisions concerning:

- the granting of general authorizations or individual licenses to provide telecommunications services;

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- universal service obligations and the mechanism for funding the net cost of such obligations;
- access deficit contributions;
- special obligations imposed on operators having significant market power, including the determination of interconnection charges using principles of cost orientation;
- numbering, carrier selection and number portability;
- rights of way; and
- the essential requirements that must be complied with in the provision of services and when interconnecting with public telecommunications networks.

The National Regulatory Authority has established detailed regulations governing the telecommunications sector and has monitored their application, while the Ministry of Communications retained the responsibility for defining telecommunications policy in Italy. See The Telecommunications Regulations and Implementing Regulations .

The activities of Telecom Italia and TIM were subject to the terms and conditions of their public operating concessions (the Public Concessions ) which were the basis under which telecommunication services were

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provided by Telecom Italia and TIM prior to adoption of the Telecommunications Regulations. The Public Concessions were expected to be made consistent with the new regulatory framework by January 1, 1999, as required by the Telecommunications Regulations but the National Regulatory Authority only started the procedures to achieve such amendments at the end of December 1999. See Public Concessions .

Since January 2001 Telecom Italia has been operating pursuant to a license (Order 820/00/Cons). See The Telecommunications Regulations and Implementing Regulations Authorizations and Licensing .

Other significant telecommunications measures include Ministry of Communications decrees, Presidential decrees and other regulations as well as orders of the National Regulatory Authority issued since its formation.

A new regulatory framework will be introduced in Italy by the incorporation of recently adopted EC Directives, the Framework directive together with three others on Access , Authorization and Universal Service (the Data Protection directive will be implemented separately). The new rules will be included in the national regulatory framework by July 24, 2003. In this connection, Law No. 166 of August 1, 2002 gave the Government a mandate to implement the new directives, and to adopt a code of legal and regulatory measures in the field of telecommunications. Furthermore, the European Commission published Recommendations on important product and services markets in electronic communications, as well as Guidelines for market analysis and the evaluation of significant market power.

### **The National Regulatory Authority and the Maccanico Law**

The National Regulatory Authority consists of a President that has been appointed by the Italian Government through a Presidential decree, a Committee for Infrastructures and Networks, a Committee for Products and Services and the Council. Each of the Committees members is selected by the Italian Parliament (four by the Senate and four by the Chamber of Deputies) and appointed through a Presidential decree. Each of the Committees and the Council is responsible for establishing regulations for their specific areas.

The Committee for Infrastructures and Networks is responsible for, among other things, allocating radio frequencies relating to telecommunications services; defining objective and transparent criteria for establishing tariffs for interconnection and network access; regulating relationships among telecommunications companies; settling disputes regarding interconnection; and defining the scope of the universal service obligation and the operators subject to it, together with criteria for calculating and sharing its costs.

The Committee for Products and Services is responsible for, among other things, regulating product quality and conformity with EU directives governing the relationship between companies controlling fixed or mobile telecommunications networks and telecommunications service providers.

The Council is responsible for adopting regulations establishing criteria for issuing licenses for the telecommunications sector and for TV and radio activities (including cable and satellite broadcasting).

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The Framework Law provides that the National Regulatory Authority shall cooperate with the Italian Government and the Parliament, advising and assisting them in several areas:

- preparation of regulations in the telecommunications field;
- preparation of drafts for renewal of and amendments to concessions, authorizations, and program contracts (*contratti di programma*), which are usually multi-year agreements between the relevant Ministry and the concession holders concerning quality of service and tariffs;
- supervision of the procedures and requirements for adopting general authorizations and issuing individual licenses, with reference to matters such as network access and interconnection conditions;
- establishment of the criteria to be followed by operators in determining tariffs;
- monitoring operators to ensure their compliance with such tariff criteria;
- issuance of directives aimed at ensuring accounting separation between different activities carried out by the same operator;
- monitoring of the performance of services to ensure compliance with contracts and qualitative levels of service;
- issuance of directives regarding quality of services;

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- examination of complaints filed by users and customers in relation to quality of services and the level of tariffs;
- control of steps taken by operators to ensure equal treatment of their customers and verifying periodically the quality of the service provided; and
- control of operators' compliance with the general principles issued by the Italian Government and the National Regulatory Authority in relation to public services.

The National Regulatory Authority has been operational since June 1998.

The National Regulatory Authority has investigative powers, as well as the authority to impose sanctions on operators who do not comply with their directives and resolutions. In addition, the National Regulatory Authority is entitled to propose to the Ministry of Communications the revocation and/or suspension of general authorizations and individual licenses in the event of repeated violations by the holder. The Maccanico Law also permits the National Regulatory Authority to limit access to networks for security reasons.

## **The Telecommunications Regulations and Implementing Regulations**

The principal provisions contained in the Telecommunications Regulations, which affect the provision of telecommunications services by the Telecom Italia Group and its competitors in Italy relate to:

- authorizations and licensing;
- universal service obligations;
- obligations imposed on operators having significant market power, in particular with respect to interconnection agreements and accounting policies;
- numbering (carrier selection, preselection, and number portability);
- rights of way;
- alignment of Public Concession to the new regulatory framework;
- assignment of UMTS licenses; and
- introduction of new broadband services (ADSL and XDSL).

*Authorizations and Licensing*

The Ministry of Communications has the power to grant individual authorizations and licenses.

The Telecommunications Regulations distinguish between a regime of general authorizations, under which operators meeting pre-established conditions determined by the Ministry of Communications may provide telecommunications services or operate telecommunications networks within the scope of such authorizations without individual licenses for the provision of telecommunications services and the operation of telecommunications networks. Operators are required to obtain individual licenses from the Ministry of Communications to provide telecommunications services or operate telecommunications networks not covered by a general authorization. An individual license is required for:

- provision of fixed public voice telephony services;
- mobile and personal communications services;
- creation and operation of public telecommunications networks;
- when specific obligations are to be imposed or limited resources such as frequency bandwidths have to be allocated.

The number of individual licenses can be restricted only to the extent required to ensure the efficient use of radio frequencies or until sufficient additional numbers are made available. The procedures for granting such licenses must be based on objective, non-discriminatory criteria. Mobile and personal communications licenses will be required to permit the provision of services using different technologies and cannot include unjustified technical restrictions.

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The Ministry of Communications Decree of November 25, 1997, concerning the issue of individual licenses and general authorizations in the telecommunications sector, pursuant to the Telecommunications Regulations ( License Decree ) imposes specific obligations on operators in accordance with the scope of their individual licenses. Moreover, on dominant operators, and thus on the companies of the Telecom Italia Group, additional obligations are imposed such as:

- non-discriminatory and cost-oriented interconnection offering;
- publication of a standard list of interconnection tariffs;
- offering of special accesses to the network (i.e., access at network termination points other than the standard ones);
- accounting separation between the interconnection offering and other activities carried out by the operator;
- carrier selection and number portability (see also Special Status of Operators Having Significant Market Power and Numbering ); and
- carrier selection should be considered both as easy access and equal access .

The Ministry of Communications issued, on February 5, 1998, a decree regarding fees to be paid by authorized and licensed operators, specifying the fees the latter will have to pay to refund the relevant administrative costs incurred by the National Regulatory Authority and the fees for the assignment of frequencies and numbering resources.

Telecom Italia (but not TIM) has been operating under a license regime since January 2001.

Presidential Decree No. 211 of August 1, 2002 changed the period of individual licenses in the TLC sector from 15 to 20 years (with an extension also for those already issued).

### ***Universal Service Obligations***

Under the Telecommunications Regulations, the universal service obligations include the provision of fixed-line public voice telephony service, publication of telephone directories and provision of subscriber information services, public payphones, free emergency call services and special services for disabled or disadvantaged people. To date Telecom Italia is the only operator subject to the universal service obligations, although similar obligations could be imposed on other operators. In such an event such other operators will be required to provide all or part of the services included in the universal service obligations on all or part of the national territory, under reasonable and non-discriminatory conditions. The net costs for the provision of the universal service is calculated on a long run forward-looking incremental cost basis. The telecommunications operators providing fixed-line public voice telephony service or mobile and personal communications services are required, under certain circumstances, to contribute to such costs.



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In compliance with Ministry Communication Decree of March 10, 1998, Telecom Italia submits yearly (by March 31 of each year) to the National Regulatory Authority the evaluation of its net cost of the universal service. The National Regulatory Authority determines if the net cost represents an unfair burden on Telecom Italia and, in that case, appoints an independent Advisor to audit the cost evaluation. Before July 1 of each year, the National Regulatory Authority determines the final evaluation of the net cost, taking into account any indirect benefits, and informs the Ministry of Communications of the amounts due from each operator called to contribute.

By July 15 of each year, the Ministry of Communications publishes the amount due by the operators obliged to finance universal service, which has to be paid by August 15th . Telecom Italia, as the operator required to provide the universal service, receives payment from the Ministry of Communications on September 15 of the same year.

In accordance with the Telecommunication Regulations, Telecom Italia submitted the net cost of providing universal service for the first time for the year 1998. The National Regulatory Authority concluded that for 1998 the costs of such service were not an unfair burden for Telecom Italia. The National Regulatory Authority appointed an independent Advisor to audit the 1999 net costs submitted by Telecom Italia. On August 1, 2000, the National Regulatory Authority recognized a net cost for the provision of the universal service in the year 1999 of 62.4 million. The operators obliged to contribute to finance such net cost were: (a) Telecom Italia (57.1%); (b) TIM (28.1%); (c) Omnitel (13.8%), and (d) Infostrada (1%).

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With Order 8/00/CIR Telecom Italia was requested to provide an assessment on the net cost foreseen for the year 2001, together with information regarding areas and customers estimated as not profitable, in order to allow the National Regulatory Authority to launch a public consultation aimed at determining the guidelines for the provision of the universal service on a competitive basis. On January 31, 2001, pursuant to the same Order, Telecom Italia filed its evaluation for the year 2001. On July 12, 2001, the National Regulatory Authority opened a public consultation in order to assess the possibility of using a bidding procedure for the assignment to operators, other than Telecom Italia, of all or part of the obligations relating to the universal service. The outcome of the consultation was published on January 17, 2002. No decision has been taken by the National Regulatory Authority.

In connection with the net cost for the year 2000 submitted by Telecom Italia, the National Regulatory Authority recognized a net cost of 58.9 million, of which Telecom Italia contributes 48.3%. Other Operators obliged to contribute to finance such net cost are: TIM (31.4%); Omnitel (18.9%), and Infostrada (1.4%).

Regarding the net cost of 1999 and 2000, reimbursements have not yet been paid to Telecom Italia by the other operators, as some of them have filed a claim in the Administrative Court.

With respect to 1999, on January 27, 2002 the Administrative Court issued a decision in favor of the Other Local Operators, based only on procedural matters. Consequently, the procedure for the evaluation of the net cost for 1999 was re-opened by the National Regulatory Authority. With Order 5/03/CIR the National Regulatory Authority issued a final decision confirming its Order 8/00/CIR.

Decision from the Court on costs of 2000 is still pending.

In December 2001, the National Regulatory Authority published rules designed to grant to low income and to disabled customers certain reductions of the monthly rental fee for voice telephony services.

In 2002, Telecom Italia was confirmed as the operator with the obligation to supply the Universal Service under the conditions laid down in the regulations.

The National Regulatory Authority approved the net cost sustained by Telecom Italia to provide the Universal Service in 2001 of 40.52 million, to which Telecom Italia itself is to contribute 42.68% (euro 17.29 million), the remaining cost being funded by Other Local Operators (OLOs) (TIM, Vodafone, WIND, Infostrada).

### ***Special Status of Operators Having Significant Market Power***

Under the Telecommunications Regulations, telecommunications operators operating fixed-line or mobile networks, or offering fixed public voice telephony services, leased lines or international circuits, are subject to special obligations with respect to interconnection and accounting policies if they have Significant Market Power (SMP). An operator is presumed to have Significant Market Power if its share of the relevant market is greater than 25%, although the National Regulatory Authority may determine that an operator having a market share greater than 25%

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does not have Significant Market Power, in view of the operator's ability to influence market conditions and its access to financial resources, or that an operator with a market share lower than 25% does have such power.

Starting from July 2003, with the introduction of the new European Framework, criteria for the identification of Significant Market Power will change: the European Commission, with its Recommendation C(2003)497, identifies 18 separate markets; the National Regulatory Authority will have to carry out a separate Market Analysis in each market, in order to identify:

- the level of competition in each market;
- the need to indicate one or more operator as having Significant Market Power;
- the appropriate remedies, i.e. the rules to apply, if the case, to grant a correct competition.

In April 1998, Telecom Italia was identified as an operator having Significant Market Power in the markets of fixed telecommunications networks, fixed-line public voice telephony services, leased lines and interconnection services. Telecom Italia is the sole operator identified as having Significant Market Power for the

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above-mentioned markets. In April 1998, TIM was identified as having Significant Market Power in the market of mobile telecommunications services. See EU Telecommunications Law The 1999 Review .

With order 197/99 the National Regulatory Authority in September 1999 also determined that TIM and Omnitel had Significant Market Power for mobile telecommunications services and for domestic interconnections. The National Regulatory Authority reviews and evaluates Significant Market Power operators every year. In 2001, the National Regulatory Authority started a market analysis to identify the operators with Significant Market Power in the year 2000. In addition, on August 7, 2002, the National Regulatory Authority started a procedure to identify telecommunications organizations with Significant Market Power for 2001.

The Antitrust Authority concluded its inquiry with the aim of identifying the operators with Significant Market Power in the Internet access market (Resolution No. 219/02/CONS sent to Telecom on July 31, 2002) and the SMP 2000 inquiry (Resolution No. 350/02/CONS).

### ***Significant Market Power Internet***

In its approval of the measure granting equal status to Internet Service Providers (ISP) and OLOs (Law No. 59/2002), Parliament ruled that, within two months of the law coming into effect (by June 26, 2002), the National Regulatory Authority would update the list of operators with Significant Market Power in the Internet access market.

In Resolution No. 132/02/CONS of April 24, 2002, the National Regulatory Authority commenced the inquiry by conducting a public consultation with the aim of Updating the list of operators with significant market power on the Internet access market [...] which concluded with Resolution No. 219/02/CONS. This resolution identified Telecom Italia and Wind as operators with Significant Market Power in the market of calls terminating on the Internet using dial-up technology, and also identified Telecom Italia alone in the final market of switched Internet access services from the fixed network. The Resolution, which became effective immediately, referred to Presidential Decree No. 318/97 for the remedies (publication of interconnection price lists, separate accounting, cost orientation, etc.) which the two operators are bound to respect.

### ***Significant Market Power 2000***

In Resolution No. 350/02/CONS the National Regulatory Authority confirmed for the year 2000 that the following operators have Significant Market Power:

- 1) Telecom Italia in the markets of public fixed telephone networks and services, leased line systems, and the national interconnection market;
- 2) TIM in the markets of public mobile and national interconnection communications systems (termination);
- 3) Vodafone Omnitel in the markets of public mobile and national interconnection communications systems (termination).

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As far as the named operators are concerned, this special status automatically imposed a series of extra legal obligations over and above those which all telecommunications operators are normally expected to fulfill: cost orientation of interconnection prices (and also of retail/leased lines for Telecom Italia), transparency, non-discrimination, and, only for Telecom Italia, separate accounting.

Telecom Italia was designated as an operator with Significant Market Power in the interconnection market, despite having reduced its market share in 2000 to approximately 11% (based on revenues).

### *Significant Market Power 2001*

An inquiry was begun by the National Regulatory Authority on August 7, 2002. An official decision was taken on May 7, 2003, but the text has not been published yet. From a press release by the National Regulatory Authority, we understand that the decision will confirm Telecom Italia as having SMP in the market of fixed network services, as well as TIM and Vodafone Omnitel in the mobile market.

The National Regulatory Authority intends to carry out the market analyses, under the new European regulatory framework by December 2003. In order to do this, the National Regulatory Authority intends to

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separate the most important markets according to current laws (Presidential Decree No. 318/97 and Law No. 59/02) into the 18 markets identified by the recommendation of the European Commission, and to entrust a large part of the above-mentioned analyses to external consultants.

The National Regulatory Authority will adopt the resolutions designating the operators with Significant Market Power for years 2003 onwards, and establish suitable regulatory measures for 2004.

Finally, on March 20, 2002 the National Regulatory Authority began an inquiry into Enel/Wind to verify whether, according to Article 9, sub-section 2 of Presidential Decree No. 318/97, it is necessary to adopt separate accounting directives with regard to Wind, and to impose restrictions ex ante regarding the use of infrastructures associated with special and exclusive rights, including access to information about the users of electricity.

**Interconnection.** Telecommunications operators providing fixed-line public voice telephony services, mobile telecommunications services or leased line systems and having Significant Market Power are required to negotiate and enter into interconnection agreements at the request of other operators wishing to provide telecommunications services, to apply non-discriminatory terms and to communicate copies of their interconnection agreements to the National Regulatory Authority. Public fixed network operators and leased line service providers having Significant Market Power are required to publish a Reference Interconnection Offer (RIO). As required by EU Directive 96/19, Telecom Italia published its first RIO on July 1, 1997. Such list was subject to approval by the National Regulatory Authority. The Ministry of Communications Decree of April 23, 1998, published on June 10, 1998, pertaining to the interconnection agreements ( Interconnection Agreements Decree ) also provides specific implementing rules to be applied to interconnection agreements to be executed by telecommunications operators having a significant market power and providing fixed public voice telephony services, mobile telecommunications services or leased lines systems. Such rules deal with, among other things, nondiscriminatory and transparent practices, economic offering conditions (based on actual costs, including a reasonable return on investments), accounting separation and the content of the RIO to be published by the above mentioned operators, except those operating mobile networks. The economic conditions included in the RIO must range between the minimum and maximum thresholds fixed by the Recommendation of the European Commission C(98)50, with interconnection tariffs exceeding the maximum thresholds requiring justification by the concerned operators.

On July 15, 1999, Telecom Italia submitted a new cost based RIO. Prices proposed were consistent with the thresholds fixed by the Recommendation of European Commission 98/511/CE (Best Practice 1999). With Order 1/00/CIR of February 2000 the National Regulatory Authority established some modifications to be introduced in Telecom Italia's RIO 1999, including the retroactive effect from January 1, 1999 for interconnection prices. In the same Order the National Regulatory Authority fixed terms and a deadline for publication of the Reference Interconnection Offer 2000. As a result, on April 3, 2000, Telecom Italia published the RIO 2000, which was evaluated by National Regulatory Authority in Order 10/00/CIR published on November 2, 2000.

Consequently, on April 9, 2001, Telecom Italia published a revised RIO for the year 2000, consistent with the new order, which increased the number of interconnection services (i.e., access to non-geographical numbers for dial-up Internet) and defines service level agreements.

In Resolution 13/01/CIR Telecom Italia was authorized not to insert the economic conditions for the routing of international traffic of other operators towards the United States, Canada, Switzerland, Norway and the member states of the European Community.

On September 7, 2001 Telecom Italia published the RIO 2001 for interconnection and unbundling of the local loop services. In the RIO 2001 there was a change from historical to current cost accounting methodology for interconnection traffic services, whereas local loop unbundling

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services are to be evaluated at historical costs. The RIO was evaluated in the Order 4/02/CIR of March 1, 2002.

In compliance with the rules laid down in Resolution No. 4/02/CIR, Telecom Italia re-published on April 3, 2002 the Reference Offer for 2001 which contains technical and economic conditions for supplying the interconnection services for local loop unbundling. The new RIO include generalized reductions on the prices of services provided to interconnected operators.

With regard to direct calls to Internet, Order No. 25/01/CIR established that Telecom Italia should introduce the new flat-rate interconnection rate known as FRIACO (the licensed operators pay a fixed charge instead of

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an amount based on the minutes of interconnection). On March 12, 2002, the National Regulatory Authority issued Resolution No. 5/02/CIR, approving Telecom Italia's flat interconnection rate, but reducing the prices proposed by the Company.

According to Law 59 of April 8, 2002, Internet Service Providers also have the right to be granted the same economic conditions applicable to the other licensed operators according to the RIO. With Order 9/02/CIR of July, 18, 2002 the National Regulatory Authority defined the criteria of application to ISPs of the economic conditions of RIO, in compliance with the Law 59.

On April 18, 2002 Telecom Italia published the RIO 2002 for Interconnection and Unbundling 2002. The offer was successively integrated with Partial Circuits and FRIACO services (April 30, 2002), with PVC (Permanent Virtual Channel) ADSL and HDSL services (June 14, 2002), and with billing services (July 4, 2002).

With Order 2/03/CIR of February 27, 2003, the National Regulatory Authority asked Telecom Italia to integrate the RIO with other services (e.g. interconnection links at 34 and 155 mbps rates) and to modify the economic conditions of traffic conveyance services (origination, termination and transit) and other services such as number portability and Partial Circuits. Consequently, TI published a new RIO 2002 on March 27, 2003.

On the same date of Order 2/03/CIR, the National Regulatory Authority published Order 3/03/CIR, which (on the basis of the previous Order 152/02/CONS) introduces a network cap, a mechanism for defining in advance the rules for pricing RIO services according to the RPI (Retail Price Index) and productivity factors; the network cap applies for the period 2003-2006. The Order 152/02/CONS established also non discrimination criteria in interconnection and wholesale market between Telecom Italia and the other licensed operators: a) same conditions to other licensed operators as applied to its retail units; b) further obligations of accounting separation; c) functional separation between network and retail units; and d) price squeeze tests for retail offers.

In compliance with Order 3/03/CIR, Telecom Italia submitted the RIO 2003 on April 11, 2003, which is currently under evaluation by the National Regulatory Authority.

**Local Loop Unbundling.** With Order 2/00/CIR issued on March 16, 2000 the National Regulatory Authority published the general guidelines regarding the services that must be offered by Telecom Italia on an unbundled basis: twisted copper pairs; fiber optics; access extension (lines between switches), and digital transmission channels (i.e., digital circuits between the local office of Telecom Italia and the operator's point of presence) and the related economic pricing criteria, based on fully distributed historical costs. The Order allows other operators to have direct access to end users by leasing the network components from Telecom Italia (full unbundling) as well as leasing only the high bandwidth (shared access).

Telecom Italia appealed this Order to the Tribunale Amministrativo Regionale del Lazio (TAR Lazio), in particular with respect to the inclusion of fiber optic in the mandatory offer and the costing criteria. On May 12, 2000, Telecom Italia put forward a Reference Offer for Local Loop Unbundling, for approval by the National Regulatory Authority. The National Regulatory Authority finally issued Orders 13/00/CIR and 14/00/CIR, respectively on December 30, 2000 and In January 2001. The former regards the technical and procedural aspects of the provisioning of local loop unbundling and co-location. The latter sets the rates for the unbundled services.

Telecom Italia published a revised Offer for 2000 on January, 31, 2001.



During 2001, in line with the suggestions made by the National Regulatory Authority, special areas were made available in exchanges to accommodate other operators with the aim of unbundling local loops. At December 31, 2001 Telecom Italia handed over equipped technological areas to operators in 748 exchanges. In addition, following Resolution No. 24/01/CIR, on December 12, 2001, Telecom Italia presented its rate plan to the National Regulatory Authority for shared access and sub loop (shared access to the local network and access to line boxes).

On April 18, 2002 Telecom Italia published the Reference Offer of Local Loop Unbundling for 2002, with price reductions for copper pair. On March 2002 around 17,400 unbundled lines were in place, 27 licensed operators requested co-location, 1,043 local switches for co-location were requested by licensed operators and 919 sites were ready for co-location.

On June 24, 2002, Telecom Italia presented the National Regulatory Authority with a Virtual Unbundling offer, which offers carrier preselection, inclusive of the payment for the unbundling charge wherever it is

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temporarily impossible to offer co-location. On September 16, 2002, following a number of meetings with the National Regulatory Authority, Telecom Italia further reduced the price of some unbundling services:

- a) shared access: the monthly subscription rate was reduced from euro 4.34 to euro 2.80; the activation charge was reduced from euro 94.36 to euro 81.00;
- b) full unbundling: the monthly subscription rate for the ADSL pair was reduced from euro 12.60 to euro 11.10;
- c) the fee for qualification of the ADSL pair was reduced from euro 39.51 to euro 10.37.

On February 27, 2003, with Order 2/03/CIR, the National Regulatory Authority approved Telecom Italia's Reference Offer for 2002 (OR 2002), after hearing the opinions expressed by the Antitrust Authority and the European Commission, and after Telecom Italia's submission to the National Regulatory Authority of its regulatory accounting for 2001, which took place on December 20, 2002.

Order No. 02/03/CIR confirms the monthly rental fees of LLU and sets a reduction of activation fees. As regards co-location services, the Order asked the application of internal Telecom Italia costs (approximately-40%) to the square-meter costs for co-location paid by OLOs. Furthermore the integration of the Offer with the coming services is required.

As regards RO 2003, Order 3/03/CIR of February, 27 2003, asked Telecom Italia to set the monthly rental fee on the basis of the following criteria: a) the best European tariff, b) the anticipation of efficiency on operational costs, c) the non discrimination principle and d) on the basis of the cost structure of access network assets.

**Mobile termination rate.** According to the GSM Concessions of December 1994, mobile network operators were responsible for fixing tariffs for calls originated on the fixed network and terminated on mobile networks. Such regulatory framework has been modified by DPR 318/97 establishing, as a new principle, that the originating operator is responsible for fixing the retail tariff. This principle has been reaffirmed by the National Regulatory Authority with Order no. 85/98. Since issuing this order the Regulator has started an assessment of termination rates charged by mobile network operators and with Order 338/99 it set 19.0 eurocents/min, the maximum average termination price. The National Regulatory Authority has deemed it necessary to issue new regulations and on February 5, 2003 issued Order n. 47/03 setting new maximum values for the termination rates applied by mobile operators (TIM and Vodafone Omnitel) for calls originated on third networks. The ceilings for mobile termination charges will be 14.95 eurocents/min, as from June 1, 2003. For 2004 and 2005 the National Regulatory Authority has provided a mechanism (so called network cap) for the planned reduction of termination costs of fixed-mobile which will be introduced along with the improvements and fine-tuning of the regulatory accounting system based on incremental costs and the review of the obligations following the implementation of the new European regulatory framework. The National Regulatory Authority believes that, within this framework, a planned reduction of a maximum of 10% per year minus inflation in 2004/2005 would be reasonable.

**Accounting Policies.** Operators having Significant Market Power are required to have an accounting system showing their costs in a transparent manner. Upon request, such operators must provide the National Regulatory Authority with a description of their cost accounting system to verify compliance with the provisions of the Telecommunications Regulations. Moreover, operators of fixed public networks and mobile networks and providers of fixed public voice telephony services, mobile telecommunications services and leased line services with significant market power must keep a separate accounting system distinguishing between the activities related to the building and operation of public telecommunications networks, the activities related to the provision of telecommunication services, the interconnection offering and the universal service provision.

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The National Regulatory Authority chose KPMG as the independent Advisor for the auditing of the accounting separation Reports. In accordance with the Telecommunication Regulations, on September 4, 2000 Telecom Italia submitted the Regulatory Accounting Reports for the year ended December 31, 1999 to the National Regulatory Authority. On September 14, 2001 the Regulatory Accounting Reports for the year ended December 31, 2000 were also submitted to the National Regulatory Authority.

Due to a delay in the appointment of the independent advisor, the results of the audit on 1999 and reports were published only on November 6, 2002 with Order 337/02/CONS. The results of audit on 2000 Reports were published in March 2003 with the Order 48/03/CONS. .

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On June 17, 2002, the National Regulatory Authority issued Order 152/02 CONS which requires Telecom Italia to provide more detailed accounting reports on a current cost basis (fully allocated costs); the cost basis previously adopted was the historical one. In compliance with Order 152/02 CONS on December 2002 Telecom submitted the regulatory accounting Reports of year 2001 the auditing of which is in progress. During 2001 the National Regulatory Authority issued an order which raised the allowed return on capital employed WACC (weighted average cost of capital) for regulatory purposes from 12.5% to 13.5% before taxes.

### ***TIM cost accounting policy***

According to Order 197/99 TIM and Vodafone Omnitel have been notified as a Significant Market Power operator in the national interconnection market and must provide a cost oriented fixed-mobile termination rate.

On the basis of Order 338/99 TIM was required to implement cost accounting report in order to calculate a fixed-mobile termination rate. In accordance with Order 340/00, in 2001 TIM produced a cost accounting system based on Fully Allocated Historical Cost Data for the year 1999 (positive certification was issued by the advisor of the National Regulatory Authority at the end 2002). It also introduced an accounting system based on a FAC-CC model (Fully Allocated Cost on a Current Cost basis), as an intermediate step towards the adoption of long-run incremental costs to determine the fixed mobile rates. In December 2001 the National Regulatory Authority adopted Order n. 485/01 requiring the SMP operators to prepare historical accounts for the year 2000.

With the recent Order no. 399/02, the National Regulatory Authority requested both historical cost data and Current Cost data for the year 2001. It also required a Long run incremental cost orientation for the year 2002 as the last step for cost orientation.

### ***Numbering***

In accordance with the Telecommunications Regulations and by the issuance of various Order 3 the National Regulatory Authority issued regulations related to Number Portability and Carrier Preselection as described below.

### ***Number Portability ( NP )***

Since February 2000, following the National Regulatory Authority Order 4/99/CIR and 7/00/CIR, which is consistent with EU Directive 98/61/CE, Service Provider Portability (SPP) in fixed networks was introduced, including non-geographic numbers (Premium Rates, Freephone Numbers, Splitting Charges).

Service Provider Portability allows an end user to retain his number independent of the organization providing service, in the case of geographic numbers at a specific location (same Local Area) and in the case of other than geographic numbers at any location. Implementation of SPP is related to negotiations and technical implementation timing among operators. Telecom Italia upgraded its network and operational systems to be in a position to offer NP consistent with the requirements of the regulations. NP for non-geographic numbers started in May 2000. NP for geographic numbers is planned to develop along with unbundling of the local loop.

Number portability for mobile services was established during 2001 and commenced in April 2002.

On March 28, 2002, the National Regulatory Authority issued Order 7/02/CIR: by November 30, 2002 the National Regulatory Authority will determine the price of Mobile Number Portability ( per number costs ) which shall be equal to the one-off price that the operator receiving the customer/recipient must pay to the operator giving the customer/donor the price. Mobile Number Portability will apply starting January 1, 2003.

Per cost number will not be higher than the price applied to fixed-line services as established by Order 10/00/CIR at 10.02. In January 2003, The National Regulatory Authority issued a new Order (13/02/CIR) setting a cap price for the portability charge. This charge can not be higher than the price established for Number Portability between fixed operators.

**Carrier Preselection.** Carrier selection (call by call) has been operational since the end of 1998 for long distance (national and international) and fixed mobile calls. Carrier selection for local calls has been available since January 2000.

Since February 2000, in accordance with Order 3/99/CIR and 4/00/CIR, which introduced new obligations for the provision of Carrier Preselection (i.e., timing, minimum daily number of user activations), customers can

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make inter-district, international calls and calls to mobile networks using a pre-selected carrier as an alternative to Telecom Italia, without dialing the identifying code required. Since July 2000 customers have also been able to make local calls (within the same district) with a pre-selected operator.

### ***Rights of Way***

The Telecommunications Regulations prohibit public authorities from discriminating in the granting of rights of way for the installation of public telecommunications infrastructures. The National Regulatory Authority and the local public authorities can promote the sharing of such structures and rights of way. If the access to such rights of way cannot be granted to a new operator, the National Regulatory Authority and the local public authorities can allow the access to existing infrastructure. The parties involved agree on the commercial terms of the sharing of the existing infrastructure.

Decree Law No. 198 of September 4, 2002 establishes fundamental principles with regard to the installation and alteration of TLC infrastructures that are regarded as strategic, and fixes precise terms for the issue of authorizations, abrogating the procedure of environmental impact assessment (VIA) and limiting the financial responsibility of companies to expenses associated with installation operations, digging and occupation of public property. Law No. 166 of August 1, 2002, also defined the new standards relating to the installation, access and sharing of multi-service cables and of cable ducts that need to be built following construction and maintenance work on civil works.

### **Public Concessions**

The Telecommunications Regulations provided that by January 1, 1999, the Public Concessions were to be modified to make them consistent with the new regulatory framework, on the initiative of the National Regulatory Authority, with the aim of bringing the Public Concessions into line with the Telecommunications Regulations. All special or exclusive rights held by Telecom Italia under the former monopoly system, and not compatible with the introduction of competition, were to be considered abolished.

The National Regulatory Authority opened an inquiry on December 15, 1999 with the aim of bringing the Public Concessions into line with the new regulatory framework, modifying the content of the Public Concessions and eliminating the special and exclusive rights and obligations which were in conflict with the Telecommunications Regulations, such as approval by the Ministry of Communications of the long term and technical plans of Telecom Italia, the installation and operating of public telephone facilities in specific areas of the country, and the development of services in small centers.

At the end of its inquiry the National Regulatory Authority issued three individual licenses and a general authorization to Telecom Italia formally notified on January 19, 2001:

- An individual license for the installation and provision of public telecommunications networks, and for the provision to the public of voice telephone services (modification of the concessions and associated agreements formerly granted to SIP, Iritel and Italcable).
- An individual license for the installation and operation of a network of coastal stations with the aim of providing mobile maritime services via Inmarsat satellite (modification of the concession and associated agreement formerly granted to Iritel).

- An individual license for the plant and operation of radio-electric boarder stations, and the supply of mobile maritime services and mobile services via satellite through Inmarsat terminals (modification of the concession and associated agreement formerly granted to Sirm).
- Authorization for the supply of satellite network and communications services (modification of the concession and associated agreement formerly belonging to Telespazio).

Each individual license included a list of specific charges, drawn up on the basis of the indications given by the ministerial Decree of November 25, 1997, containing Provisions for the issue of individual licences in the telecommunications sector .

The licenses and authorizations issued to Telecom Italia have the same expiry date as the Public Concessions (2012, according to Article 14 of Law No. 359/92, containing Urgent measures for the rehabilitation of public finances ).

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Pursuant to Law No. 448 of December 23, 1998, a new fee was instituted from January 1, 1999 to take the place of the license fee payable under the previous regulatory regime. The amount of the operating fee is based on a sliding scale (2.5% for 2001, 2.0% for 2002 and 1.5% for 2003). The Ministerial Decree of March 21, 2000 established that the fee should only be applied to revenues from installation activities and the supply of public telecommunications networks, local telephone service and mobile and personal service.

Under its Public Concession, Telecom Italia had the right to provide all mobile public telecommunications services, regardless of the technologies used. These rights were transferred to TIM as a consequence of the TIM Demerger. In accordance with the Presidential Decree No. 211 of August 1, 2002, the duration of TIM's GSM concession is 20 years, commencing on February 1, 1995 (before such decree the duration was 15 years).

The Telecommunications Regulations provided that by January 1, 1999, the existing GSM concessions (Omnitel also was granted a GSM concession) were to be modified to make them consistent with the new regulatory framework. In March 2001 the GSM concessions were transformed into individual licenses.

TIM is also a holder of an individual license for radio mobile analogical (TACS) public service, for radio mobile paging public service and for the installation of their relative networks. The term of validity for the license corresponds to that of the original concession (2012 with a further five year extension according to the Order n. 286 issued by the National Regulatory Authority on September 25, 2002).

## **Licensed Operators**

In December 2002, the number of licenses for the provision of both fixed voice telephony service and building public telecommunications networks and for mobile and satellite services granted by the Ministry of Communications and the National Regulatory Authority was about 209.

In the segment of mobile telecommunications services, one license was granted to the third national mobile operator (DCS-1800, GSM) Wind, which started on March 1, 1999, and another license (only for DCS-1800) was granted to the fourth national operator BLU, which started on May 16, 2000. Wind is the sole Italian telecommunications operator that was granted both a mobile and a fixed license at the time it started its operations. Fixed licenses have also been awarded to TIM (February 2001) and Omnitel. Mobile telecommunications services based on the DCS-1800 technology are also provided by the two GSM operators, TIM and Omnitel.

The Italian government awarded five UMTS licenses in Italy in December 2000. TIM, together with Omnitel S.p.A. (now Vodafone Omnitel N.V.), WIND S.p.A., Andala S.p.A. (now H3G S.p.A.) and IPSE S.p.A., were awarded licenses to provide the third generation mobile services. TIM committed to pay 2,417 million for its license, with 2,066 million paid in December 2000 and 117 million paid in November 2001 and November 2002. The remaining 117 million will be paid during 2003.

In 2002, Blu, the fourth operator, was acquired by TIM, with its customers transferred to Wind.



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On August 1, 2002, TIM was granted individual licenses for the point multi-point system (Wireless Local Loop) on a frequency band of 27.5-29.5 GHz and a width of 112 MHz.

In accordance with Presidential Decree No. 211 of August 1, 2002, the duration of all individual licenses is now 20 years starting January 1, 2002 (before such decree the duration was 15 years). Transition towards the third generation will be gradual with an extensive launch of the service expected in 2004.

### *XDSL/ATM Broadband*

In December 1999, Telecom Italia received temporary authorization from the National Regulatory Authority for the wholesale offering of ADSL/ATM access service to Other Licensed Operators and Internet Service Providers. In February 2000, Telecom Italia started the always on retail offering for fast internet access. The ADSL 640 wholesale offer has been partially modified by the National Regulatory Authority with order 217/00/CONS issued in April 2000. In February 2001, the National Regulatory Authority approved the Permanent Virtual Circuit (ADSL up to 2 Mbit/s and HDSL up to 155 Mbit/s technologies) offer as presented by Telecom Italia and authorized Telecom Italia to offer XDSL retail services branded as RING and FULL BUSINESS COMPANY from April 2001. At the end of 2002, ADSL 640 and XDSL wholesale services were available for about 70% of total lines; this percentage is expected to be 80% at the end of 2003. At the end of April 2003, the service is available in 1,300 towns.

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### **Tariff and Pricing Policy**

#### *Overview*

Telecom Italia operates in both domestic and international markets. Its pricing policy is established in accordance with existing regulations for Regulated Services, and in accordance with market and competitive factors.

**Fixed Network.** Management believes that it is essential for Telecom Italia to have the flexibility to price its telecommunications services selectively in order to counter increased competition.

With Order 171/99 the National Regulatory Authority described the rules to be applied by Telecom Italia in setting the tariffs for the services offered. The Agency distinguished two kinds of tariffs. The first required prior approval by the Agency and applied to:

- services under a price-cap obligation (RPI-X): the X is differentiated according to different levels of competition in the provision of the various telecommunications services (such as installation, connection charge, local voice calls, long distance voice calls, international voice calls);
- services under cost-orientation and accounting separation obligations: Interconnection, Special Access and Leased Lines, due to the Significant Market Power of Telecom Italia in the provision of these services; and
- services to be kept affordable, on the basis of the regulation concerning the universal service obligation.

The second category of tariffs required only a prior communication to the National Regulatory Authority itself and applied to so-called value added services for which a high level of competition exists.

**Mobile Network.** GSM prices are established autonomously by each of the GSM Operators, taking into account, among other factors, structure and levels of prices/tariffs for interchangeable services (analog mobile services and basic telephony services) and the policies of the main European operators, subject only to the obligation to give the Ministry of Communications or the National Regulatory Authority, as applicable, 30 days notice of changes in prices. Since June 1998, subscribers' TACS traffic fees were liberalized, so that TIM can modify all TACS prices according to its own strategy (but such fees may not be set lower than those for GSM).

#### ***Regulation of Tariffs and Pricing***

On July 28, 1999, the National Regulatory Authority introduced the price cap mechanism to promote productivity and efficiency for Telecom Italia through December 31, 2002. The price cap mechanism related to:

- rental and connection charges;
- local charges;
- trunk charges; and
- international charges.

The Order stated that, on a yearly basis for three years (until December 2002), the reduction of overall customer expenditure had to be less than or equal to RPI + 4.5%. In the same Order, the National Regulatory Authority introduced specific subcaps on rental fees (RPI + 1%), local calls (RPI + 0%) and overall expenditure of residential customer (RPI-2.5%).

Following the EU Commission infringement procedure against Italy concerning the rebalancing of voice telephony tariffs (subscription fees, and charges for local, inter-district and international calls), on December 11, 2000, the National Regulatory Authority issued Order 847/00/CONS revising the price cap formulas in effect for rental and installation fees, and charges for local, national and international calls. For the period from January 2001 through December 2002, the price caps in effect were as follows:

General price cap (installation fees; monthly rentals, local, national and international call charges)	RPI	-4.5%
Sub-price cap on overall expenditures of residential users	RPI	-2.5%
Sub-price cap on installation fees and monthly rentals	RPI	+6%
Sub-price cap on local call charges	RPI	+0%

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The change compared to the previous price cap formulas was an increase from RPI + 1% to RPI + 6% in the sub-price cap on installation fees and monthly rental charges.

The general effect of the new price cap formulas for 2001 provided for an increase of up to 8.5% in Telecom Italia's access service charges (i.e., subscription fee) and a reduction of 9.8% in Telecom Italia's traffic charges.

Tariffs set on the foregoing basis are proposed directly by the operator to the National Regulatory Authority and, to the extent the National Regulatory Authority does not object within 30 days (reduced from 90 days), the tariffs will be considered to have been approved.

Prices for all other services (other than universal services) provided by Telecom Italia may be established without the approval of the National Regulatory Authority. Management believes that the ability to price each service (other than universal services) selectively is important to Telecom Italia's competitive position.

The National Regulatory Authority on August 5, 2002, launched a public consultation on the possible renewal of the Price Cap Mechanism. From the results of this consultation, it is known that all interested parties are in favor of a reduced control of prices.

Telecom Italia believes the National Regulatory Authority agrees with the introduction of a Safeguard Cap: a mechanism more flexible than Price Cap, which should prevent Telecom Italia from raising its average price: this does not forbid a small raise of a single price, provided that reduction in other prices grant that the average increase is zero (or lower).

However, with Order 152/02/CONS, the National Regulatory Authority introduced another mechanism to control prices, based on price tests. Telecom Italia's offers must undergo two tests:

- Test 1 (costs): prices must be higher than the underlying costs of Telecom Italia. The purpose of Test 1 is to avoid dumping;
- Test 2 (replicability): offers must be higher than the underlying costs of an efficient alternative Operator, including a predefined mark-up. The purpose of Test 2 is to ensure that other operators are able to compete with Telecom Italia.

In some case, it may happen that a specific offer lies between the range of variation of the two tests: in this case, the National Regulatory Authority will perform a specific analysis taking into account also existing offers by alternative operators (which may sell services at a level lower than the one identified by test 2).

### ***Pricing Policy and Telecom Italia's Tariffs***

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**Tariff Rebalancing.** Telecom Italia commenced rebalancing in 1991 with further adjustments approved by the Ministry of Communications in 1993, 1994, 1996, 1997 and 1998, and by the National Regulatory Authority in 1999, 2000, 2001 and 2002. The adjustments have progressively rebalanced Telecom Italia's tariffs to align them more closely to underlying costs, taking into account demand for its services, particularly with respect to international calls, and inflation. As a consequence, subscription fees have been raised, while the relationship between tariffs for local and domestic long distance calls has gradually been narrowed to a current ratio of approximately 1:1.8 for reduced rate calls and 1:3.6 for standard rate calls.

These tariff adjustments caused subscribers' costs to remain unchanged in real terms in 1995, and decreased in real terms by 2.6%, 3.4%, 1.6% and 3.8% in 1996, 1997, 1998 and 1999, respectively; they decreased in real terms by 4.5% in 2000, 2001 and 2002, respectively.

These decreases should be compared to inflation rates as set forth in the table below

	Year ended December 31,							
	1995	1996	1997	1998	1999	2000	2001	2002
	(%)							
Inflation Rate	5.4	4.0	1.9	2.0	1.7	2.5	2.7	2.5

Rebalancing has been accompanied by a simplified tariff structure which has reduced the number of tariff schemes, and clarification of the price of the services being offered to customers. For example, in the case of

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domestic fixed public voice telephony services, during the year 2001 the local tariffs were extended to all trunk calls within the same area code, while for trunk calls between different area codes (long distance domestic calls) a weekend price was introduced, and the number of zones based on distance was reduced from three to two. During 2002, the following tariff changes were introduced:

From February 1, 2002:

monthly fee for residential customers: increase of +6.3%;

30 minutes per month of free local calls for residential customers (which brought an average overall reduction of local calls of about -8%);

reduction of the off-peak tariff for trunk calls (for all customers) to the level of weekend tariff (average overall reduction of about -5%).

From July 1, 2002:

monthly fee for business customers: increase of +4%;

monthly fee for residential customers: increase of +6.9%;

30 minutes per month of free local calls also for business customers (which brought a further average overall reduction of local calls of about -3%);

15 minutes per month of free trunk calls for residential customers (which brought an average overall reduction of local calls of about -9.5%);

changes in the structure of international tariffs: tariffs are now different (for some countries) if the called party is a fixed or a mobile customer (this does not take in account international roaming). The average spend does not change.

From December 30, 2002:

international zones are reduced from 7 to 6; the overall reduction in prices is about 5.6%.

Following the EU Commission infringement procedure against Italy concerning the rebalancing of voice telephony tariffs (subscription fees, and charges for local, inter district and international calls), on December 11, 2000, the National Regulatory Authority issued Order 847/00/CONS revising the price cap formulas in effect for rental and installation fees, and charges for local, national and international calls. For the period from January 2001 through December 2002 the level of monthly rental sub cap was established at RPI+6% by the National Regulatory Authority's Regulation 847/00/CONS.

With Order 469/01/CONS of December 19, 2001 the National Regulatory Authority established for 2002 the same level of monthly rental sub cap as that of 2001 (RPI+6%). On May 20, 2002 Telecom Italia notified the National Regulatory Authority of the final tariff changes relating to rebalancing, to be applied from July 1, 2002. Monthly rental for residential customers increased from 11.36 to 12.14.

Additional tariff rebalancing has been in effect since February 1, 2002. Residential basic subscriber charges were increased by 6.3% (from 10.69 to 11.36 a month, net of VAT) while the weekend rate ( 0.02582 per minute plus the unit charge when the call is answered and VAT) was extended from 6.30 p.m. to 8 a.m. on weekdays and from midnight until midnight on Saturday, Sunday and public holidays for all local and long-distance calls.

On December 6, 1999, the National Regulatory Authority published Order No. 338/99, on fixed-to-mobile call prices: with this Order new and lower prices became effective on February 17, 2000 taking into account the reduction of termination charges and Telecom Italia retention. In 2001, the National Regulatory Authority concluded the proceedings on interconnection between fixed and mobile networks, begun in 2000, stating that TIM had observed the termination tariff for calls originating from the fixed network indicated in Order 338/99.

In 2001, the National Regulatory Authority published Order No. 485/01 CONS entitled Guidelines for the regulatory accounting of operators with Significant Market Power and Order 486/01 CONS that opens a public consultation on introduction of calculation methods for the maximum termination prices (price cap), as applied by operators with Significant Market Power.

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The new charging regime provides for tariff levels which vary according to the type of originating calls from Telecom Italia's fixed network (from Residential users, from Business customers, from public Payphones) and according to the called mobile network (Omnitel, TIM, WIND) and are independent from the type of subscription of the mobile customers (Family, Business).

For international traffic, the current rate structure continues to be optimized to correspond more closely with the type and volume of traffic and the evolution of competition in various geographic areas. Volume discounts and discounts based on the calling destination have been offered to business customers under the most recently implemented tariff structure.

For ISDN and telecommunications services provided through INs, tariffs will evolve in line with those for traditional telecommunications traffic, but are expected to involve specific tariff packages to stimulate growth.

Within the framework of the price cap mechanism and in observance of Resolution No. 847/00/CONS of December 11, 2000, the adjustments of February 1, July 1, and December 30, 2002 became effective and further reduced telephone expenses for residential and business customers. The adjustment of the monthly subscription charges was accompanied by further price reductions for local, out-of-district and international calls.

## **EU Telecommunications Law and Regulation**

Italy is a member of the EU and, as such, is required to implement the directives issued by the EU. Although directives must be incorporated into domestic legislation to be fully effective, a directive or certain provisions of a directive may take effect automatically in a Member State on the prescribed deadline if it is sufficiently clear and specific, even if it is not formally adopted by such Member State by the prescribed deadline. If a directive is not formally implemented by the prescribed deadline, the only remedy available for an interested party is to seek damages against the Member State. Italy is also the addressee of various EU resolutions, recommendations and communications which are not legally binding, although politically important.

### ***EU Directive on Competition in the Markets for Telecommunications Services and Networks***

In June 1990, the European Commission adopted a Directive on Competition in the Markets for Telecommunications Services ( EU Directive 90/388 ), which opened to competition telecommunications services other than fixed public voice telephony services. In particular, EU Directive 90/388 required the liberalization of circuit and packet switched data transmission, in accordance with regulations promulgated by each National Regulatory Authority. EU Directive 90/388 was formally implemented in Italy by Decree 103/1995.

On March 13, 1996, the European Commission adopted EU Directive 96/19, modifying EU Directive 90/388, which required the introduction of full competition in the telecommunications market, both for services and networks. In particular, EU Directive 96/19 called for liberalization of fixed public voice telephony services and the operation of networks to support such services by January 1, 1998. Pursuant to the Telecommunications Regulations implementing this EU directive and Law 650, the operation of telecommunications networks (other than for providing fixed public voice telephony services) was liberalized on effectiveness of the Telecommunications Regulations, and the offering of the infrastructure for the provision of fixed public voice telephony services has been liberalized since January 1, 1998. Under EU Directive 96/19, Telecom Italia published its standard interconnection offer.



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In March 2001, the European Commission published in the Official Journal a notice concerning a draft directive on competition in the markets for electronic communications services, consolidating existing directives on competition in telecommunications market. The Directive makes reference to electronic communications services and electronic communications networks in order to take account of the convergence phenomenon which shapes the information technology, media and telecommunications industry, by bringing together under one single definition all electronic communications services and/or networks involved in the transmission of electromagnetic signals (i.e., fixed, wireless, cable TV, satellite networks). Among other provisions, the draft Directive provides that member States must remove exclusive and special rights in the provision of all electronic communications networks and in the use of radio frequencies. Also, dominant providers of electronic communications services must operate their public electronic communications networks and cable TV networks

under separate legal entities. The directive was adopted by the European Commission on September 16, 2002 (Directive 2002/77/CE) and was published in the Official Journal on September 17, 2002.

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### ***Other Directives Relating to Liberalization of Telecommunications Services***

Following the adoption of EU Directive 90/388, other directives and decisions were adopted by the European Commission including:

- EU Directive 94/46 (the *Satellite Directive* ), which liberalized satellite telecommunications services and EU Directive 88/301 relating to telecommunications terminal equipment (the *Telecommunications Terminal Equipment Directive* ), which liberalized the market for terminal equipment, i.e. equipment directly or indirectly connected to the termination of a public telecommunications network used to send, process or receive information. The *Satellite Directive* was implemented in Italy by Law Decree No. 55 of February 11, 1997.
- With Decision No 1215/2000/EC of May 16, 2000 the European Parliament and the European Council extended a coordinated authorization approach in the field of satellite personal communications services in the EU until December 31, 2003, implying that member States coordinate on authorization procedures with a view to authorizing the same satellite personal-communications services throughout the Community.
- EU Directive 95/51 which allows CATV operators to provide through of their cable networks all telecommunications services. This directive was implemented in Italy by Law 650 and the *Telecommunications Regulations*.
- EU Directive 96/2, liberalizing mobile telecommunications services within the EU (the *Mobile Telecommunications Directive* ). The most important elements of the *Mobile Telecommunications Directive* implemented by Law 189 are the following:
  - Mobile telecommunications operators are authorized to construct their own infrastructure for the mobile network or to utilize infrastructure owned by third parties.
  - Direct interconnection among mobile networks is to be guaranteed.
  - The number of licenses for mobile telecommunications systems may be limited only on the basis of essential requirements and in case adequate frequencies are not available.
  - The conditions for granting licenses for access to frequencies and for interconnection to the fixed public telephony network shall be regulated with transparency, proportionality and non-discrimination.
  - Licenses to provide mobile telecommunications services using the advanced DCS 1800 digital technology were required to be issued by January 1, 1998.

### ***Electromagnetic fields***

In July 1999, the Council adopted a recommendation on the limitation of exposure of the general public to electromagnetic fields. The recommendation is based on a set of basic restrictions and reference levels as developed by the International Commission on non-ionizing radiation protection (ICNIRP) in the Guidelines for limiting exposure to time-varying electric, magnetic and electromagnetic fields. In accordance with the provisions contained in Recommendation 1999/519/CE, the Commission in April 2002 drew up the first Implementation

report confirming the reference levels of exposure limits set by the 1999 Recommendation.

*The ONP Directives*

The EU directive relating to open network provision ( ONP ) (Council Directive 90/387/EC) (the ONP Framework Directive ) sets out a body of principles for access to public telecommunications networks and services. The principles set out in this directive are intended to harmonize technical interfaces, usage conditions and rate principles throughout the EU and to insure objectivity, transparency and non-discrimination in access to services provided in accordance with ONP segments. The implementation of the general principles set forth in the ONP Directive has been deferred to other directives, such as the EU directive relating to leased lines (Directive 92/44/EC) (the Leased Line Directive ).

The Leased Line Directive, adopted following the ONP Directive, requires Member States to ensure provision of a minimum set of leased lines and to publish certain information concerning the characteristics of the service (e.g., period of supply, duration of the contract and quality standards). It also establishes that, in order

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to ensure transparency, the relevant tariffs should be on a flat-rate basis, consisting of an initial connection charge and a periodic rental fee. According to this directive, leased line tariffs must be cost oriented. On October 6, 1997, the European Parliament and the Council adopted an EU Directive amending the ONP Framework Directive and Leased Line Directive for the purpose of adaptation to a competitive environment in telecommunications (Directive 97/51/EC). This Directive establishes that the ONP obligations, in the new competitive environment, apply only to organizations with significant market power (25% of relevant market).

On December 13, 1995, the European Parliament and the Council adopted the EU directive relating to ONP voice telephony (the ONP Voice Telephony Directive ) (Directive 95/62/EC), applying ONP regulation to voice telephony services. This directive provides rules for publication of information, quality of services, subscription contracts, tariffs, accounting principles and access and use conditions.

On February 26, 1998, the European Parliament and the Council adopted the EU Directive on the application of ONP to voice telephony and on universal service for telecommunications in a competitive environment (Directive 98/10/EC). This Directive replaces the ONP Voice Telephony Directive, ensures the availability throughout the European Community of good quality fixed public telephony services and defines the set of services to which all users should have access in the context of universal service, in the light of specific national conditions, at an affordable price.

**Licenses.** On April 10, 1997, the European Parliament and the Council adopted the EU directive relating to general authorizations and individual licenses, establishing a common framework for general authorizations and individual licenses and defining the conditions attached to such authorizations and licenses (Directive 97/13/EC).

**Interconnection.** On June 30, 1997, the European Parliament and the Council adopted the EU directive relating to interconnection, establishing a common framework for interconnection obligations and interconnection tariff principles (Directive 97/33/EC). This Directive, that applies to organizations providing publicly available telecommunication services/networks, requires Member States to remove restrictions which prevent commercial negotiation about interconnection in accordance with EU Law. In particular all organizations providing public networks and/or publicly available telecom services:

- have the right and the obligation to negotiate interconnection;
- must publish terms and conditions for interconnection, including points of interconnection and interface specifications (reference interconnection offer);
- must offer interconnection services applying ONP principles of non-discrimination and transparency; and
- must introduce accounting separation for interconnection.

In late 1997, the Commission adopted Part 1 of a Recommendation on Interconnection in a Liberalized Market , which was officially approved on January 8, 1998. The purpose of this Recommendation was to make available to the national regulatory authorities in the Member States information concerning best practice for interconnection pricing and accounting separation, based on experiences from liberalized telecommunications markets around the world. In particular, Part I of this Recommendation concerned the pricing of call termination on networks operated by operators with significant market power. The Commission recommended maximum interconnection charges to be applied by such operators starting January 1, 1998. Part 2 of the Recommendation, which was officially adopted on April 8, 1998, aimed at ensuring transparency in the methods used for calculating interconnection charges. This Recommendation concerned the implementation of accounting

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separation and cost accounting systems by operators identified by their national regulatory authorities as having significant market power in accordance with Directive 97/33. The purpose of accounting separation, promoting the principles of transparency and cost orientation is to provide an analysis of information derived from the accounting records which reflect the performance of the different segments of the business as if they had been operated as separate businesses. The Commission adopted an amended Recommendation in March 2000. It has reviewed the best current practice charges for 2000 and saw no need to change them for 2001. On February 22, 2002 the Commission adopted a recommendation introducing further amendments to Recommendation 98/195/EC (previously amended by Recommendation 2000/263/EC), phasing out the Commission's benchmarking exercise for call termination charges on fixed networks operated by organizations with significant market power. However, the points in the Recommendation concerning costs have not been amended.

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### ***Commission's Communication Concerning the Introduction of Third Generation Mobile Communications in the EU.***

On December 14, 1998, the European Parliament and the EU Council adopted decision 128/99/EC with the aim at facilitating the coordinated introduction of a third generation mobile and wireless communication system (UMTS) in the Community, on the basis of internal market principles and in accordance with commercial demand.

In March 2001, the Commission published a Communication concerning the introduction of third generation Mobile Communications in the European Union. The Communication confirmed the confidence the Commission has in the Third generation market perspectives, while recalling the underlying policy objectives in terms of building the Information Society, capitalizing on the success of Second generation, securing jobs, and preserving and expanding the lead the EU has on mobile communications in terms of technology development, competitiveness and service deployment. The Commission began a dialogue with the member States, operators and manufacturers in order to consider specific means to facilitate deployment of Third generation, and, among others, the conditions to permit network infrastructure sharing, which the Commission favors. On June 12, 2002, The Commission produced an analysis of the situation of 3G today, adopting a Communication entitled *Towards a full roll out of third generation mobile communication*. The Communication provides an overview of the 3G sector, focusing on the technological aspects, the new regulatory framework, the secondary trading of spectrum and on the obstacles to the roll out of 3G networks, such as environmental and local planning issues and health concerns.

### ***Leased Lines Pricing***

The Commission adopted, on November 24, 1999 a Recommendation on Leased Lines Interconnection prices for a liberalized telecommunications market.

Pricing of services for the interconnection of leased lines have to be provided in the RIO of public fixed network operators designated by the national regulatory authority as having significant market power in accordance with Directive 97/33/EC.

The Recommendation takes the form of a set of recommended price ceilings based on the prices in the three lowest cost Member States. Where charges are above the price ceilings, the National Regulatory Authority is to use its rights under article 7(2) of the Interconnection Directive (97/33/EC) to request full justification of the charges, and, if appropriate, require these charges to be lowered.

### ***Local Loop unbundling***

In response to the conclusions of the special European Council in Lisbon in March 2000 and to the commitments made in the Commission's Communication on the results of the public consultation on the 1999 Review, the Commission proceeded with a separate legal measure on Local Loop Unbundling distinct from the proposal for a Directive on Interconnection and Access.

In December 2000, the European Parliament and the European Council adopted Regulation No. 2887 ( Regulation 2887 ) on local loop unbundling. Regulation 2887 is concise, consisting of only five articles. The decision to use a regulation on LLU instead of a Directive was

made because regulations do not require time for transposition and are immediate in effect once adopted. Regulation 2887 covers unbundled access to the access to the local loops and related facilities of fixed public telephone network operators that have been designated by the national regulatory authority as having Significant Market Power in the provision of fixed public telephone networks. Notified operators are required to publish December 31, 2000 and keep updated, a reference offer for unbundled access to their local loops and related facilities. Operators are required to meet reasonable requests from beneficiaries for unbundled access to their local loops and related facilities under transparent, fair and non-discriminatory conditions, and charge prices for such services set on the basis of cost-orientation.

When the National Regulatory Authority determines that the local access market is sufficiently competitive, it shall relieve the notified operators of the obligation for cost-oriented prices.

***Radio spectrum policy***

In July 2000, the Commission presented a proposal for a decision of the European Parliament and of the Council on a regulatory framework for radio spectrum policy in the European Community, which is intended to

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ensure the harmonized availability and efficient use of radio spectrum, where required to implement Community policies in areas such as communications, transport, broadcasting and research and development. The proposal draws upon the experience gained with Community decisions in the areas of satellite Personal Communications Services and UMTS. The decision was adopted on March 7, 2002 and published in the Official Journal on April 24, 2002. The decision seeks to complement, rather than to replace, the spectrum management activities of ITU/WRC and CEPT and of the member States by providing for a Radio Spectrum Committee which the Commission will consult periodically on relevant matters, thus contributing to the formulation, preparation and implementation of the Community radio spectrum policy.

Moreover, the Commission has announced its intention to adopt a Decision to establish a Radio Spectrum Policy group (RSPG), whose main function would be to advise the EU the Commission on the requirements and on the co-ordination of policy approaches and harmonized conditions related to radio spectrum. The decision was adopted in Summer 2002.

### ***Voice over Internet***

On December 22, 2000 the Commission published in the Official Journal a Communication on the status of voice services over the Internet. This updates a similar notice issued in January 1998 and follows a public consultation held in 2000.

The Commission considers that Internet telephony in general continues to fall outside the definition of voice telephony, except where Internet telephony meets each of the conditions established in the Directive as set out in the 1998 notice. This means, that Member States should normally continue to allow Internet access/service providers to offer voice on Internet under data transmission general authorizations, and that no mandatory requirement for an individual license is required. Conversely, voice communication services fulfilling the four conditions enshrined in the Directive and therefore appearing as substitutes for voice telephony services provided by traditional means should be regarded as voice telephony and be submitted to the relevant regulatory regime, in consideration of the principle of technological neutrality.

### ***VAT and Electronic commerce***

The Commission tabled in June 2000 proposals for a regulation to amend Reg. 218/92 on VAT and electronic commerce and for a Directive to amend the VI VAT Directive. The Commission's proposal aims to ensure that certain electronically delivered services are taxed at the place of consumption. The proposals also clarify that VAT would apply to television and radio broadcasting services that are supplied on a subscription or pay-per-view basis. On May 7, 2002 the Council adopted the Commission's proposal for the Directive. According to the new rules, EU suppliers will no longer have to levy VAT when they sell certain electronic services to non-EU Member States. Non-EU suppliers selling into the EU to private consumers would have to charge VAT and register for VAT purposes in one of the Member States. The new rules will need to be implemented by July 1, 2003.

Concerning the regulation, the Council reached a political agreement on the proposal in February 2002 but the Parliament needs to be consulted on the draft Regulation. Moreover, in November 2000 the Commission proposed a proposal for a Directive on the harmonization of the rules relating to VAT invoicing. The Directive 2001/115/EC was adopted and published on the Official Journal on December 20, 2001. The directive amends the existing provision on VAT invoices contained in the VI VAT directive to take account of electronic commerce. It contains provisions which aim at harmonising the statements that must be included on invoices for VAT purposes, allowing invoices to be transmitted and stored electronically, and enabling competent authorities of a Member State to access electronic invoices that are stored in other Member States.



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On June 8, 2000 the European Parliament and the Council adopted Directive 2000/31/CE on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce).

This Directive disposes the free circulation of the Information Society services in the Internal Market, the exclusion of prior authorization for the services offer, the general information to be provided by the service provider, the possibility to conclude contracts by electronic means, the general non liability of intermediary service providers at certain conditions (mere conduit).

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### ***Internet Domain Name***

In April 2000 the Commission published a Communication on the organization and management of the Internet International and European policy issues 1998-2000. The EP adopted a resolution in March 2001.

Moreover, a Communication on the follow-up of the Working paper on the creation of .EU. Internet top level domain was published by the Commission in July 2000.

On April 22, 2002 the European parliament and the Council adopted a Regulation on the implementation of the .eu Top Level Domain, which sets out the framework to allow companies, organizations and individuals to register a .eu domain name address provided that they are established or reside in the EU. The regulation also provides for a register which will be the entity responsible for the organization, administration and management of the .eu top level domain.

### ***Public procurement***

On May 12, 1999, the EU Commission adopted a Communication including a list of services regarded as excluded from the scope of Council Directive 93/38/EEC coordinating the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors (under Article 8 of this Directive, the Commission may exempt services from the application of the public procurement rules where it believes competition has developed sufficiently).

The Commission has thus reached the conclusion that public contracts relating to most telecommunications services in most Member States should be considered excluded from the scope of the Utilities Directive.

### ***Television without Frontiers***

On October 3, 1999 the Council adopted a Directive on the coordination of certain provisions laid down by law, regulation or administrative action in Member States, concerning the pursuit of television broadcasting activities (Television without Frontiers, 89/552/EEC). This Directive was amended by the Directive 97/36/EC.

It provides specific regulation on the insertion of the advertising during programs, advertising ceilings during one hour and during one day, minor protection measures and the possibility by Member States to adopt more strict rules than those fixed in the Directive.

In April 2003 a public consultation began, in order to eventually update the Directive in view of adapting it to the new market and technological context.

*The 1999 Review*

It was intended that the 1998 regulatory package be reviewed by January 1, 2000. The Commission started a number of studies on the following subjects: (i) remaining barriers in the EU-wide telecommunications market; (ii) assessment of the interconnection situation in the EU; (iii) fixed-mobile convergence/integration; (iv) consumer demand; (v) quality of telecommunication services and consumer protection; (vi) need for a European regulator; and (vii) universal service obligations.

As a result of the above-mentioned studies, the Commission proposed the following five Directives:

- a common regulatory framework for electronic communications networks and services ( Framework Directive );
- the authorization of electronic communications networks and services ( Authorization Directive );
- access to, and interconnection of, electronic communications networks and associated facilities ( Access Directive );
- universal service and users' rights relating to electronic communications networks and services ( Universal Service Directive ); and
- the processing of personal data and the protection of privacy in the electronic communications sector ( Personal Data Directive ).

The Framework, Authorization, Access and Universal service Directives were adopted in March 2002 and published in the Official Journal on April 24, 2002. Member States must adopt these Directives into their own laws by July 24, 2003. The new Directives will substantially change the existing regulatory framework.

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**Framework Directive.** In an important change described by the Commission as rolling back regulation, the Directive redefines the concept of Significant Market Power and the threshold for imposing obligations on certain operators. The directive amends the current definition of Significant Market Power based on a 25% or more share of the relevant market.

In the Directive, the notion of SMP is based on the concept of dominant position, calculated in a manner consistent with competition law practice. Significant Market Power implies the application of rules in accordance with the conditions imposed by the other Directives.

**Authorization Directive.** The Authorization Directive provides for electronic communications services and networks to be provided under general authorization. Licenses will no longer be required and specific rights of use would be granted, separately from authorizations, for the assignment of radio frequencies and numbers.

A notification will require only the following elements:

- a declaration of the intention to start operation;
- contact information of the company requesting the authorization; and/or
- a short description of the service provided.

Upon notification the company can start to operate a network and provide services, provided that it has the right to use radio frequency and numbers if needed. No information should be required prior to, or as a condition for, market access. Nonetheless, Member States could require some justified information (listed in the proposal) from undertakings.

**Access Directive.** The Access Directive represents a significant departure from the current Interconnection Directive 97/33/EC which sets out common obligations to be followed by Significant Market Power operators in all Member States.

Under the directive, national regulatory agencies will have flexibility to select which access and interconnection obligations to impose on operators notified as having Significant Market Power in relevant markets. A maximum list of obligations is contained in the directive. The proposed operators with rights and obligations to interconnect are essentially the same as those defined in the current ONP Interconnection Directive.

National regulatory agencies will carry out an analysis of the competitiveness of a designated list of relevant product and service markets and identify which operators (if any) have Significant Market Power on any of the particular markets. A National Regulatory Authority will be able to impose price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access services.

National regulatory agencies will also be able to impose obligations for transparency, non-discrimination, and accounting separation on Significant Market Power operators in relation to interconnection and/or network access. These obligations are carried over from the current regulatory framework.

**Universal Service Directive.** The Universal Service Directive replaces the existing directive on voice telephony and universal services. The Directive also contains rules on number portability, carrier selection and carrier pre-selection which are currently in the Interconnection Directive. The directive also covers the provision of leased lines and other mandatory services as well as a number of issues concerning users rights, such as contracts, tariff transparency and information and quality of service.

In general, the existing requirements for the provision of universal service, voice telephony facilities and leased lines will remain in place, at least for the time being. The principal changes are described below.

In an important section on retail price regulation (up to now only covered in national law), it is proposed that, when an operator has Significant Market Power in the provision of access to, and use of, public telephone services, the National Regulatory Authority must:

- determine appropriate mechanisms for retail price control, such as price caps or specific price floors and ceilings;

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- ensure that the Significant Market Power operator sets prices at normal commercial levels;
- notify to the Commission the names of organizations subject to retail price control; and
- retail price control mechanisms should not be applied where effective competition exists.

The directive also provides for the extension of the requirement for number portability to mobile operators.

The processing of personal data and the protection of privacy is currently regulated by the general Data Protection Directive (95/46/EC) with specific issues in the telecommunications sector addressed by the Data Protection and Telecommunications Directive (97/66/EC).

### ***Data Protection Directive***

In July 2000, the Commission published a Draft proposal for a Directive for data protection on the Electronic Communications sector. It aims at replacing directive 97/66 of 1997 on the processing of personal data and the protection of privacy in the telecommunications sector by updating and adapting it to market and technological development.

On July 12, 2002, Directive 2002/58/CE was adopted on the treatment of personal information and on the safeguarding of privacy in the electronic communications sector. The new directive abrogates and replaces the above-mentioned directive 97/66.

The main changes are the extension of scope and technological neutrality. The principle of technological neutrality implies that consumers and users should get the same level of protection regardless of the technology used. Telecommunications services and networks would be replaced by electronic communications services and networks in line with the proposed common Framework Directive.

The scope of the new directive is to include networks used for radio and television broadcasting and cable TV networks, irrespective of the type of information conveyed (these were excluded from Directive 97/66/EC) but would exclude content of broadcasting transmissions.

### ***Guidelines on Market Analysis***

In March 2001 the Commission published Draft Guidelines on market analysis and the calculation of Significant Market Power. The Commission has called for public comments and an exchange of views among the interested authorities and different market operators. The Guidelines set out the principles for use by national regulatory authorities in the analysis of effective competition, when determining whether an operator has significant market power. Operators having significant market power may be subject to obligations under other Directives in the regulatory package. The guidelines were adopted in July 2002.

On June 17, 2002, the Commission issued the draft of the Recommendation on the list of markets to which the new framework will be applied and a working document, for opening the public consultation on the Recommendation in accordance with Art. 15(1) of the Framework Directive. The Recommendation was adopted in February 2003.

***Recommendation on relevant markets***

Article 15(1) of the Framework Directive requires the Commission to adopt a Recommendation on relevant product and service markets. The Recommendation aims at identifying markets for which competition law remedies may be insufficient to effectively redress possible market failures.

The Recommendation was adopted on February 11, 2003 and identifies 18 relevant markets at retail and wholesale level. The range of different network topologies and technologies deployed across the EU means that in some cases National Regulatory agencies must decide the precise geographical boundaries between, or elements within, particular product and service markets identified in the Recommendation. National regulatory authorities may identify markets that differ from those of the Recommendation, provided they act in accordance with Article 7 of the Framework Directive.

***Recommendation on remedies***

The recommendation is under preparation by the Commission. The purpose of this recommendation will be to indicate to the respective national regulatory authorities which remedies have to be applied according with the

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principle of proportionality in order to achieve the objectives set out in the Framework directive. The Recommendation is at the earliest stage (no draft yet) and it should be adopted within the year 2003.

### **Competition Law**

Telecom Italia is subject to Law No. 287 of October 10, 1990 ( Law 287 ), the Italian competition law of general application, to the substantive rules of the Maccanico Law ( Law 249 ) and to the competition rules of the EU. Law 287 forbids:

- agreements (including resolutions and concerted practices) aimed at fixing prices, limiting production or access to markets and technological developments, sharing of markets, applying different conditions for the same services to the detriment of competitors, and subjecting contracts to the acceptance of conditions that, according to their nature and common practice, are not linked to the object of the contract;
- abuses of dominant position (including practices aimed at fixing prices, limiting production or access to markets and technological developments, applying different contractual conditions for the same services to the detriment of competitors, as well as subjecting contracts to the acceptance of conditions that, according to their nature and common practice, are not linked to the object of the contract); and
- concentrations of enterprises (i.e., mergers, acquisitions of controlling interests and concentrative joint ventures) which would result in the creation or strengthening of a dominant position. All concentrations in relation to which the combined overall turnover, in Italy, of the companies involved is higher than 377 million or the turnover of the company being acquired is, in Italy, higher than 37 million, must receive a prior authorization from the Antitrust Authority. These thresholds are adjusted every year to take account of inflation. Failure to file prior notification of a concentration to the Antitrust Authority will result in a fine from 1% to 10% of the turnover of the parties involved in the concentration, or higher in the case of fines for violation of a prohibition of a concentration.

Law 287 is administered by the Antitrust Authority which, either on its initiative or following a complaint submitted by any interested party (the Interested Party ), has the power to investigate and ascertain compliance with Law 287. When the Antitrust Authority finds prima facie evidence that Law 287 has been violated, the parties involved (including the Interested Party) are notified of the opening of a formal investigation. The party under investigation (the Investigated Party ) and the Interested Parties shall then have the right to be heard and to file written arguments with the Antitrust Authority. Pending the investigation, the Antitrust Authority may also require the parties involved and third parties to disclose information or to submit documents that it considers useful for the investigation. In addition, the Antitrust Authority may appoint experts and carry out direct inspections at the Investigated Party 's premises in order to examine and seize relevant documents.

If at the conclusion of the investigation the Antitrust Authority determines that Law 287 has been violated, it orders the Investigated Party to cure the relevant violation and, in the case of serious violations, imposes fines up to 10% of the turnover relating to the relevant activities. Any failure to comply is sanctioned with an additional fine up to 10% of the turnover of the Investigated Party.

With respect to competition matters, the decisions of the Antitrust Authority are considered administrative acts and may be appealed before the TAR of Lazio, based in Rome, for violation of law, abuse of power and lack of jurisdiction. The TAR may either reject the appeal or declare the Antitrust Authority 's decision null and void. The TAR, upon request of the complainant, may also suspend the enforcement of the decision of the Antitrust Authority. The TAR 's judgments may be further appealed before the State Council, whose decision is final.



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The Antitrust Authority has no powers other than those indicated above. It may not issue provisional injunctions or impose liquidated damages for abuses of dominant positions. For these remedies, Law 287 confers special jurisdiction on the Court of Appeal that has jurisdiction over the relevant case.

In addition to Law 287, the Maccanico Law confers upon the National Regulatory Authority the power to enforce provisions aimed at ensuring pluralism in the communications sectors, including radio and television broadcasting activities.

Moreover, the competition rules of the EU ( EU Competition Law ) also have a direct effect in Italy. The main principles of EU Competition Law are contained in Articles 81 and 82 of the Treaty of Rome. Article 81 prohibits agreements or concerted practices between undertakings that may affect trade between Member States

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and has the object or effect of restricting competition within the EU. Article 82 prohibits any abuse of a dominant position within a substantial part of the EU that may affect trade between Member States. These rules are primarily enforced by the European Commission, which cooperates with the national competition authorities, and through the national courts. The Antitrust Authority has the power to apply Article 81(1) and Article 82, following its own procedures and imposing, if necessary, the fines provided for under Law 287. In September 1991, general guidelines were published by the European Commission on the application of EU Competition Law in the telecommunications sector. In August 1998, the European Commission published a notice updating the 1991 guidelines. These guidelines outline the EU's approach to common competition issues.

On December 11, 1996, the Commission adopted a Communication on the application of the competition rules to access agreements in the telecommunications sector. The purpose of this notice is:

- to set out access principles stemming from EU law in order to create more market certainty;
- to define and clarify the relationship between competition law and sector specific regulation; and
- to explain how competition rules will be applied in a consistent way across the converging sectors. On October 3, 1997, the EU adopted a further communication on the definition of the relevant market for the purpose of EU competition law. The aim of this notice is to provide guidance as to how the Commission applies the concept of relevant product and geographic market in its ongoing enforcement of EU competition law.

In April 1999, the Commission adopted a White Paper on modernization of the rules implementing Articles 81 and 82 of the EC Treaty, which examined various options for reforming the system and proposed the adoption of fundamentally different enforcement system called a direct applicable exception system. Such system is based on the direct applicability of the exception rule of Article 81.3, implying that the Commission and national competition authorities and courts would apply Art. 81.3 in all proceedings in which they are called upon to apply Art. 81.1, which is already directly applicable.

In September 2000, the Commission presented a Proposal for a Council regulation on the implementation of the rules on competition which provides for the abolition of the Commission exclusivity in the application of art. 81.3; a system of legal exception and evaluation ex post of the agreements; an effective decentralization of the enforcement of EU competition rules; and the strengthening of Commission's investigation powers. Further to the debate at the European parliament in December 2001, the Council adopted Regulation No 1/2003 on December 16, 2002 implementing Articles 81 and 82 of the EC Treaty. This regulation will replace Regulation 17/62 when it comes into force on 1.5.2004. Until then, Regulation 17/62 remains in force. The new Regulation simplifies the way in which the EC Treaty's antitrust rules are enforced in the European Union. Most importantly, the new Regulation abolishes the practice of notifying business agreements to the Commission, therefore reducing bureaucracy and legal costs for companies. The simplified system of the new Regulation is designed to facilitate the effective enforcement of the antitrust rules in the EU comprising more than 15 Member States. The new regulation allows national courts and competition authorities to directly apply Article 81(3) without prior involvement of the Commission.

Under the Regulation, where the trend of trade between Member States, the rigidity of prices or other circumstances suggest that competition may be restricted or distorted within the common market, the Commission may conduct an inquiry into a particular sector or into a particular type of agreements across various sectors. The Commission may request the undertakings or associations concerned to supply all the information necessary for giving effect to Arts. 81 and 82 of the Treaty and may carry out any inspections necessary for that purpose.

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Under Regulation 17/62, in October 1999, the Commission launched the first phase of sectoral inquiries into telecommunications, regarding the conditions for providing and pricing of leased lines. In September 2000, the Commission published a Working document on the initial findings of the leased lines sector inquiry. In December 2002, the European Commission announced that it is closing the sector inquiry into leased lines pricing together with two cases concerning Belgium and Italy.

In February 2000, the European Commission launched the second phase of the investigation on competition rules into the telecommunications sector, sending out formal information requests concerning the conditions and pricing of national and international mobile roaming. In December 2000, the Commission published the Working Document on the preliminary findings of this phase of the sector inquiry. In July 2000, the Commission sent a

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request for information to the incumbent telecommunications operators to find out whether, and under what conditions, they allow their competitors access to the local loop. In July 2001, the Commission sent a questionnaire to new entrants asking to identify the remaining difficulties in obtaining local loop access. The purpose of the enquiry is to detect any abuses of a dominant position. These new requests for information mark the third stage of the sectoral enquiry on the telecommunications industry. The evaluation of the information collected is still ongoing.

On December 11, 2001 the European Commission issued a Green paper on the Review of Council Regulation (EEC) No 4064/89, concerning mergers with community dimensions. The Commission seeks to launch a wide ranging debate on the functioning of the EU merger control regime based on the experience gained during the last 10 years. On December 11, 2002 the Commission published a proposal for a Council Regulation on the control of concentrations between undertakings. The proposal tackles jurisdictional issues (such as the notion of concentration and the community dimension), substantive issues (such as the concept of dominance) and Procedural issues (such as the timing of notifications, the suspension of proceedings, etc.).

In December 2002 the Commission published also Draft Guidelines on horizontal mergers (which addresses the issue of oligopolies and collective dominance) and draft Best Practices on the conduct of EC merger control proceedings. The consultation process is still ongoing.

The Commission finds it is the appropriate time to review the Regulation, to ensure effective, efficient, fair and transparent control of concentrations at the most appropriate level.

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**GLOSSARY OF SELECTED TELECOMMUNICATIONS TERMS**

The following explanations are not intended as technical definitions, but to assist the general reader to understand certain terms as used in this Annual Report.

**Access charge:** Amount paid per minute charged by the national operators for the use of their network by operators of other networks. Also, known as an interconnection charge .

**ADSL (Asymmetric Digital Subscriber Line):** A copper based access technology that allows a telephony channel and a digital channel (from 1.5-8 Mbit/s) to be carried from the network to the customer (downstream) and a telephony channel and a low bit rate digital channel (16-64 Kbit/s) to be carried from the customer to the network (upstream). It is generally utilized in conjunction with an ATM transport network.

**Analog:** A transmission or switching which is not digital, e.g., the representation of voice, video or other modulated electrical audio signals which are not in digital form.

**Analog network:** A network using analog technology with circuit switching, capable of connecting one user with all the others, but with limited transmission capacity.

**ATM (Asynchronous Transfer Mode):** A broadband switching technology that permits the use of one network for different kinds of information (e.g., voice, data and video).

**Backbone:** A primary shared communication path that serves multiple networks and may facilitate communications between different protocols.

**Broadband services:** Services characterized by a transmission speed of 2 Mbit/s or more. According to international standards, these services are divided into two categories: (i) Interactive services, including videotelephone/videoconferencing (both point-to-point and multipoint); videomonitoring; interconnection of local networks; file transfer; CAD; highspeed fax; e-mail for moving images or mixed documents; broadband videotex; Video on demand; retrieval of sound programs or fixed and moving images; and (ii) Broadcast services, such as sound programs, television programs (including high-definition TV and pay TV) and selective document acquisition.

**Broadcast:** Simultaneous transmission of information to all nodes and terminal equipment of a network.

**BSS (Business Support System):** The system used by network operators to manage business operations such as billing, sales management, customer-service management and customer databases. A type of Operations Support System OSS.

**Business Packet:** The Italian packet-switching data network.

**Carrier:** Traditionally, the carrier is the company that makes the physical lines available.

**CATV (Cable television):** Cable or fiber-based distribution of TV programs.

**Cellular:** A technique used in mobile radio technology to use the same spectrum several times in one network. Low power radio transmitters are used to cover a cell (i.e., a limited area) so that the frequencies in use can be reused without interference for other parts of the network.

**Channel:** The portion of a communications system that connects a source to one or more destinations. Also called circuit, line, link or path.

**Closed User Group:** A group of telecommunications users that share a longstanding economic interest. This definition has arisen in a regulatory context; it permits the partial liberalization of some telecommunications services.

**Coaxial cable:** A type of electrical cable in which a central conductor covered by an insulator is then surrounded with a cylindrical conducting sheath whose axis coincides with that of the central conductor, hence the term "coaxial".

**Corporate Network:** A network, which could be a virtual private network, provided by a corporation for its own use and possibly for that of other corporations. The network's features are tailor-made to address the

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specific need of the client. It is separate from the network provided by the national telecommunications carrier, but it may be connected to the latter for the use of selected facilities.

**Data Network Access Point:** Unit of measurement used in data network business.

**DCS 1800 (Digital Communication System):** A derivative of the GSM cellular mobile telephone standard. 1800 refers to the frequency used of 1800 MHz. DCS 1800 is the European PCN standard.

**Digital:** A mode of representing a physical variable such as speech using digits 0 and 1 only which vary in relation to the variable being represented. The digits are transmitted in binary form as a series of pulses. Digital networks are rapidly replacing the older analog ones. They allow for higher capacity and higher flexibility through the use of computer-related technology for the transmission and manipulation of telephone calls. Digital systems offer lower noise interference and can incorporate encryption as a protection for external interference.

**District traffic:** Long distance telephone calls within the same area code.

**ESPRIT (European Strategic Programme for Research and Development in Information Technologies):** A program financed by the EU to sponsor research and development in information technology.

**Exchange:** See Switch.

**Frame Relay:** A data transmission service using fast protocols based on direct use of transmission lines.

**Gateway:** A connection between the LANs and WANs of one or more suppliers. Can also mean the access nodes to international networks of various kinds.

**GPS (Global Positioning System):** A constellation of satellites, orbiting the Earth two times a day, that is able to pinpoint precisely where a certain object is on Earth.

**GSM (Global System for Mobile Communications):** A standard for mobile cellular telephony used in Europe, Asia, South Africa and Australia, based on digital transmission and cellular network architecture with roaming.

**GSM TIM Card:** A prepaid, rechargeable card which permits the TIM mobile customer to make outgoing calls up to the limit of the card and receive an unlimited number of calls.

**IN (Intelligent Network):** Network architecture that centralizes processing of calls and billing information for calls.

**INTELSAT (International Telecommunications Satellite Organization):** An international organization formed in 1964 to provide satellite communications among countries.

**Interactive:** The user can change some aspect of the program received.

**Internet:** The world's best-known data network. Initially used by the U.S. Department of Defense, the Internet now provides an interface for networks based on different technologies (LANs, WANs, data networks, etc.), but which use the TCP/IP protocol platform.

**ISDN (Integrated Services Digital Network):** A system in which several services (e.g., speech and data) may be simultaneously transmitted end to end in digital form.

**ITU (International Telecommunication Union):** The worldwide policy, spectrum regulation and standardization body in telecommunications operating under the auspices of the United Nations.

**LAN (Local Area Network):** A private network that covers a local geographic area and provides public telecommunications services as well as interconnection between personal computers.

**Modem:** Modulator/Demodulator. A device that modulates digital data to allow their transmission on analog channels, generally consisting of telephone lines.



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**Multimedia:** A service involving two or more communications media (e.g., voice, video, text, etc.) and hybrid products created through their interaction.

**Network:** An interconnected collection of elements. In a telephone network, these consist of switches connected to each other and to customer equipment. The transmission equipment may be based on fibre optic or metallic cable or point to point radio connections.

**Nodes:** Topological network junction, commonly a switching center or station.

**ONP (Open Network Provision):** Principles and conditions laid down by the EU for access to and usage of public telecommunications networks and services. A network architecture that permits telecommunications services to be offered on facilities of public operators and for equipment to be connected to such networks.

**Optical fiber:** A transmission medium which permits extremely high capacities. It consists of a thin strand of glass that provides a pathway along which waves of light can travel for telecommunications purposes.

**OSS (Operations Support System):** Methods and procedures (mechanized or not) which directly support the daily operation of the telecommunications infrastructure.

**Outsourcing:** Hiring outsiders to perform various telecommunications services, which may include planning, construction, hosting of a network or specific equipment belonging to a company, and, ultimately, the management of entire telecommunications systems. Value-added applications may also be provided in various sectors.

**PABX:** Private Automatic Branch Exchange. Telephone switchboard for private use, but linked to the national telephone network.

**Packet-Switched Services:** Data services based on parceling or breaking the data stream into packets and switching the individual packets. Information transmitted (whether voice or data) is segmented into cells of a standardized length, which are then transmitted independently of one another, allowing maximization of available capacity and usage of a single transmission path for multiple communications. The cells are then reassembled upon reaching their destination.

**Pay-Per-View:** A system by which the viewer pays to see a single program (such as a sporting event, film or concert) at the moment at which it is transmitted or broadcast.

**Pay TV:** Paid-for TV channels. To receive Pay TV or Pay-Per-View programs, a decoder must be connected to the television set, connected to a conditional access system.

**PCN (Personal Communications Network):** PCN is a cellular telephony network designed to have the high capacity required to support a mass market service.

**PCS:** Means personal communications services.

**Penetration:** The measurement of the take-up of services. As of any date, the penetration is calculated by dividing the number of subscribers by the population to which the service is available and multiplying the quotient by 100 on such a date.

**Platform:** The total input, including hardware, software, operating equipment and procedures, for producing (production platform) or managing (management platform) a particular service (service platform).

**POTS (Plain Old Telephone Service):** The basic telephony service supplying standard, single-line telephones, fixed-line services and access to public voice telephony network.

**PSTN (Public Switched Telephone Network):** The public telephone network delivering the basic telephone service and, in certain circumstances, more advanced services.

**Roaming:** A function that enables wireless subscribers to use the service on networks of operators other than the one with which they signed their initial contract.

**Satellite services:** Satellites are used, among other things, for links with countries that cannot be reached by cable or to provide an alternative to cable and to form closed user networks.

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**SDH Standard (Synchronous Digital Hierarchy):** The European standard for high-speed digital transmission.

**Service Provider:** The party that provides end users and content providers with a range of services, including a proprietary, exclusive or third-party service center.

**SME:** Refers to the small- and medium-size enterprise market which consists of businesses having between 3 and 50 employees.

**SOHO:** Refers to the small office/home office market which consists of businesses that use telephone lines to connect to the Internet, as opposed to dedicated lines, and is made up of small businesses, generally with one or two employees, and businesses conducted out of the home.

**Switch:** These are used to set up and route telephone calls either to the number called or to the next switch among the path. They may also record information for billing and control purposes.

**Switched Transit Traffic:** Consists of calls placed between two other countries that are routed through the Italian fixed network.

**Synchronous:** Type of data transmission in which there is permanent synchronization between the transmitter and the receiver.

**TACS (Total Access Communication System):** An analog cellular network using the 900 MHz band based on a European standard also used in the UK, Ireland, Austria and Spain. Features include handover and available add-on services include answering, call notification, call transfer, differentiation of business and private calls, authorization code for outgoing international calls and itemized billing.

**UMTS (Universal Mobile Telecommunication System):** Third generation mobile communication system.

**Universal service:** The obligation to supply basic service to all users throughout the national territory at reasonable prices.

**VAS (Value Added Services):** Value Added Services provide a higher level of functionality than the basic transmission services offered by a telecommunications network for the transfer of information among its terminals, which include wired or wireless switched-circuit analog voice communications; direct unrestricted digital point-to-point service at 9,600 bit/s; packet switching (virtual call); direct broadband analog transmission of TV signals, and supplementary services, such as closed user groups; call waiting; collect calls; call forwarding, and identification of number called. Value Added Services performed by the network, the terminals or the specialized centers include message handling services (MHS) (which can be used, among other things, for commercial documents in predetermined formats); electronic directories listing users, network addresses and terminals; e-mail; fax; teletex; videotex and videotelephone.

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Value Added Services could include also value added voice telephony services such as Freephone or Premium Rate Services.

**VAN (Value-added Network):** A type of public network that leases basic transmission facilities from a common carrier, adds features that enhance the service and provides the improved communications capability to end users. Automatic alternate routing network management and error correction are examples of the value added.

**Videotex:** A service pursuant to an ITU standard, permitting remote access to database by telephone.

**VPN (Virtual Private Network):** A network designed for a business or government agency, using the infrastructures of a carrier and providing customized services, which operates in such a manner as to appear dedicated to the user thereof.

**WAN (Wide Area Network):** A private network that covers a wide geographic area using public telecommunications services.

**WAP (Wireless Application Protocol):** A Technology which allows access to Internet using mobile radio sets, even without the use of a computer.

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**DESCRIPTION OF PROPERTY**

**General**

As of December 31, 2002, the Telecom Italia Group owned approximately 7,200 buildings located throughout Italy. Specialized buildings for telecommunications services account for the majority of properties both in number and book value. They house mainly exchange equipment and transmission equipment, and are used as part of the Telecom Italia Group's continuing telecommunications operations. General purpose properties consist chiefly of offices, depots and computer centers.

The principal categories of the Telecom Italia Group's equipment are exchanges and transmission equipment, cable networks, base stations for cellular networks and equipment for radio communications, most of which are located throughout Italy. The Telecom Italia Group also has numerous computer installations which are primarily located at the headquarters of the Telecom Italia Group's significant subsidiaries.

At December 31, 2002, telecommunications installations, including local and domestic long distance networks and radio transmission equipment, represented approximately 77% of the fixed assets of the Telecom Italia Group, land and buildings represented 11%, plant under construction, advances to suppliers and stock for fixed assets represented 8%, and furniture, office equipment and other equipment, technical installations and machinery comprised the remaining 4%.

As of December 31, 2002, the total amount of liens, mortgages and pledges on real property owned by the Telecom Italia Group was 254 million. Such liens, mortgages and pledges do not represent major encumbrances on fixed assets and on the material plans to expand or construct new facilities.

An important element of Telecom Italia's restructuring plan was to realize value on its extensive real estate portfolio.

In November 2000, Telecom Italia established a partnership with Beni Stabili, a leading Italian real estate operator, and Lehman Brothers to manage a significant portion of Telecom Italia's real estate portfolio.

Telecom Italia contributed a going concern including an important portion of its real estate portfolio to IM.SER and subsequently sold 45% of this company to Beni Stabili and 15% to Lehman Brothers.

The real estate portfolio originally held by IM.SER consisted of 581 properties, totaling 3.7 million square meters and was composed of two parts, the Real Estate Investment Portfolio and the Real Estate Trading Portfolio :

- Real Estate Investment Portfolio, consisting of 386 properties totaling approximately 2.4 million square meters, located throughout Italy. All the properties, including buildings that contain telecommunications equipment, were leased to Telecom Italia at the end of 2000 under

long-term lease contracts (21 plus 6 years) at market rates; and

- Real Estate Trading Portfolio, consisting of 195 properties totaling approximately 1.3 million square meters, located throughout Italy. Of these properties, the majority have been leased at market rates to Telecom Italia under contracts allowing for early termination in favor of Telecom Italia.

In May 2001, IM.SER contributed its Real Estate Trading Portfolio to Telemaco Immobiliare, a newly formed company. Following such contribution, IM.SER sold the shares of Telemaco Immobiliare to its shareholders. The shareholders of Telemaco Immobiliare at that time were Beni Stabili with a 45% stake, Telecom Italia with a 40% stake and Lehman Brothers with a 15% stake.

On May 16, 2001 Beni Stabili exercised an option to buy the Lehman Brothers stake in IM.SER, resulting in Beni Stabili holding a 60% stake in IM.SER and Telecom Italia a 40% stake.

During 2002 some additional real estate related transactions were completed:

#### **Tiglio Project**

Pursuant to a framework agreement signed in May 2002 between the Pirelli, Olivetti-Telecom Italia Groups and The Morgan Stanley Real Estate Funds (through MSMC Italy Holding B.V. and POPOY Holding B.V.)

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certain real estate properties as well as the entities that provide real estate services to the same companies or to their subsidiaries were transferred to two new vehicles companies set up for this purpose (Tiglio I S.r.l. and Tiglio II S.r.l.).

Among the preliminary transactions for the concentration of the real estate assets in Tiglio I and Tiglio II, on October 24, 2002, the non-proportional partial spin-off of IM.SER (60% Beni Stabili and 40% Telecom Italia) was effected by which the relative real estate assets were contributed to the company IM.SER 60 (98% Beni Stabili group and 2% Telecom Italia) and to the company EMSA Immobiliare (100% controlled by Telecom Italia) in proportion to the stakes held in IM.SER, respectively, by Beni Stabili and Telecom Italia.

Following this transaction, which came after the positive conclusion of the securitization of IM.SER 60's debt, and also to the effect of certain fixed asset acquisitions by companies in the Seat Pagine Gialle group, EMSA Immobiliare had a portfolio of 169 real estate properties.

On October 29, 2002, having satisfied the necessary conditions, a series of acts were finalized whereby the first stage of the Tiglio Project was concluded including the following:

- the subscription, simultaneously with all the other participants, to a capital increase by Tiglio I for cash, with the consequent stake in the company equaling 36.85% (in addition, at Telecom Italia Group level, to the 2.1% subscribed to by Seat Pagine Gialle), in proportion to the value of the assets transferred by Telecom Italia (and by Seat Pagine Gialle) to Tiglio I to the total assets that were taken over by the latter company;
- the subscription to a capital increase by Tiglio II paid for in kind by the contribution of Telecom Italia Asset Management business segment with the consequent stake in the company equaling 49.47%;
- the sale of the investment in EMSA Immobiliare to OMS2 (100% controlled by Tiglio I);
- the sale directly and through the subsidiary Saiat of the investment in Telimm S.r.l. to the company MSMC Immobiliare Holding (entirely controlled by Tiglio I).

With reference to the part of the Tiglio Project regarding the optimization of the service activities, in November, Telecom Italia sold its Property Management, Project Management and Agency businesses to the Pirelli & C. Real Estate group.

The above mentioned transactions gave rise to a total gross capital gain for the Telecom Italia Group of 234 million.

The agreement also calls for leveraging, during 2003, the assets of Tiglio I and Tiglio II through a market transaction within the framework of a strategy that could contribute to the development of the real estate financial market, with consequent significant opportunities for the Telecom Italia Group to leverage the investments currently held in the two companies. In the framework of this strategy, the assets of Tiglio I and Tiglio II would be contributed to one or more real estate investment funds in accordance with applicable laws and regulations, the shares of which would be purchased by institutional investors or listed and therefore offered to the public.

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Finally, as agreed between the parties, December 24, 2002 marked the completion of the merger by absorption, in Tiglio I and Tiglio II, of the real estate investment holdings owned by them falling under Tiglio Project and already 100% controlled, directly or indirectly so that the corporate structure of the two subjects could be optimized, in view of the successive actions to leverage the assets on the market.

### **Sale of IMMSI**

On November 22, 2002, Telecom Italia sold its stake in IMMSI to the company Omnipartecipazioni. The sale price was 68 million, with a gross gain of 1 million for the Telecom Italia Group.

### **Sale of Telemaco Immobiliare**

On December 20, 2002, the final sale price was fixed relating to Telecom Italia's investment in Telemaco Immobiliare to the company Mirtus. The net proceeds were 192 million for the Telecom Italia Group with a gross gain of 110 million.



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On October 31, 2002, Telemaco Immobiliare exercised a put option on 28 real estate properties owned by Telegono (a company held 40% by Telecom Italia, 45% by the Beni Stabili group and 15% by Lehman Brothers) based on agreements formalized in the Sale and Purchase Agreement on July 31, 2002 between Mirtus and the three sellers of the company. For purposes of the acquisition of such assets, Telegono signed a loan agreement that will be extinguished partly by the consideration from the sale in progress of such properties.

### **Ortensia Project**

On December 24, 2002, Telecom Italia and the other shareholders of Tiglio I (MSMC Italy Holding BV, Olivetti, Seat Pagine Gialle and Pirelli) and Tiglio II (POPOY Holding B.V.) formalized a binding agreement with the company Marzotto which became effective on March 4, 2003 to set up a common vehicle company for the land owned by Tiglio I and Tiglio II together with the portfolio of areas owned, directly and indirectly, by Marzotto. The agreement calls for the deal to be finalized in 2003 through the spin-off of the land owned by Tiglio I and Tiglio II and other assets and liabilities related thereto to a company in which Marzotto, at the end of December 2002, on the basis of formalized agreements, had contributed a business segment inclusive of the land earmarked for the initiative. Given the valuation of the assets available at this time, it is expected that, when the spin-offs are completed, Telecom Italia will hold about a 28% stake in the company (in addition, at Telecom Italia Group level, of the 1% stake that will be held by Seat Pagine Gialle).

### **Early purchase of leased assets**

On January 27, 2003, the procedures were completed for the early purchase of 12 property units (for about 300,000 square meters) from Teleleasing S.p.A. that are used by Telecom Italia S.p.A. and other Telecom Italia Group companies under financial leasing contracts. The deal involved a total financial payment of some euro 369 million for the entire Telecom Italia Group. Certain of these assets were recently agreed to be sold. See Disposition and Acquisition of Certain Equity Investments Dispositions .

## **Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

*The following discussion should be read in conjunction with the Consolidated Financial Statements included elsewhere in this Annual Report. Such financial statements have been prepared in accordance with Italian GAAP, which differ in certain material respects from U.S. GAAP. For a discussion of the principal differences between Italian GAAP and U.S. GAAP as they relate to Telecom Italia, see Note 26 of Notes to the Consolidated Financial Statements included elsewhere herein. All of the data included in Item 5. Operating and Financial Review and Prospects for 2000 is based on the pro forma 2000 numbers which accounts for the Nortel Inversora group on the equity method.*

### **Background**

*The European and the Italian market for telecommunications services.*

In 2002, the European telecommunications market grew by 5.4%; in the next several years an average annual growth of approximately 4.1% is expected, despite an expected decrease in revenues in the mobile telecommunication sector.

In 2002, the Italian telecommunications services market grew by 4.3% (source: Eito). 38.3% of total market revenues was generated by fixed line telephone services, 49.2% by wireless telephone services and 12.5% by data and internet/on line services.

As in previous years, the growth in demand for telecommunications services continues to be driven by mobile telephone services and by the development of Internet and data services. With over 54 million subscriber lines at the end of 2002, Italy is one of the European countries with the highest penetration and number of subscribers (only Germany with 58 million subscriber lines has a higher number of mobile users). Italy is also among the first European countries where commercial offers are presently available for 3G services. The new entrant (H3G) has had the capability to offer UMTS services since March 2003. TIM is planning to launch 3G services gradually in the second half of 2003 and a broad commercial offer is expected in 2004.

In 2002, over 20 million people in Italy used the Internet. Internet usage growth was sustained by the increased penetration of business and residential broadband services, led by the commercial success of ADSL, with 850,000 installed subscriber lines at the end of the year. The fixed-line market, on the other hand, was adversely impacted by a new tariff reduction imposed by the regulator.

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Over the next three years, the Italian telecommunications market is expected to grow faster than the European average, with an average yearly growth rate of 5%. The performance of broadband and new fixed line services is expected to continue to be strong, due to the migration of dial-up subscribers towards broadband services and an increase in ADSL penetration, with an average growth rate of 18% expected for these services. Meanwhile, overall market growth will be restricted by a flat access line market and a slight decrease in voice traffic value driven by price reduction (Source: 2002 EITO).

### ***Competition***

The Telecom Italia Group faces domestic competition in all of its businesses. See Item 4. Information on the Telecom Italia Group Business Strategy and Item 4. Information on the Telecom Italia Group Business Competition. Management expects further consolidation among suppliers of telecommunication services, especially at the national level. Incumbent operators (such as Telecom Italia) should be able to leverage their wider customer base and the ownership of the infrastructures to consolidate their position.

On the technological side, innovation will be aimed at offering broadband services with faster connections in the fixed line market and in the development of seamless solutions for the wireless market. The incumbent operators will focus their strategic plans on the introduction of new broadband value added services, on the defense of their domestic core businesses, and on the strengthening of their financial position through debt control.

Competitive pressure in the Italian market continued during 2002, as evidenced by the following:

- continued pressure on tariffs, with a significant impact on fixed telephony revenues;
- consolidation of Wind Infostrada as an integrated telecommunications operator (fixed and wireless). The market exit of 2G mobile operator Blu ;
- 3G mobile operator H3G launched its commercial offer in March 2003, with full voice and data services expected to be available in 2003;
- introduction of new broadband services based on fiber optic networks.

Competitive pressures were also evidenced by the following:

- issuance of licenses for fixed networks and voice telephony service, which rose from 130 at the end of 2000, to 168 at the end of 2001 and 209 at the end of 2002;
- further significant price reductions for voice traffic and for the internet access market;
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gradual development of local loop unbundling and shared access which during 2001 resulted in 15 operators starting to sell services based on local loop unbundling and 23 operators at the end of 2002; and

- the introduction of GPRS mobile services.

### *Divestitures and Cost Reduction Plan*

In September 1999, following Olivetti's takeover of Telecom Italia, the Telecom Italia Group implemented a restructuring plan which included the divestiture of certain Telecom Italia Group assets and a focus on cost reduction. During 2000 Telecom Italia largely completed this plan with the sale of Sirti (installation), Italtel (manufacturing), Teleleasing (leasing services), Meie (insurance), a sale of a significant portion of its real estate portfolio and certain other non-core assets.

These sales generated approximately 4,413 million in cash and were used to reduce the overall level of indebtedness at the end of 2000 which rose significantly as debt was incurred as a result of various acquisition and other investment activities during 2000, including the SEAT acquisition and international investments.

During 2000 the Telecom Italia Group agreed to certain employee reductions with its unions, particularly in the fixed line business. As a result, at the end of 2000, total employment in the Telecom Italia Group had been reduced in aggregate by 15,491, owing to personnel turnover, including permanent reductions in the fixed line business (primarily attributable to Telecom Italia), and the effect of the changes in the scope of consolidation (mainly due to the disposal of the Sirti and Italtel groups which led to a reduction in the number of employees of 17,857, offset in part by the increase in mobile services and the inclusion of the SEAT group with an increase of 7,179 units).

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At December 31, 2001 the Telecom Italia Group employed 109,956 persons, an increase of 2,785 employees compared to 107,171 at December 31, 2000 pro forma. The increase of 2,785 units was mainly due to the changes in the scope of consolidation (relating to increases of 1,749 units in Internet and media and 1,464 units in Mobile Services as well as the inclusion of the Entel Chile group which led to an increase of 4,681 units). This was partially offset by a reduction of 5,460 units at Telecom Italia due to personnel turnover. The main component of the turnover related to the termination of employment at the Telecom Italia level, partly as a result of employee cutbacks made under Law No. 223/1991, based on agreements with the labor unions in March and July 2000 and September 2001.

At December 31, 2002 the Telecom Italia Group employed 101,713 persons, a decrease of 8,243 employees compared to 109,956 at December 31, 2001. The reduction of 8,243 units was due to the effect of the change in the scope of consolidation (a decrease of 2,883 units) and to changes in the level of personnel (a decrease of 5,360 units). The disposals of 9Telecom group (-1,003 units), Satellite Services (-1,168 units), Sogei and Consiel (-1,538 units) and the acquisitions of Blu (+618), Webegeg group (+719) are the main components of the change in scope of consolidation. The change in overall levels consists of 12,567 employees leaving offset in part by 7,207 employees being hired. On July 30, 2002, Telecom Italia S.p.A. and certain Italian companies of the Telecom Italia Group signed agreements with the labor unions representing the sector for employee cutbacks involving a total of 3,803 employees, as established in the May 27, 2002 agreement relating to the Industrial Plan 2002-2004. Similar agreements have been signed by other Telecom Italia Group companies relating to a total of 380 employees.

Following the controlling interest acquisition by Olimpia in Olivetti, and subsequently a new management and a new Board of Directors taking control, the Telecom Italia Group implemented a further restructuring plan. See Item 4. Information on the Telecom Italia Group Business Significant Developments during 2002 The Pirelli-Olimpia Transaction and Item 4. Information on the Telecom Italia Group Reorganization. This plan also included further divestitures of assets, particularly non-strategic international assets. During 2001 and 2002 and the first months of 2003 disposals worth 5.2 billion were completed, slightly more than the initial 2002-2004 plan targets set at 5.0 billion.

The Telecom Italia Group's corporate structure has also been streamlined, reducing the total number of companies from 714 to 416.

Furthermore, cash savings (operating costs plus capital expenditures) of 1,631 million were achieved, equivalent to 80% of the three-year 2 billion target set.

The results achieved through efficiency gains and the disposals plan have strongly impacted the Telecom Italia Group's net financial debt (see for the definition Item 3. Key Information Selected Financial and Statistical Information). At year-end 2002 consolidated net debt had been reduced to 18.1 billion, slightly better than the 18.3 billion Plan target.

As of December 31, 2002, the consolidated net debt of the Telecom Italia Group amounted to 18,118 million, down by 3,824 million compared with year-end 2001 ( 21,942 million), even after a pay-out of dividends and the extraordinary distribution of reserves totaling 4,945 million. These increases to overall indebtedness were offset by disposals completed in 2002 worth 4,771 million in the aggregate. Investments and assets disposed of included Auna ( 1,998 million), Bouygues Decaux Telecom ( 750 million), Mobilkom Austria ( 756 million), Lottomatica ( 212 million), Sogei ( 176 million), Telemaco Immobiliare ( 192 million), IMMSI ( 69 million), Tiglio I and II real estate transaction ( 328 million), Telekom Austria ( 559 million), Telespazio ( 239 million), 9Telecom (- 529 million) and sundry others ( 21 million). As a result of the Merger, consolidated net financial debt of New Telecom Italia will be approximately 43 billion. See also Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data.

***Regulatory Environment***

The regulatory environment in which the Telecom Italia Group operates has been reshaped by the adoption and implementation of new laws and regulations at both the Italian and EU levels, including the Framework Law, the Maccanico Law, the Telecommunications Regulations and the Orders issued by the National Regulatory Authority.

The year 2002 continued to be characterized by an intensive implementation process in order to complete deregulation. The Telecom Italia Group now considers this process to be complete. See Item 4. Information on the Telecom Italia Group Business Competition and Item 4. Information on the Telecom Italia Group Business Regulation .

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### *Tariff Rebalancing*

Telecom Italia has progressively rebalanced its tariffs to align them more closely to its underlying costs, including tariff adjustments made in the last six years. In general, the tariff rebalancing pursued by Telecom Italia has involved a gradual increase in subscription fees for residential and business customers, along with a decrease in tariffs for domestic long distance and international calls. From February 2002, Telecom Italia began offering to residential customers a certain volume of free local call minutes; from July 2002, the local traffic benefits was also extended to business customers. Furthermore Telecom Italia offers to residential customers a certain volume of free long distance call minutes.

The overall effect on customers' total telephone bills of the tariff adjustments implemented during 2000, 2001 and 2002 are estimated as follows:

- 251 million per year (a decrease of 2.84%) in 2000;
- 165 million per year (a decrease of 1.97%) in 2001; and
- 140 million per year (a decrease of 1.69%) in 2002.

These estimates are not cumulative and are based on certain average consumption patterns (called "consumption baskets" in regulatory terms) assuming the same volume of traffic for the prior year) and do not necessarily represent the overall effects of the tariff changes on the Telecom Italia Group's accounts. The data above compares average levels of the customers' annual spending.

Following the EU Commission infringement procedure against the Republic of Italy concerning tariff rebalancing, on December 11, 2000, the National Regulatory Authority revised the price cap formulas in effect for rental and installation fees, and charges for local, national and international calls through December 2002. The change compared to the previous price cap formulas was an increase from RPI + 1% to RPI + 6% in the sub-price cap on installation fees and monthly rental charges. The same increase for access fees (RPI + 6%) was established by the National Regulatory Authority for the year 2002.

The general effect of the new price cap formulas for 2002 provided for an increase of 8.8% in Telecom Italia's access service charges (i.e. monthly subscription fee) and a reduction of 11.3% in Telecom Italia's domestic traffic charges. The changes in tariffs implemented in year 2002, which increased residential monthly subscription fees by 12.7% and reduced certain call traffic charges, resulted in lower revenues from residential users of approximately 70 million.

Greater pricing flexibility has been important to Telecom Italia's ability to remain competitive, particularly with respect to international telecommunications services for which there has been the greatest competition, and it remains an essential element of Telecom Italia's strategy to be able to price services selectively in order to respond to competition by lowering prices on selected services.

See Item 4. Information on the Telecom Italia Group Business The Organizational Structure Domestic Traffic Domestic Fees and Tariffs Tariff Rebalancing , Item 4. Information on the Telecom Italia Group International Traffic International Tariffs Tariff Rebalancing and Item 4. Information on the Telecom Italia Group Regulation Tariff and Pricing Policy Pricing Policy and Telecom Italia's Tariffs .

*Provisions and Write-downs and Gains on Disposal of Equity Investees of extraordinary nature*

Results of operations in 2002 and 2001 were disproportionately impacted (compared to 2000 pro forma) by high levels of extraordinary expenses and income, including provisions and write-downs in equity investees and goodwill for subsidiary and affiliated companies, as well as the gains on disposal of investments. The following table sets out certain of these expenses and income and their impact on 2002 and 2001 results, before income taxes. Additional information can be found in Note 23 of Notes to the Consolidated Financial Statements included elsewhere herein.

	Year ended December 31,		
	2000(1) (pro forma)	2001	2002
	(millions of Euro)		
Provisions and write-downs of goodwill and equity Investees		(2,984)	(6,237)
Gains on the disposal of equity investments, fixed and intangible assets	1,146	392	2,413

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidated method.



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- In 2002, extraordinary provisions and write-downs of goodwill and equity investees ( 6,237 million) were as follows:
  - write-down of the investment held in Is TIM ( 1,491 million) and provision added to the reserve for risks and charges related to Is TIM ( 850 million) against the guarantees provided by the Telecom Italia Group to financial institutions and suppliers as creditors of Is TIM and the loans to Is TIM by the Telecom Italia Group. Telecom Italia concluded that the value of its investments was permanently impaired, since, starting from the awarding of the license, some measures which should have fostered effective competition and guaranteed the full operability of the new entrant, did not effectively take place. These measures are essential in the light of international experience and pursuant to applicable legislation in Turkey. Is TIM made repeated and formal efforts but was de facto prevented from entering the Turkish mobile telephony market, thereby infringing the terms and conditions of the tender pursuant to which its license was awarded. Due to the above mentioned difficulties, the conditions permitting a return of investment did not exist;
  - write-down of Seat Pagine Gialle goodwill ( 1,544 million) and provision added to the reserve for forward purchase commitments of Seat Pagine Gialle Shares ( 1,942 million) for the estimated non recoverability of the original price of the put option. These write-downs were taken as the Telecom Italia Group no longer considers its Directories business to be a core, strategic business. The write-down and the provision were made on the basis of the average Seat Pagine Gialle ordinary share price on the Italian Stock Exchange over the second half of 2002. In 2001, under financial expense, a provision of 569 million was also recorded for the forward purchase commitment of Seat Pagine Gialle shares connected with the estimated non recoverability, at that time, of the original price to exercise the option;
  - other write-downs of investments of 46 million and of goodwill for 321 million (of which: 103 million for Blu, 75 million for Corporacion Digital, 96 million for Netco Redes and 47 million for other minor companies);
  - provision to reserve ( 43 million) for the estimated losses arising from the exercise of put options by the founding shareholders of Consodata S.A., a subsidiary of Seat Pagine Gialle.
- In 2001, the extraordinary provisions and write-down of goodwill and equity investees ( 2,984 million), were as follows: i) 1,303 million for the write-down of goodwill relating to consolidated companies (9Telecom group, Entel Bolivia, Entel Chile group, Maxitel group, Tele Celular Sul group, Tele Nordeste Celular group, TIM Brasil (TIM Celular Centro Sul, TIM Rio Norte and TIM Sao Paulo, into which were merged the two other companies and was renamed TIM Celular), Med-1 group and certain companies in the Seat Pagine Gialle group); ii) 1,078 million for the write-down of goodwill relating to companies accounted for by the equity method (GLB Serviços Interativos, Solpart Participacoes, Telekom Austria and the Nortel Inversora group); and iii) 603 million for other provisions relating to investments.

Such provisions and write-downs of goodwill and equity investees were consistent with the strategic guidelines of the 2002-2004 Industrial Plan. In particular, after careful examination, adjustments were made to equity investees and goodwill and provisions were recorded for the losses of subsidiaries and affiliated companies in which it was apparent that the reason for the performance of the companies was not solely due to general economic conditions.

- In 2002, gains on the disposal of equity investments, fixed and intangible assets ( 2,413 million) are attributable to:
  - the sale of the 26.89% interest held by the Telecom Italia Group in Auna ( 1,245 million), the 19.61% interest held by the Mobile Business Unit in Bouygues Decaux Telecom ( 484 million), the 25% interest held by the Mobile Business Unit in the Mobilkom Austria group ( 115 million), the 40% interest held in Telemaco Immobiliare ( 110 million), the 100% interest held in Telespazio ( 70 million), the 45% interest held by the Telecom Italia Group in Immsi ( 1 million) and of other equity investments, fixed assets and business segments ( 21 million);
  - the acceptance of the tender offer for Lottomatica shares by the Information Technology Market Business Unit ( 133 million);



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- the concentration of the real-estate assets through the companies IMSER, Emsa and Telimm into Tiglio I ( 159 million);
- the transfer of Telecom Italia s Asset Management unit to Tiglio II ( 60 million); and
- the transfer by Telecom Italia of its real estate services units (excluding facilities management) to the Pirelli & C. Real Estate group ( 15 million).

Furthermore, in 2002, the Telecom Italia Group incurred the following expenses:

- 135 million of losses from the sale of the 15% stake in Telekom Austria;
- 235 million of expenses connected with the disposal of equity investments; and
- 316 million related to the provisions made in conjunction with the disposal of the investment in the 9Telecom group (in particular, in view of the loss reported prior to sale, the French group 9Telecom had a negative effect on the 2002 statement of operations of the Telecom Italia Group of approximately 389 million).
- In 2001, gains on the disposal of equity investments, fixed and intangible assets ( 392 million) are attributable to:
  - the gain on the sale of the 70% holding in Mirror International Holding (the company through which the satellite companies were contributed to the Lehman Brothers group) for 170 million; and
  - the gain on the disposal of the 30% holding in Mediterranean Nautilus S.A. to the Israeli company F.T.T. Investments for 94 million.
- In 2000, gains on the disposal of equity investments, fixed and intangible assets ( 1,146 million) are attributable to the old divestiture plan of the Telecom Italia Group ( 969 million), which was related to the sale of 80.1% of the Italtel group ( 393 million), the Meie group ( 232 million), Teleleasing ( 21 million), the Sirti group ( 11 million) and the sale of a portion of the real estate portfolio through the sale by Telecom Italia of the 60% of IM.SER ( 312 million) to third parties. The remaining gains of 177 million were related to the sale of other equity investments and intangibles, fixed assets and business segments, of which 55 million came from the sale of the investment in the Bharti group in India.

### **Critical Accounting Policies**

Telecom Italia s discussion and analysis of its financial condition and results of operations are based upon Telecom Italia s consolidated financial statements, which have been prepared in accordance with Italian GAAP. Reported financial condition and results of operations of Telecom Italia are sensitive to the accounting methods, assumptions and estimates that underlie the preparation of financial statements. Telecom Italia bases its estimates on historical experience and on various other assumptions that Telecom Italia believes are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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The selection of critical accounting policies, the judgments and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing Telecom Italia's financial statements. Telecom Italia believes the following critical accounting policies involve the most significant judgments and estimates used in the preparation of its consolidated financial statements.

The Telecom Italia Group also is required to select accounting principles for the annual reporting of its US GAAP results. Included in the following discussion are the US GAAP principles selected by the Telecom Italia Group that have the potential to generate significant differences from Italian GAAP and for which management is required to make substantial estimates and assumptions.

### ***Revenue recognition***

Telecom Italia's primary revenue streams consist of fixed line telecommunication services, mobile telecommunication services, the sale of products including primarily telecommunication (both fixed and mobile)

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equipment and office products, IT software and services, advertising services, publishing, and internet access and related services.

Revenues related to fixed line and mobile telecommunication services, principally network access, long distance, local and wireless airtime usage, are recognized when the services are provided based on the actual minutes of traffic provided and the contracted fee schedule with the customer. Certain revenues derived from telecommunication services, such as installation and activation fees are recognized at the date of installation or activation. Revenues billed in advance are deferred and recognized at the date the related service is provided.

Under U.S. GAAP, we defer recognition of non-refundable connection fees and other initial fees and recognize these over the estimated customer relationship period. We also defer the associated direct expenses over the estimated customer relationship period in an amount equal to or less than the amount of deferred revenues. If the length of the estimated customer relationship period increases or decreases, the amounts of deferred revenue and deferred expense is adjusted over the revised estimated life.

Revenues from the sale of products, including telecommunication equipment and office products, are recognized when title transfers to the customer, which is either at the date the products are shipped or when the products are delivered and accepted by the customer.

IT services and software revenues are recognized at the date the related services are provided.

Revenues from the sale of advertising and publishing are recognized at the date of publication, which corresponds to the time at which the related publications are printed and delivered. Advertising revenue from on-line services is recorded on the date the on-line advertisement is posted to the related web site. Advertising revenue from television is recorded on the date at which the advertisement is shown. Payments received for advertising services to be rendered in future periods are deferred and recognized at the time the advertising is provided.

Revenues from Internet access and related services primarily represent subscription services, which are recognized over the subscription period on a straight-line basis.

Provisions for returns and other adjustments related to sales are provided in the same period the related sales are recorded. The provision is based on an analysis of historical return patterns, which are subject to such factors as product quality, warranty lives and macroeconomic factors.

In connection with recording revenue, estimates and assumptions are required in determining the expected conversion of the revenue streams to cash collected. The reserve estimation process requires that management make assumptions based on historical results, future expectations, the economic and competitive environment and changes in the credit worthiness of the Telecom Italia Group's customers, and other relevant factors. If these assumptions prove to be incorrect, Telecom Italia's actual conversion rate of recorded revenue to cash may be lower than expected and we would be required to increase our allowance for doubtful accounts.

### *Accounting for long-lived assets*

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Property, plant and equipment and purchased intangible assets other than goodwill are recorded at acquisition cost. If such assets are acquired in a business combination, the purchase price is allocated to the estimated fair value of the acquired property, plant and equipment and intangible assets. Property, plant and equipment and intangible assets are depreciated or amortized on a straight-line basis over their estimated useful lives.

Property, plant and equipment are valued at acquisition or construction cost, less accumulated depreciation. Construction costs include directly allocable costs, an appropriate allocation of material and production overhead and interest accruing during the construction related to debt specifically associated with the related construction project.

Accounting for long-lived assets and intangible assets involves the use of estimates for determining the fair value at the acquisition date for assets acquired in a business combination, and the useful lives of the assets over which the costs of acquiring these assets are charged to the statement of operations. The useful lives of long-lived assets are subject to such variables as technological feasibility, obsolescence, changes in consumer demand and strategic management decisions.

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When an impairment in the value of assets occurs, nonscheduled write-downs are made. Telecom Italia assesses the impairment of identifiable intangibles and long-lived assets whenever there is reason to believe that the carrying value may exceed the fair value and where a permanent impairment in value is anticipated. The determination of impairments of long-lived and intangible assets involves the use of estimates, which include but are not limited to the cause, the expected timing and the amount of the impairment. Impairment is based on a broad measure of factors. In evaluating assets for impairment, Telecom Italia typically considers, among other things, technological obsolescence, discontinuance of services, changes in market prices, significant negative industry or economic trends, significant underperformance relative to expected historical or project future operating results and other changes in circumstances that may indicate impairment.

To assess impairment of property, plant and equipment and amortizing intangible assets for purpose of U.S. GAAP, the Telecom Italia Group uses the guidance outlined in SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. If based on the preceding discussion management has concluded that impairment indicators exist, the Telecom Italia Group will initially review for possible impairment by assessing the undiscounted cash flows expected to be derived from the asset or group of assets, comparing the lowest level of total expected undiscounted cash flow to the carrying value. If the carrying value of the asset or the group of assets exceeds the sum of the undiscounted cash flows, impairment is considered to exist. An impairment charge is assessed by comparing the assets fair value to the carrying value. Fair value can be calculated by a number of different approaches, including discounted cash flow, comparables, market valuations or quoted market prices. The process and steps required to assess the possible impairments of assets, including the identification of possible impairment indicators, assessing undiscounted cash flows, selecting the appropriate discount rate, the calculation of the weighted average cost of capital and the discounts or premiums inherent in market prices requires a substantial amount of management discretion and judgment. If actual results differ from these estimates, or if the Telecom Italia Group adjusts these estimates in future periods, operating results could be significantly affected.

### ***Valuation of goodwill***

Goodwill resulting from business combinations is amortized on a straight-line basis over its estimated useful life.

The determination of goodwill is dependent on the allocation of the purchase price to the tangible and intangible assets acquired and liabilities assumed. Such allocation is often based on judgmental factors and estimates of fair values for assets that may not have a readily determinable market value. In addition, the useful life assigned to goodwill is an estimate based on the judgment of management at the time of acquisition. The estimated useful life is subject to adjustment if facts and circumstances indicate that the assets' economic life has been affected by other variables, including technological feasibility, competitive factors and contractual rights.

Nonscheduled write-downs are provided when an impairment in the value of goodwill occurs. Telecom Italia reviews on a regular basis the performance of its subsidiaries. When there is reason to believe that the goodwill arising from the acquisition of a business is impaired and that the impairment is of a permanent nature, Telecom Italia compares the carrying amount of that subsidiary or business to its fair value. The determination of the fair value of a subsidiary involves extensive use of estimates. Methods commonly used by Telecom Italia for valuations include discounted cash flow methods, comparable market multiples and quoted stock market prices, if available. Factors affecting estimated fair values typically include discount rates, future cash flows, growth rates, weighted average cost of capital, market prices and control premiums. These estimates, including the methodologies used, are important in determining fair value and ultimately the amount of any goodwill impairment.

As of January 1, 2002 the Telecom Italia Group adopted the requirements of SFAS 142, *Goodwill and Other Intangible Assets*, and as a result the Telecom Italia Group has ceased amortization of goodwill and indefinite lived intangible assets for U.S. GAAP purposes. The requirements of SFAS 142 include that goodwill be tested for impairment at least annually (and between annual tests when certain triggering events occur) using a two-step methodology. The first step screens for potential impairment at the reporting unit level, while the second step measures the impairment, if any. Under U.S. GAAP, the quoted market price of an asset, if available, should be used. If not available, then other valuation

techniques, including discounted cash flow, comparables, etc., are acceptable. The selection of the various assumptions that are necessary to arrive at the fair value of a reporting unit, including the assumptions used in the underlying business plans, require substantial management judgment and discretion. If actual results differ from these estimates, or if the Telecom Italia Group adjusts these estimates in future periods, operating results could be significantly affected.



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### ***Financial assets***

Telecom Italia holds minority interests in companies having operations or technology in areas within its strategic focus, some of which are publicly traded and that have highly volatile share prices. Telecom Italia records an investment impairment charge when it believes an investment has experienced a decline in value that is permanent. Determining whether an impairment is permanent involves considerable judgment and relies heavily on an assessment by management regarding the future development of the investee. In measuring impairments, Telecom Italia uses fair value as described above for goodwill impairments.

Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments.

For purposes of the Telecom Italia Group's U.S. GAAP reporting, the Telecom Italia Group uses the guidance established in APB 18, *The Equity Method of Accounting for Investments in Common Stock*. If management concludes that an investment has incurred an other than temporary decline in value, a charge to earnings is recorded. In determining whether a decline is other than temporary and the amount of the decline, management considers several factors such as the investee's inability to sustain an earning capacity which would justify the carrying amount, the current fair value (quoted market price, when available) of the investment and other factors, including assessments of the investee's business plan and the medium to long-term economic outlook for the industry. The evaluation of all of these factors entails that management formulates assumptions that are subject to uncertainty.

### ***Deferred taxes***

Telecom Italia is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves a jurisdiction-by-jurisdiction estimation of actual current tax exposure and the assessment of the temporary differences resulting from differing treatment of items, such as accruals and amortization, among others, for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities, which are included within Telecom Italia's consolidated balance sheet. Telecom Italia must assess in the course of its tax planning process the ability of the Company and its subsidiaries to obtain the benefit of deferred tax assets based on expected future taxable income and available tax planning strategies. If in management's judgment, the deferred tax assets recorded will not be recovered, a valuation allowance is recorded to reduce the deferred tax asset.

Significant management judgment is required in determining Telecom Italia's provision for income taxes, deferred tax assets, deferred tax liabilities and valuation allowances to reflect the potential inability to fully recover deferred tax assets. In the Telecom Italia Group's Italian GAAP financial statements, the Telecom Italia Group generally applies a realization period of three to five years for the recognition of both deferred tax assets and liabilities. The analysis is based on the estimates of taxable income in the jurisdictions in which the Telecom Italia Group operates and the period over which the deferred tax assets and liabilities will be recoverable. If actual results differ from these estimates, or Telecom Italia adjusts these estimates in future periods, Telecom Italia may need to establish an additional valuation allowance which could adversely affect Telecom Italia's financial position and results of operations.

Under U.S. GAAP, the Telecom Italia Group assesses the recoverability of tax assets based on the criteria of "more likely than not", that is, a probability of recoverability just over 50%. The probability assessment requires significant judgment regarding the timing of future book and tax reversals, which could be materially different from the actual results.

*Accrued liabilities*

Considerable judgment is exercised by Telecom Italia in recording the Company's accrued liabilities and its exposure to contingent liabilities related to pending litigation or other outstanding claims subject to negotiated settlement, mediation, arbitration or government regulation as well as other contingent liabilities.

Judgment is necessary in assessing the likelihood that a pending claim or a liability will arise and to quantify the possible range of the final settlement. In case the occurrence of a contingency or potential liability is more likely than not, Telecom Italia accrues an amount for contingent liabilities that represents management's estimate at that date. Because of the inherent uncertainties in the foregoing evaluation process, actual losses may be different from the original estimated amount accrued.

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For purposes of U.S. GAAP, the Telecom Italia Group applies the guidance outlined in SFAS 5, *Accounting for Contingencies*. Under SFAS 5 a loss contingency is considered to exist when a future use of assets to settle a liability or claim is considered probable and can be reasonably estimated. The necessary estimates used by management rely on the analysis of internal specialists, attorneys, actuaries or other external specialists as considered necessary. A revision of the original estimates may significantly affect future operating results.

### ***Financing, acquisition and lease transactions***

Telecom Italia has entered into several financing, acquisition and lease transactions that have resulted in material off balance sheet accounting treatment. These transactions include entering into a put and call-agreement related to the acquisition of SEAT, the sale and the subsequent lease of certain real estate assets, the sale of a portion of Telecom Italia's equity interest in certain satellite sector entities, and the sale of trade accounts receivable under a securitization program.

Telecom Italia has acquired several companies using the shares of listed subsidiaries as a form of currency, often in conjunction with a mix of cash. For purposes of acquisition accounting, no economic value is ascribed to the shares exchanged, therefore the recorded value of the acquired company does not reflect the value of the underlying shares given up. For purposes of U.S. GAAP, the shares of the subsidiaries used to acquire a target are fair valued as part of the purchase price, generally based on the quoted market price of the shares at the date of the announcement. As there is an economic value ascribed to these shares, the total investment in the acquired company is generally larger, including the associated goodwill, on a U.S. GAAP basis. From 2002, as part of the adoption of SFAS 142, this goodwill is no longer amortized, but rather becomes subject to the fair value impairment tests as previously described.

Under Italian GAAP the put-call arrangement associated with the acquisition of SEAT effectively results in a commitment of the Company to acquire a certain number of additional shares of SEAT at an agreed upon price. Neither the increase in the value of the investment in SEAT, nor the related commitment were required to be recorded as an asset and liability, respectively. Under U.S. GAAP these types of arrangements, and others entered into by the Telecom Italia Group that involve the use of puts and calls as a means to effect a transaction, are accounted for based on the substance of the underlying contractual rights and benefits, and can serve to increase the acquisition cost, total indebtedness or compensation expense.

The sale and the subsequent lease of certain real estate assets, the sale of a portion of Telecom Italia's equity interest in certain satellite sector entities, and the sale of accounts receivable under securitization programs have been recorded as sale transactions and gains or losses were recognized for the differences between the fair value of the consideration received and the carrying value of the real estate assets, investments, and receivables sold. The real estate assets sold continue to be used in the ordinary course of operations of the Telecom Italia Group and are accounted for as operating leases. Management has substantial flexibility in structuring transactions to effect the recognition of assets, liabilities gains and losses. For purposes of U.S. GAAP, the sale of the real estate portfolios were not considered to be sales as the Telecom Italia Group maintained a continuing interest in the properties, therefore no gains were recognized and the assets remain on the balance sheet, with the cash received treated as a secured borrowing. Similarly, the securitization of certain equity stakes in the satellite sector with a special purpose entity resulted in that structured entity also being fully consolidated in the U.S. GAAP results of the Group.

However, the Group was able to deconsolidate the special purpose entity related to the accounts receivable securitization program initiated in 2001.

In general, U.S. GAAP requires a substance over form approach to structured transactions, including real estate leases, securitizations and other structured finance transactions. For purposes of U.S. GAAP, the Telecom Italia Group will adopt the financial reporting guidelines of FIN 46,

Consolidation of Variable Interest Entities (an interpretation of ARB 51). Consolidation will no longer be determined solely on the majority of voting interests approach, but instead on identifying the enterprise holding the controlling financial interests in the variable interest entity. The assessment of which party is the controlling financial interest will require management to assess each transaction in which it currently holds such financial interests, assessing the probability of expected future gains and losses to arrive at a final decision regarding consolidation.

*Derivatives*

The Telecom Italia Group enters into several different types of derivative contracts in order to adjust and manage the various cash flows associated with foreign currency and interest rate exposures. For purposes of

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Italian GAAP, the changes in the fair value of the derivative contract are not accounted for in the statement of operations until the contract has expired. The notional amount of the contracts open at the end of the fiscal year is disclosed.

Starting in 2001, for purposes of U.S. GAAP the Telecom Italia Group has used the guidance established in SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Under U.S. GAAP, the Telecom Italia Group recognizes the change in the fair value of the derivative contract in the calculation of net income or loss for the period. The assessment of the fair value of a derivative contract requires the use of quoted market prices, banker price quotations, price quotations for similar instruments traded in different markets and, where applicable, pricing models. Pricing models and their underlying assumptions impact the amount and timing of unrealized gains and losses recognized, and the use of different assumptions could produce different financial results.

### ***Adoption of International Accounting Standards***

Recently, the EU has again restated its intention to require all listed companies within the EU member countries to adopt consistent accounting standards. The accounting standards that have been selected by the EU as the framework for this adoption are International Accounting Standards, now referred to as International Financial Reporting Standards ( IFRS ). The adoption of IFRS will be required no later than 2005. The adoption will require enabling legislation in each jurisdiction, including Italy, in order to grant to public companies in each member state the authorization to adopt accounting principles that are divergent from national standards. The requirement to adopt IFRS is part of the EU's efforts to increase transparency and foster capital market efficiency in the EU.

The Telecom Italia Group currently uses Italian GAAP as its basis for financial reporting. The Telecom Italia Group also uses U.S. GAAP to meet its regulatory reporting requirements in the United States. For certain transactions, the results as reported under Italian GAAP can differ materially from the same transaction reported under U.S. GAAP. The Telecom Italia Group has established within selected subsidiaries designated IAS teams to assess the impact of adoption on the financial reporting of those entities, including a review of the various alternatives available under IFRS for accounting policies. Given the relatively early stage of implementation of IFRS, it is too early to determine the impact, if any, that the adoption of IFRS will have on the financial position and results of operations of the Telecom Italia Group.

## **Results of Operations**

### **General**

During 2000 Telecom Italia completed the merger of Tin.it, its internet service provider, with SEAT, in a transaction which resulted in the Telecom Italia Group owning approximately 60% of SEAT's ordinary share capital. Although SEAT was fully consolidated for balance sheet purposes at December 31, 2000, SEAT's results of operations were not included in the Telecom Italia Group's statement of operations for purposes of Italian GAAP. As a result, the full impact of the SEAT acquisition was included in results of operations beginning only in 2001. Therefore the results of operations of the Internet and Media Business Unit is not comparable between 2001 and 2000 due to the SEAT acquisition. SEAT, as merged with Tin.it makes up Telecom Italia's Internet and Media Business Unit.

Late 2000 marked the start of the transformation of the Telecom Italia Group announced in conjunction with the take-over by Olivetti. The transformation was shaped by the divestiture of non-core businesses, the focus on core areas and the reorganization of the controlling structure of the international companies. The Telecom Italia Group was reorganized into various autonomous Business Units from the standpoint of

management, objectives, strategies and operational leverage.

At the beginning of 2001 the Telecom Italia Group reorganized its businesses into business units and began reporting its results by business unit during 2001.

Following the controlling interest acquisition by Olimpia in Olivetti, and a new management and a new Board of Directors taking control, the Telecom Italia Group implemented a further restructuring plan. This plan also included further divestitures of assets, particularly non-strategic international assets. In addition, during 2002 the Telecom Italia Group reorganized its business units as follows:

- in early 2002, the IT Services Business Unit was split into two distinct units: Information Technology Market and Information Technology Group; beginning January 1, 2002, Saritel S.p.A. was

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consolidated in the Information Technology Group Operating Activity instead of the Domestic Wireline Business Unit. For purposes of a more meaningful comparison, the data relating to 2001 and 2000 (pro forma) has been restated;

- in May 2002, the International Operations (IOP) Operating Activity was eliminated. While the companies involved maintained the same corporate control structure, the companies and business segments of Telecom Italia which formerly reported to the IOP have been transferred to Domestic Wireline (Intelcom San Marino and Golden Lines), the Foreign Holdings Corporate Function (9Telecom Reseau group, BBNed group, Auna group, Telekom Austria group, Telekom Srbija, Etec S.A. and the residual segment of the former IOP), while all the companies based in Latin America are now coordinated by Latin America Operations (LAO).

At the end of 2002 the businesses of the Telecom Italia Group was organized on the basis of the following Business Units:

**Domestic Wireline.** This business unit includes Telecom Italia Domestic Wireline (TIDW) which relates to the Italian domestic fixed line voice and data businesses on the fixed network; national businesses such as Atesia, related to call center, telemarketing and market research; Path.Net, responsible for the development and management of the single Public Administration Network (R.U.P.A.); and international activities relating to developing networks such as the European, Mediterranean and Latin American fiber optic rings. As a result of the 2002 reorganization Saritel has been moved to the Information Technology Group Operating Activity and Intelcom San Marino S.p.A. is now part of the Domestic Wireline Business Unit.

**Mobile.** This business unit includes national and international mobile telecommunications businesses which are managed by TIM. Beginning in 2001 international mobile operations were consolidated and managed by TIM, through TIM International. International mobile operations are concentrated in the Mediterranean Basin and in Latin America.

**South America.** In May 2002, following the elimination of the International Operations (IOP) Operating Activity, all the companies based in Latin America are now coordinated by Latin America Operations (LAO). Starting from February 2003, Latin America Operations (LAO) reports directly to Mr. Carlo Buora, Chief Executive Officer for the fixed line telephone services and to Mr. Marco De Benedetti, CEO of the Business Unit Mobile for wireless services.

**Internet and Media.** This business unit includes the SEAT group, which was consolidated with the Telecom Italia Group in results of operations for the first time in 2001. This business segment is responsible for the whole chain of value in the media sector. Its operations run from directories to telephone publishing and television. The Business Unit is also the national leader in the marketing of products and services for the office. Seat Pagine Gialle promotes the development of all Internet services for residential customers and for small and medium-size companies, offering access, portals and web services. The Directories and Directory Assistance portion of the Internet and Media segment are expected to be divested in 2003. Please see Item 4. Information on the Telecom Italia Group Recent Developments SEAT Spin-off and Proposed Sale.

**Information Technology Market.** The Information Technology Market Business Unit (the Finsiel group) was created in the early months of 2002 with the aim of focusing the activities previously concentrated in the Information Technology Services Business Unit by type of customer. The Business Unit is responsible for organizing the information technology activities of the Telecom Italia Group oriented towards the external market, in particular, central and local administrations moving towards decentralization and e-government, as well as banks and businesses. Its product range covers the whole chain of value of information services. The IT Market Business Unit creates solutions and services around platforms and products of the main market vendors. Customers' problems are solved in one of three possible ways: by acquiring existing solutions on the market, developing special solutions, or by integrating components offered by Finsiel with typical market platforms (e.g.: Microsoft, SAP and Oracle).

**Information Technology Group.** The Information Technology Group Operating Activity was created in early 2002 as a result of the rationalization of activities previously carried out in the Information Technology Services Business Unit. The unit also incorporates the operations of the TILab group which focuses on research and development. The Operating Activity is responsible for organizing technological innovation and service information technology activities within the Telecom Italia Group, pursuing objectives that will augment efficiency, improve quality and stimulate innovation.



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For a complete description of these Business Units, see Item 4. Information on the Telecom Italia Group Business Units. For purposes of the following discussion selected financial data of each Business Unit has been provided for 2000 (pro forma), 2001 and 2002.

**Recent Developments Telecom Italia Group Results for the First Quarter Ended March 31, 2003 compared to March 31, 2002**

The information in this section should be read in conjunction with Telecom Italia's consolidated financial statements, and the notes thereto, included elsewhere in this Annual Report.

The summary historical consolidated financial data for the Telecom Italia Group as of March 31, 2003, and for the three months ended March 31, 2002, have been derived from unaudited interim consolidated financial statements which, in our opinion, reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of our results of operations for the unaudited interim periods. Results for the three months ended March 31, 2003 are not necessarily indicative of results that may be expected for the entire year.

	<b>Three Months ended March 31,</b>	
	<b>2002</b>	<b>2003</b>
	<b>(Unaudited)</b>	
	<b>(millions of Euro)</b>	
<b>Statement of Operations Data:</b>		
Operating revenues	7,265	7,125
Other income	73	65
<b>Total revenues</b>	<b>7,338</b>	<b>7,190</b>
Cost of materials	295	338
Salaries and social security contributions	1,170	1,079
Depreciation and amortization	1,421	1,319
Other external charges	2,815	2,769
Changes in inventories	(21)	(36)
Capitalized internal construction costs	(73)	(145)
<b>Total operating expenses</b>	<b>5,607</b>	<b>5,324</b>
<b>Operating income</b>	<b>1,731</b>	<b>1,866</b>
Financial income	171	206
Financial expense	(681)	(622)
<i>of which writedowns and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies, net</i>	(34)	(118)
Other income and expense, net	543	(2)
<b>Income before income taxes and minority interests</b>	<b>1,764</b>	<b>1,448</b>
Income taxes	(624)	(703)

Net income before minority interests	1,140	745
Minority interest	(419)	(242)
Net income	721	503

	As of December 31, 2002	As of March 31, 2003
		(Unaudited)
		(millions of Euro)
<b>Balance Sheet Data:</b>		
Total current assets	15,716	15,828
Total fixed assets, net	19,291	18,748
Intangible assets, net	13,052	12,792
Total assets	52,786	51,400
Total short-term debt	5,089	3,599
Total current liabilities	17,616	15,731
Total long-term debt	15,018	14,889
Total liabilities	39,959	37,909
Total shareholders' equity before minority interest	9,049	9,518
Total stockholders' equity	12,827	13,491

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The following table sets forth operating revenues, gross operating profit and operating income by Business Unit.

	<u>Operating Revenues</u>		<u>Gross Operating Profit</u>		<u>Operating Income</u>	
	<u>Three months ended</u>		<u>Three months ended</u>		<u>Three months ended</u>	
	<u>March 31,</u>		<u>March 31,</u>		<u>March 31,</u>	
	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>
			(Unaudited)			
			(millions of Euro)			
Domestic Wireline(1)	4,175	4,235	1,941	1,973	1,198	1,233
Mobile	2,498	2,616	1,221	1,262	831	897
South America(2)	370	292	127	102	46	37
Internet and Media	333	345	27	47	(69)	(35)
IT Market(1)	278	156	33	10	25	0
IT Group(1)	168	229	11	11	(12)	(23)
Other activities and elimination(1)(3)	(557)	(748)	(86)	(102)	(288)	(243)
<b>Total</b>	<b>7,265</b>	<b>7,125</b>	<b>3,274</b>	<b>3,303</b>	<b>1,731</b>	<b>1,866</b>

- (1) Since January 1, 2003, the groups Netikos, Webegg and TILab, as well as the companies Loquendo and Eustema are no longer part of the IT Group Operating Activity. As a result of this reorganization, the groups Netikos and Webegg and the company Eustema were transferred to the IT Market Business Unit, the company Loquendo has been moved to the Domestic Wireline Business Unit and the TILab group is included in Other Activities. The data relating to the first quarter ended March 31, 2002 has been reclassified and presented consistent with the first quarter ended March 31, 2003 presentation.
- (2) The data refers to Entel Chile group, Entel Bolivia group, the company Telecom Italia America Latina and the business segment South America of Telecom Italia.
- (3) The data presented includes the operations of the Foreign Holdings Corporate Function, TILab, the Real Estate activities, previously carried out by the Real Estate and General Services Operating Activity which was eliminated in February 2003 and the former Business Unit Satellite Services (the Telespazio group) which was disposed of during the 4th quarter of 2002 and consolidated in the statement of operations only for the first nine months of 2002.

**Telecom Italia Group Consolidated Results**

For the three months ended March 31, 2003, the consolidated net income after minority interests was 503 million ( 745 million before minority interests) compared to 721 million ( 1,140 million before minority interests) for the first three months of 2002, which included net capital gains of 339 million arising from the disposal of equity stakes in Bouygues Decaux Telecom and Lottomatica. Excluding these net capital gains, consolidated net income after minority interests for the first three months of 2003 increased by 121 million compared to the first three months of 2002.

The Telecom Italia group's consolidated operating revenues for the three months ended March 31, 2003 were 7,125 million, a decrease of 140 million or 1.9% compared to the same period in 2002. Excluding the negative effects of exchange rate fluctuations ( 348 million) and changes to the consolidation area ( 218 million), organic growth reached 6.4% (an increase of 426 million). In particular, 9Telecom group and Sogei S.p.A. (consolidated for the first six months of 2002) as well as the Telespazio group (consolidated until 30 September 2002) left the scope of consolidation, while the Webegg group was added. Organic growth of consolidated operating revenues (revenues based on constant currency

and excluding the effects of consolidation changes) reflected:

- the significant increase in the revenues of the Mobile business unit which in Italy grew as a consequence of the positive performance of voice traffic, the development of value-added services (VAS) and sales of mobile phones boosted by the expansion of Multimedia Message Services (MMS);
- the increase in the revenues of wireline/integrated companies in South America and Domestic Wireline (an increase of 1.4% compared to the first quarter of 2002) was due primarily to the growth in income from basic subscription charges and from sales. It more than compensated for the slight decline in traffic (a decrease of 7.2 million compared to the first quarter of 2002) which decreased in the retail segment and increased in the wholesale area; and
- the positive contribution of the Internet and Media business unit.

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As of March 31, 2003, Telecom Italia had 27.1 million domestic subscriber fixed lines, including ISDN equivalent lines (substantially in line with domestic subscriber fixed lines as of December 31, 2002 and March 31, 2002) and TIM in Italy had 25.7 million domestic mobile lines (compared to 25.3 million as of December 31, 2002 and 24.1 million as of March 31, 2002).

Telecom Italia's consolidated gross operating profit as calculated below (Gross Operating Profit) was flat at 3,303 million for the three months ended March 31, 2003 compared to 3,274 million for the three months ended March 31, 2002 (please see table below). Excluding the negative effects of exchange rate fluctuations and changes to the consolidation area (96 million), organic growth was 3.9% (an increase of 125 million).

The following table reconciles operating income to the calculation of Gross Operating Profit by showing the Statement of Operations items included in calculating Gross Operating Profit:

	<b>Three Months ended March 31,</b>	
	<b>2002</b>	<b>2003</b>
	<b>(Unaudited) (millions of Euro)</b>	
Operating income	1,731	1,866
Depreciation and Amortization	1,421	1,319
Other external charges:		
• Provision for bad debts	86	75
• Write-downs of fixed assets and intangibles	3	0
• Provision for risk	23	30
• Other provisions and operating charges	78	71
Other income (excluding operating grants, reimbursements for personal costs and costs of external services rendered)	(68)	(58)
<b>Gross Operating Profit</b>	<b>3,274</b>	<b>3,303</b>

Telecom Italia believes that Gross Operating Profit (as calculated above) provides the best indication of the Telecom Italia Group's operating performance and is meaningful information for investors. In addition the Telecom Italia Group also believes (although other telecommunication operators will calculate such information differently) that Gross Operating Profit permits an adequate comparison of the Telecom Italia Group's performance against its peer group.

Gross operating margin (Gross Operating Profit as a percentage of operating revenues) was 46.4% for the three months ended March 31, 2003, compared to 45.1% for the three months ended March 31, 2002.

Telecom Italia's consolidated operating income (total revenues less total operating expenses, including depreciation and amortization and other charges) amounted to 1,866 million for the three months ended March 31, 2003 compared to 1,731 million for the three months ended March 31, 2002 (an increase of 7.8%). Excluding the negative effects of exchange rate fluctuations and changes to the consolidation area, organic growth was 6.4%. The increase in operating income was largely due to the decrease in depreciation and amortization principally due to the write-down of the Seat Pagine Gialle goodwill made in 2002.

As a percentage of operating revenues, operating income increased from 23.8% in the first quarter of 2002 to 26.2% in the first quarter of 2003.

Financial income and financial expense, net, showed an improvement of 94 million, from a negative balance of 510 million in the first quarter of 2002 to a negative balance of 416 million in the first quarter of 2003, mainly as a result of the followings:

- a decrease in interest expense due to lower average borrowings outstanding during the first quarter of 2003 as well as the improvement of the exchange rate which positively impacted some Latin American companies operating in Brazil and Venezuela, partially offset by;
- the increase in net write-downs and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies (from 34 million in the first three months of 2002 to 118 million in the first quarter of 2003).

Other income and expense, net was a loss of 2 million in the first quarter of 2003 compared to income of 543 million in the first quarter of 2002, a decrease of 545 million. This decrease was principally a result of the

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disposals of Bouygues Decaux Telecom ( 484 million) and Lottomatica ( 133 million) which occurred in the first quarter of 2002.

The Telecom Italia Group's net financial debt of 16,079 million represented a decrease from December 31, 2002 of 2,039 million, mainly as a result of the followings:

- cash flow from operating activities was higher than capital expenditures (goodwill included) and financial investments totaling 860 million ( 1,227 million in the first three months of 2002); and
- proceeds from the first two installments relating to the disposal of Telekom Srbija of 60 million.

Net financial debt is determined as follows:

	As of December 31, 2002	As of March 31, 2003
		(Unaudited)
	(millions of Euro)	
Short-term debt, including current portion of long-term debt	5,089	3,599
Long-term debt	15,018	14,889
Cash and cash equivalents:		
• Bank and postal accounts	(1,251)	(1,884)
• Cash and valuables on hand	(4)	(44)
• Receivables for sales of securities	(55)	(77)
• Marketable debt securities	(278)	(283)
Financial accounts receivable (included under Receivables and Other Current Assets )	(683)	(406)
Financial prepaid expense/deferred income, net and accrued financial income/expense, net	282	285
<b>Net Financial Debt</b>	<b>18,118</b>	<b>16,079</b>

The portion of gross financial debt due beyond twelve months rose from 75% at December 31, 2002 to 81% at March 31, 2003, including in long-term debt its current portion the percentage went up to 93% (88% as of December 31, 2002). See, however, Item 8. Financial Information Condensed Consolidated Pro Forma Financial Data and Item 8. Financial Information Pro Forma Liquidity and Capital Resources.

The securitization program, begun in June 2001, also continued for trade accounts receivable generated by the services rendered to residential customers of Telecom Italia S.p.A. The securitization of receivables led to an improvement in consolidated net financial debt as of March 31, 2003 of 839 million ( 826 million as of December 31, 2002).

As of March 31, 2003, the Telecom Italia Group had 100,765 employees, a decrease of 948 units compared to December 31, 2002. The fall is primarily due to the changes to the area of consolidation (a decrease of 819 units), in connection with the disposal of Tess, Telecom Italia's wholly owned subsidiary operating in the information systems for payroll services (a reduction of 404 units), the sale of the Logistic business segment of Telecom Italia Domestic Wireline (a decrease of 337 units) and the disposal of other minor companies in the Internet and Media

Business Unit (a decrease of 78 units).

***Business Units***

The following discussion relates to the Telecom Italia Group's principal Business Units as they were organized in the first quarter of 2003. In particular, in early 2003, the Telecom Italia Group further reorganized certain of its business units. Starting from January 1, 2003, the groups Netikos, Webegg and TILab, as well as the companies Loquendo and Eustema are no longer part of the Information Technology Group Operating Activity. As a result of this reorganization:

- the groups Netikos and Webegg and the company Eustema are included in the Information Technology Market Business Unit;
- Loquendo is included in Domestic Wireline Business Unit; and
- TILab group is included in Other Activities.



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Domestic Wireline gross operating revenues for the three months ended March 31, 2003 were 4,235 million, an increase of 1.4% compared to 4,175 million for the three months ended March 31, 2002. The increase in revenues was due, in particular, to the higher revenues from basic subscription charges and sales which more than offset the slight decline in traffic revenues (a decrease of 7.2 million compared to the first quarter of 2002). The decline in traffic revenues was attributable to a reduction in the retail sector offset in part by an increase in the wholesale sector. The slight reduction in retail traffic (a decline of approximately 13.3 million or 0.8%) was due to the erosion of revenues from Voice and On Line Dial Up traffic partially offset by an increase in revenues from VAS traffic and Data traffic. In particular, the erosion of revenues from Voice and On Line Dial Up traffic continues to be affected by a number of factors, such as:

- Domestic Wireline's marketing strategy of giving preference to flat rate plans, which, in terms of economic results, lower the average yield on traffic and increase revenues from basic subscription charges; and
- rate adjustments which lower average prices and access charges.

Revenues from national and international wholesale traffic (a total increase of 6.1 million or 1.3% compared to the first quarter of 2002), was attributable to growth of international traffic as a result of higher volumes of in transit traffic, which compensated for the reduction in national traffic generated mainly by an average reduction in the yield equal to 30%, compared to the first quarter of 2002.

Revenues from basic subscription charges and sales increased by approximately 110 million compared to the first quarter of 2002. Revenues from basic subscription charges rose by approximately 80 million, reflecting an increase in the retail segment of approximately 87 million, for access (an increase of approximately 54 million) and ADSL (an increase of approximately 27 million). Revenues from sales rose by approximately 30 million.

Gross operating profit increased from 1,941 million in the three months ended March 31, 2002 to 1,973 million in the three months ended March 31, 2003.

The Domestic Wireline Business Unit gross operating margin increased from 46.5% in the three months ended March 31, 2002 to 46.6% in the three months ended March 31, 2003. This improvement was due to the cost savings generated by further reductions in personnel, lower general and administrative expenses and network efficiency.

Operating income improved by 2.9% from 1,198 million in the first three months of 2002 to 1,233 million in the first three months ended March 31, 2003.

As of March 31, 2003, the Domestic Wireline Business Unit had 53,177 employees, a reduction of 680 units compared to December 31, 2002 (of which 337 units was relating to the sale of the Logistic business segment).

***Mobile (TIM group)***

TIM group gross operating revenues were 2,616 million for the three months ended March 31, 2003, a 4.7% increase over gross operating revenues for the same period in 2002 ( 2,498 million). Net of devaluation of the Brazilian and Venezuelan exchange rates, the revenue growth in the first quarter of 2003 would have reached 15.4% with respect to the same period in 2002. This increase was primarily due to the positive performance of the Domestic Business and the improvements in STET Hellas (the Greek mobile operator).

Consolidated Gross Operating Profit increased by 3.4% from 1,221 million for the three months ended March 31, 2002 to 1,262 million for the three months ended March 31, 2003. Excluding the negative effects of exchange rate fluctuations, organic growth reached 8.1%. Such increase was due to the positive performance of the existing activities (Italy, Greece and Brazilian companies operating the TDMA technology), which offset the higher cost attributable to the start-up of the GSM service in Brazil launched in October 2002. The gross operating margin declined slightly from 48.9% for the first three months of 2002 to 48.2% for the first three months of 2003.

TIM group operating income for the three months ended March 31, 2003 increased by 7.9% to 897 million compared to the first three months of 2002 ( 831 million).

As of March 31, 2003, the TIM group had 40.2 million wireless lines, not including Telecom Italia Group wireless lines, an increase of 2.7% compared to December 31, 2002. The TIM group lines include the lines of Aria Is TIM (the Turkish mobile operator) and the lines of Radiomobil.

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The Mobile Services Business Unit's employees numbered 18,913 as of March 31, 2003, an increase of 211 compared to December 31, 2002.

For TIM, the Mobile Services business unit's parent company, operating revenues for the three months ended March 31, 2003 were 2,149 million, an increase of 9% over the three months ended March 31, 2002. The growth of operating revenues was the result of the positive trend both in the evolution of voice traffic (+5.3% with respect to the same period of 2002) and of value added services (VAS), which in the first quarter of 2003 amounted to 233 million (+38.7% with respect to the same period of 2002). In the first quarter of 2003 the ratio of operating revenues from VAS to total service revenues was 11.1% compared to 8.6% in the first quarter of 2002.

TIM Gross Operating Profit for the three months ended March 31, 2003 was 1,136 million, a 7.6% increase compared to the first three months of 2002, while gross operating margin decreased to 52.9% from 53.5%.

TIM operating income for the first three months of 2003 was 880 million, a 10.8% increase compared to the three months ended March 31, 2002. Such increase benefited from lower amortization expense, relating to the UMTS license as a result of the issuance of the Presidential Decree No. 211 of August 1, 2002 which changed the period of individual licenses in the TLC sector from 15 to 20 years (with an extension also for those already issued).

### *South America*

The following information relates to the Entel Chile group, the Entel Bolivia group, the company Telecom Italia America Latina and the South America business segment of Telecom Italia.

Gross operating revenues for the first three months of 2003 decreased by 21.1% from 370 million for the first three months of 2002 to 292 million. The decrease in gross operating revenues was mainly due to exchange rate fluctuations which had a negative impact of 101 million (88 million for Chilean Peso and 13 million for the Boliviano). Excluding this effect, 23 million of growth would have been recorded, related to the improved revenues of the Entel Chile group (an increase of 8.1% in local currency) partly offset by a slight reduction in revenues of Entel Bolivia (a decrease of 0.8%). In addition revenues were also reduced due to the suspension with effect from April 1, 2002 of the contribution of the management fee under the terms of the contract with Telecom Argentina, due to Telecom Argentina's financial difficulties.

Gross Operating Profit was 102 million in the first three months of 2003 compared with 127 million for the first three months of 2002, a decrease of 19.7%. Excluding the negative effects of exchange rate fluctuations, organic growth was 9 million. Gross operating margin increased from 34.3% in the first three months of 2002 to 34.9% in the three months ended March 31, 2003.

Operating income decreased by 9 million or 19.6% from 46 million in the first quarter of 2002 compared to 37 million in the first quarter of 2003. The negative impact due to exchange rate fluctuations was 12 million.

As of March 31, 2003, South America had 5,412 employees, with a decrease of 49 units compared to the end of 2002.

\* \* \* \*

In order to give an overall view of Latin America Operations (LAO), the following table sets forth, for the periods indicated, certain financial and other data for all the companies operating in South America (including also those operating under the Mobile business unit), providing both wireline and mobile phone services.

<u>South America</u>	<b>Three Months ended March 31,</b>	
	<b>2002</b>	<b>2003</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	758	584
Gross Operating Profit	241	165
Operating income	44	14
Number of employees at period-end(1)	11,977	12,794

(1) As of December 31, 2002 the employees numbered 12,511.

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### ***Internet and Media***

For the three months ended March 31, 2003, SEAT's consolidated operating revenues were 345 million compared to 333 million for the three months ended March 31, 2002, an increase of 3.6%. This increase was mainly due to the positive contributions of the Directories business (an increase of 2.1% compared to the first quarter of 2002) and of Internet services which achieved a significant increase in operating revenues and continued to increase its profitability as a consequence of diversification of revenue sources and broadband development.

The gross operating profit increased significantly (+74.1%), from 27 million in the first quarter of 2002 to 47 million in the first quarter of 2003, principally due to improvements in almost all areas of business and, in particular, in the areas of the Internet, Directories and Television.

For the three months ended March 31, 2003, operating income was a loss of 35 million compared to a loss of 69 million in the same period of 2002, an improvement of 49.3%. The lower loss was partly due to the reduction of adjusting provisions resulting from a more effective management of credit.

As of March 31, 2003, SEAT group had 7,559 employees, with a decrease of 156 units compared to the end of 2002.

### ***Information Technology Market***

Gross operating revenues were 156 million for the first quarter of 2003 compared to 278 million for the first quarter of 2002, a decrease of 32 million on a comparable consolidation basis (excluding data relating to Sogei and Consiel and including the Webegg group, the Netikos group and Eustema). This decrease was mainly attributable to the reduction in the revenues of Finsiel, resulting from lower volumes and generally lower prices charged to main customers, and to a contraction in the revenues of the Webegg group and, to a lesser extent, of Banksiel. This contraction was offset by an increase from the rise in the activities of Eustema and Eis, and the effect of the contributions made by Agrisian.

Gross Operating Profit decreased from 33 million ( 22 million on a comparable consolidation basis) in the first quarter of 2002 to 10 million in the first quarter of 2003 and operating income decreased from 25 million ( 14 million on a comparable consolidation basis) in the first quarter of 2002 to 0 million in the first quarter of 2003. These decreases were due to the above-mentioned price reductions with regard to main customers and were principally attributable to Finsiel.

As of March 31, 2003, Information Technology Market had 5,478 employees, with a decrease of 28 units compared to the end of 2002.

### ***Information Technology Group***

Gross operating revenues were 229 million for the first quarter of 2003 compared to 168 million for the first quarter of 2002, an increase of 61 million. This increase was principally due to higher volumes of work on business systems, operational systems and institutional projects, as well

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as the conclusion of some projects which were still in progress at December 31, 2002, namely projects for the Domestic Wireline Business Unit of Telecom Italia on Broadband, UNICA TD and Order Manager.

The gross operating profit, which remained unchanged in absolute terms ( 11 million in the first quarter of 2003 and 2002), and the operating loss ( 23 million in the first quarter of 2003 compared to a loss of 12 million in the first quarter of 2002) reflect the fall in prices which took place in the second half of 2002. Furthermore, operating loss was impacted by the increase in depreciation as a result of higher investments in infrastructure activities, principally made in the second half of 2002.

As of March 31, 2003, Information Technology Group had 5,059 employees, with an increase of 20 units compared to the end of 2002.

### ***Results of Operations for the Three Years Ended December 31, 2002***

#### ***Change in scope of consolidation***

The results of operations of the Telecom Italia Group fully consolidate all Italian and foreign subsidiaries (other than subsidiaries not material to the Telecom Italia Group) in which Telecom Italia holds, directly or indirectly, more than 50% of the voting stock or has dominant influence (effective control).

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Beginning with the 2001 results of operations, Nortel Inversora and the controlled Telecom Argentina group (Nortel Inversora group), which in 2000 were consolidated proportionally as permitted by art. 37 of Legislative Decree No. 127/1991, have been accounted for using the equity method. Prior to 2000 the Nortel Inversora group had been accounted for by the equity method.

Other entities in which Telecom Italia holds, directly or indirectly, between 20% and 50% of the voting rights, including jointly controlled companies, are accounted for under the equity method. These include a large number of its international investments. The equity in the earnings of such entities (i.e.: Telecom Italia's proportional share in the profits or losses of these entities) is included in financial expense. See Note 22 of Notes to the Consolidated Financial Statements included elsewhere herein.

*For purposes of the discussion which follows, we will only use the pro forma 2000 numbers so that all three years, 2002, 2001 and 2000, will be comparable as it relates to the treatment of the Nortel Inversora group.*

The following main changes in the scope of consolidation took place during the three year period (2002, 2001 and 2000):

- some investments were disposed of in 2002 and were consolidated in the results of operations as follows: the 9Telecom group for the period from January 1, 2002 to June 30, 2002; the former Satellite Services Business Unit for the period from January 1, 2002 to September 30, 2002 and the company Sogei for the period from January 1, 2002 to June 30, 2002;
- the groups SEAT Pagine Gialle, Jet Multimedia, Magéos Explorer and Maxitel and the companies Digitel and Eustema were acquired at the end of 2000 and were consolidated in 2000 only for balance sheet purposes. These groups and companies were fully consolidated in the 2001 results of operations;
- the Entel Chile group was included in the scope of consolidation beginning in 2001. Prior to 2001 this group was accounted for on an equity basis;
- the Sirti and Italtel groups, disposed of during the last part of fiscal 2000, were consolidated only in the statement of operations for the period from January 1, 2000 to September 30, 2000.

The following table sets forth the Telecom Italia Group's Italian GAAP statements of operations for the years ended December 31, 2000 (pro forma), 2001 and 2002.

	2000(1)	2001	2002
	(pro forma)		
	(millions of Euro)		
Operating revenues	27,169	30,818	30,400
Other income	402	417	479
<b>Total revenues</b>	<b>27,571</b>	<b>31,235</b>	<b>30,879</b>
Cost of materials	2,132	1,972	1,779

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Salaries and social security contributions	4,745	4,666	4,540
Depreciation and amortization	5,209	6,275	5,877
Other external charges	10,130	12,171	11,949
Changes in inventories	(255)	58	28
Capitalized internal construction costs	(831)	(581)	(675)
	<u>21,130</u>	<u>24,561</u>	<u>23,498</u>
Total operating expenses			
Operating income	<u>6,441</u>	<u>6,674</u>	<u>7,381</u>
Financial income	806	1,076	1,236
Financial expense	(2,261)	(5,031)	(3,399)
<i>of which writedowns and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies, net</i>	<i>(1,011)</i>	<i>(1,616)</i>	<i>(465)</i>
Other income and (expense), net	(184)	(3,452)	(5,637)
	<u>4,802</u>	<u>(733)</u>	<u>(419)</u>
Income (loss) before income taxes and minority interests			
Income taxes	(1,910)	(925)	716
	<u>2,892</u>	<u>(1,658)</u>	<u>297</u>
Net income (loss) before minority interests			
Minority interest	(864)	(410)	(619)
	<u>2,028</u>	<u>(2,068)</u>	<u>(322)</u>
Net income (loss)			

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.



**Table of Contents****Business Unit Financial Data**

The Telecom Italia Group operates predominantly in Italy and its core business is focused on domestic and international telecommunications services. For purposes of this Operating and Financial Review the Telecom Italia Group is providing three years of certain financial data for its Business Units.

The table below sets forth the gross operating revenues, gross operating profit, operating income and other data for the Telecom Italia Group's Business Units, for the last three years:

		<b>Domestic Wireline</b>	<b>Mobile</b>	<b>South America</b>	<b>Internet and Media</b>	<b>IT Market</b>	<b>IT Group</b>	<b>Sub Total</b>	<b>Other activities and eliminations</b>	<b>Consolidated Total</b>
		(1)		(1)(2)		(3)	(3)		(4)	
(millions of Euro, except number of employees)										
<b>Gross operating revenues</b>	2002	17,022	10,867	1,409	1,991	912	1,215	33,416	(3,016)	30,400
	2001	17,168	10,250	1,534	1,957	1,198	1,198	33,305	(2,487)	30,818
	2000 (pro forma)(6)	17,419	9,418	312	263	1,135	1,332	29,879	(2,710)	27,169
	2000	17,419	9,418	2,100	263	1,135	1,332	31,667	(2,756)	28,911
<b>Gross operating profit(5)</b>	2002	7,965	5,039	450	593	104	140	14,291	(327)	13,964
	2001	7,750	4,760	527	444	166	188	13,835	(216)	13,619
	2000 (pro forma)(6)	7,403	4,447	172	(35)	136	203	12,326	(109)	12,217
	2000	7,403	4,447	1,073	(35)	136	203	13,227	(109)	13,118
<b>Operating income</b>	2002	4,700	3,358	146	232	61	(21)	8,476	(1,095)	7,381
	2001	4,361	3,136	187	31	123	22	7,860	(1,186)	6,674
	2000 (pro forma)(6)	3,904	2,988	99	(73)	105	(15)	7,008	(567)	6,441
	2000	3,904	2,988	473	(73)	105	(15)	7,382	(577)	6,805
<b>Capital expenditures</b>	2002	2,462	1,715	216	81	30	158	4,662	180	4,842
	2001	2,801	3,151	406	175	30	162	6,725	265	6,990
	2000 (pro forma)(6)	2,710	4,206	68	34	37	159	7,214	161	7,375
	2000	2,710	4,206	592	34	37	159	7,738	161	7,899
<b>Number of employees at the year end</b>	2002	53,682	18,702	5,461	7,715	4,493	7,327	97,380	4,333	101,713
	2001	57,895	16,721	5,746	9,264	6,441	6,844	102,911	7,045	109,956
	2000 (pro forma)(6)	62,366	15,257	1,087	7,515	7,400	6,385	100,010	7,161	107,171
	2000	62,366	15,257	8,585	7,515	7,400	6,385	107,508	7,161	114,669

(1) The data relating to 2001 and 2000 has been reclassified and presented consistent with the 2002 presentation.

(2) The data refer to Entel Chile Group, Entel Bolivia Group, the company Telecom Italia America Latina and the business segment South America of Telecom Italia.

(3) In early 2002, the IT Services Business Unit was split into two distinct units: Information Technology Market and Information Technology Group. Beginning January 1, 2002, Saritel S.p.A. was consolidated in the Information Technology Group Operating Activity instead of the

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Domestic Wireline Business Unit.

- (4) The data presented include the operations of the Foreign Holdings Corporate Function and the former Business Unit Satellite Services (the Telespazio Group) which was disposed of during the 4th quarter of 2002 and consolidated in the statement of operations only for the first nine months of 2002.
- (5) Gross operating profit is a non-GAAP financial measure. The following table reconciles operating income to the calculation of Gross Operating Profit by showing the Statement of Operation items included in calculating Gross Operating Profit on a consolidated basis.

	Year ended December 31,			
	2000	2000 pro forma	2001	2002
	(millions of Euro)			
Operating income	6,805	6,441	6,674	7,381
Depreciation and Amortization	5,647	5,209	6,275	5,877
Other external charges:				
• Provision for bad debts	477	394	439	542
• Write-downs of fixed assets and intangibles	48	48	16	57
• Provision for risk	119	108	189	109
• Other provisions and operating charges	382	353	382	436
Other income (excluding operating grants, reimbursements for personnel costs and costs of external services rendered)	(360)	(336)	(356)	(438)
<b>Gross Operating Profit</b>	<b>13,118</b>	<b>12,217</b>	<b>13,619</b>	<b>13,964</b>

- (6) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora Group using the equity method instead of the proportional consolidation method.

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*Year ended December 31, 2002 compared with Year ended December 31, 2001.*

**Consolidated Operating Revenues**

The Telecom Italia Group's consolidated operating revenues decreased by 1.4% in 2002 compared to 2001. Organic growth (revenues based on constant currency and excluding the effects of consolidation changes) was 3.8%, excluding the effect of changes in exchange rates (a decrease of 763 million) and the effect of the change in the scope of consolidation (a decrease of 755 million). In particular, consolidated operating revenues were impacted by the disposition of the 9Telecom group and Sogei (which were consolidated only for the first six months of 2002), as well as by the disposition of the former Satellite Services Business Unit starting from October 1, 2002.

The increase in revenues, on a comparable consolidation basis, reflected the positive contribution made by the Mobile Business Unit and higher revenues from the Internet and Media segment, offset by a reduction in the amount contributed by the Domestic Wireline Business Unit where traffic revenues, despite a 2.4% increase in terms of minutes, decreased by 8.3% as a result of a lower average return on traffic (retail and wholesale). Such decrease was only partially offset by the increase in basic subscription charges.

The table below sets forth, for the periods indicated, gross operating revenues and consolidated operating revenues by Business Unit and the percentage contribution of such Business Unit to the Telecom Italia Group's consolidated operating revenues.

	Year ended December 31,					
	2001(1)			2002		
	Gross Operating Revenues (2)	Consolidated Operating Revenues(3)	% of Consolidated Operating Revenues	Gross Operating Revenues(2)	Consolidated Operating Revenues(3)	% of Consolidated Operating Revenues
	(millions of Euro, except percentages)					
Domestic Wireline(4)(7)	17,168	15,220	49.4%	17,022	15,091	49.6%
Mobile	10,250	9,963	32.3%	10,867	10,595	34.9%
South America(5)(6)	1,534	1,531	5.0%	1,409	1,369	4.5%
Internet and Media	1,957	1,880	6.1%	1,991	1,900	6.2%
IT Market(7)(8)(9)	1,198	1,135	3.7%	912	876	2.9%
IT Group(7)	1,198	156	0.5%	1,215	111	0.4%
Other activities(10)	2,009	933	3.0%	1,433	458	1.5%
<b>Total operating revenues</b>	<b>35,314</b>	<b>30,818</b>	<b>100.0%</b>	<b>34,849</b>	<b>30,400</b>	<b>100.0%</b>

(1) The data relating to 2001 has been reclassified and presented consistent with the 2002 presentation.

(2) Gross operating revenues are total revenues of the various business areas of the Telecom Italia Group before elimination of intercompany sales (but after elimination of sales between companies within the same major business area).

(3) Consolidated operating revenues are revenues recorded by each business area on a consolidated basis after elimination of intercompany sales.

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- (4) In May 2002, the International Operations (IOP) Operating Activity was disbanded. As a result the following companies became part of the Domestic Wireline Business Unit: Intelcom San Marino and Golden Lines.
- (5) The data refer to Entel Chile group, Entel Bolivia group, the company Telecom Italia do Brasil (in 2002 renamed Telecom Italia America Latina) and the business segment, South America of Telecom Italia.
- (6) Beginning with the year ended December 31, 2001, Nortel Inversora and the controlled Telecom Argentina group (Nortel Inversora group), which in 2000 were consolidated proportionally, have been accounted for using the equity method. Prior to 2000 the Nortel Inversora group was accounted for on the equity method.
- (7) In early 2002, the IT Services Business Unit was split into two distinct units: Information Technology Market and Information Technology Group. Beginning January 1, 2002, Saritel S.p.A. has been consolidated in the IT Group Operating Activity instead of the Domestic Wireline Business Unit.
- (8) On July 31, 2002, Finsiel disposed of its 100% stake in Sogei S.p.A. to the Ministry of Economy and Finance Fiscal Policy Department; as result of this, the 2002 figures presented include Sogei only for the first six months.
- (9) On October 3, 2002, Finsiel disposed of its 100% stake in Consiel S.p.A. to World Investment Partners S.A.; as a result of this, the 2002 figures presented include Consiel only for the first eight months.

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- (10) The data presented include the operations of the Foreign Holdings Corporate Function (9Telecom Reseau group disposed of in August 2002 and consolidated in the statement of operations for the first six months of 2002 , the BBNed group and what remains of the former IOP) and the former Business Unit Satellite Services (the Telespazio group) which was disposed of during the 4th quarter of 2002 and consolidated in the statement of operations only for the first nine months of 2002.

The table below sets forth, for the periods indicated, consolidated operating revenues by geographic area:

Geographic Area	Year ended December 31,			
	2001		2002	
	(millions of Euro, except percentages)			
Italy	24,456	79.4%	24,652	81.1%
Other European countries	2,169	7.0%	2,182	7.2%
North America	968	3.1%	354	1.2%
Central and South America	2,592	8.4%	2,638	8.7%
Australia, Africa and Asia	633	2.1%	574	1.8%
Total operating revenues	30,818	100.0%	30,400	100.0%

**Operating Expenses**

The table below sets forth, for the periods indicated, total consolidated operating expenses by major components and expressed as a percentage of total consolidated operating revenues.

	Year ended December 31,			
	2001		2002	
	(millions of Euro, except percentages)			
Cost of materials	1,972	6.4%	1,779	5.9%
Other external charges	12,171	39.5%	11,949	39.3%
Personnel costs (salaries and social security contributions)	4,666	15.1%	4,540	14.9%
Changes in inventories	58	0.2%	28	0.1%
Capitalized internal construction costs	(581)	(1.9)%	(675)	(2.2)%
Depreciation and amortization	6,275	20.4%	5,877	19.3%
Total operating expenses	24,561	79.7%	23,498	77.3%

The Telecom Italia Group's operating expenses decreased by 1,063 million or 4.3% in 2002 compared to 2001. The decrease is attributable to the lower cost of materials, costs of external services rendered (included in other external charges), personnel costs, depreciation of fixed assets and amortization of goodwill.

As a percentage of the Telecom Italia Group's operating revenues, operating expenses represented 79.7% and 77.3% in 2001 and 2002, respectively.

*Cost of Materials*

Cost of materials decreased by 9.8% in 2002 compared to 2001, principally as a result of the effect of the changes in the exchange rates which impacted the Latin American companies and the effect of the change in the scope of consolidation (Telespazio and Sogei).

**Table of Contents****Other External Charges**

The table below sets forth, for the periods indicated, consolidated other external charges broken down by major components.

	Year ended December 31,	
	2001	2002
	(millions of Euro)	
Costs of external services rendered	9,552	9,229
Write-downs of fixed assets and intangibles	16	57
Provision for bad debts	439	542
Rent and lease payments	1,069	1,145
TLC license fee	524	431
Provision for risk	189	109
Other provisions and operating charges	382	436
<b>Other external charges</b>	<b>12,171</b>	<b>11,949</b>

Other external charges decreased by 222 million in 2002 compared to 2001 or 1.8%. These charges include costs of external services rendered, write-downs of fixed assets and intangibles, provision for bad debts, rent and lease payments, telecommunications license fees and other provisions and operating charges.

- Costs of external services rendered decreased by 323 million or 3.4% in 2002 compared to 2001; the reduction was principally due to continuing action taken to improve efficiency and the exit from the scope of consolidation of the Telespazio and 9Telecom groups and the company Sogei, partly offset by the increase in the costs of operating and developing mobile telecommunications services.
- Write-downs of fixed assets and intangibles increased by 41 million in 2002 compared to 2001.
- Rent and lease payments increased by 76 million or 7.1% in 2002 compared to 2001, mainly due to higher costs sustained by TIM due to its continued expansion, partly offset by the effect of the change in scope of consolidation.
- TLC license fee, which is principally payable to the Italian Government and is proportional to revenues, decreased by 93 million or 17.7% in 2002 compared to 2001 due to a reduction in both the revenue base and the rate (the aggregate rate for Telecom Italia and TIM declined from 2.5% in 2001 to 2.0% in 2002).
- Other provisions and operating charges, which include losses on disposals and write-offs of fixed assets and intangibles ( 36 million) and taxes other than income taxes ( 115 million), increased by 14.1% in 2002 compared to 2001.

**Personnel Costs**

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Personnel costs (salaries and social security contributions) decreased by 126 million or 2.7% to 4,540 million in 2002 from 4,666 million in 2001. The decrease was due to the following:

- a decrease in Telecom Italia employee costs following layoffs in 2001 previously agreed with Telecom Italia's unions and continuing reductions in employee levels particularly at Telecom Italia; and
- the changes in the scope of consolidation as a result of the exclusion of Telespazio and 9Telecom groups and the company Sogei offset only in part by the inclusion of Webegg group, Blu, EPIClink and Netesi.

As a percentage of the Telecom Italia Group's operating revenues personnel costs declined to 14.9% in 2002 compared to 15.1% in 2001. Employees at December 31, 2002 numbered 101,713 (109,956 as of December 31, 2001). The breakdown is as follows:

	<b>As of December 31,</b>	
	<b>2001</b>	<b>2002</b>
Italy	90,628	83,541
Abroad	19,328	18,172
<b>Total employees</b>	<b>109,956</b>	<b>101,713</b>

At December 31, 2002 the Telecom Italia Group employed 101,713 persons, a decrease of 8,243 employees compared to 109,956 at December 31, 2001. Of such decrease, 2,883 units arose from the net effect of changes in the scope of consolidation and the remaining 5,360 units were related to lower levels of personnel, particularly at Telecom Italia.



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The reduction due to the changes of the scope of consolidation is analyzed as follows:

- exits of the 9Telecom group (a decrease of 1,003 units), the Telespazio group (a decrease of 1,168 units), the companies Sogei and Consiel (a total decrease of 1,538 units) and other minor companies (a decrease of 711 units); and
- the inclusion of Blu (an increase of 618 units), the Webegg group (an increase of 719 units), the companies Netesi and EPIClink (a total increase of 168 units) and other minor companies (an increase of 32 units).

Telecom Italia is currently in a dispute with the Italian Social Security Authority ( INPS ) concerning the calculation of social security charges to be paid by the companies operated in Italy's telecommunications services of the Telecom Italia Group. At December 31, 2002, Telecom Italia's potential range of liability for principal contribution was estimated to be between 964 million and 1,289 million ( 409 million of which has already been paid). Management does not believe that an adverse resolution of the dispute will have a material adverse effect on the Telecom Italia Group's consolidated financial position in view of the fact that the sums due are to be paid over a period of 15 years (for more details see Item 8. Financial Information - Legal Proceedings ).

**Capitalized Internal Construction Costs**

Capitalized internal construction costs represent sales of equipment, installations and services at market prices by Telecom Italia Group companies, principally to Telecom Italia and TIM. Capitalized internal construction costs increased from 581 million in 2001 to 675 million in 2002 (or a 16.2% increase) principally due to higher levels of capital expenditures spent on products and services purchased from subsidiaries.

**Gross Operating Profit**

The table below sets forth, for the periods indicated, the Telecom Italia Group's Gross Operating Profit (see Business Unit Financial Data Note 5 for the calculation of Gross Operating Profit) and gross operating margin (gross operating profit as a percentage of operating revenues).

	Year ended December 31,			
	2001		2002	
	(millions of Euro, except percentages)			
Gross Operating Profit	13,619	44.2%	13,964	45.9%

Gross Operating Profit increased by 345 million or 2.5% in 2002 compared to 2001. Excluding the effect of changes in exchange rates (a decrease of 186 million) and the effect of the change in the scope of consolidation (a decrease of 120 million), Gross Operating Profit grew by 651 million or 4.9%. Gross operating margin increased to 45.9% in 2002 from 44.2% in 2001.

The overall increase in Gross Operating Profit was positively impacted by the reduction in costs of external services rendered and cost of materials due to continuing action taken to improve efficiency, as well as lower personnel costs.

***Depreciation and Amortization***

Depreciation and amortization which is recorded on a straight line basis over the estimated useful lives of the assets, decreased by 398 million or 6.3% in 2002 to 5,877 million compared to 6,275 million in 2001. Depreciation of fixed assets decreased by 251 million or 6.2% to 3,783 million in 2002 compared to 4,034 million in 2001. The decrease in depreciation of fixed assets was principally due to a reduction in the depreciation expense of Telecom Italia ( 240 million), owing to a lower amount of depreciable assets and a change in the mix of depreciable assets.

Amortization of intangible assets decreased by 147 million or 6.6%, from 2,241 million in 2001 to 2,094 million in 2002. Goodwill represented 844 million of intangibles in 2002 compared to 1,022 million in 2001. The decrease in amortization of goodwill ( 178 million) is mainly due to the write-down of goodwill recorded in 2001.

At year end 2002 goodwill had declined to 6,612 million from 9,141 million as of December 31, 2001, mainly as a result of the amortization described above as well as the extraordinary write-downs of goodwill on

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consolidated subsidiaries recorded in 2002 ( 1,769 million, of which 1,544 million related to Seat Pagine Gialle) partly offset by additions ( 369 million).

**Operating Income**

The table below sets forth, for the periods indicated, the Telecom Italia Group's operating income (total revenues less total operating expenses, including depreciation and amortization and other charges).

	<b>Year ended December 31,</b>	
	<b>2001</b>	<b>2002</b>
	<b>(millions of Euro)</b>	
Operating income	6,674	7,381

Operating income for the Telecom Italia Group increased by 707 million or 10.6% in 2002 compared to 2001. Excluding the effect of changes in exchange rates and the effect of the change in the scope of consolidation, operating income grew by 9.9%. The increase in the amount of operating income is mainly attributable to the improvement in gross operating profit described above and the decrease in depreciation and amortization. As a percentage of operating revenues, operating income increased in 2002 to 24.3% from 21.7% in 2001.

**Financial Income, Financial Expense, and Other Income and Expense, Net**

The table below sets forth, for the periods indicated, the components of financial and other income and expense, net.

	<b>Year ended December 31,</b>	
	<b>2001</b>	<b>2002</b>
	<b>(millions of Euro)</b>	
Financial income	1,076	1,236
Financial expense	(5,031)	(3,399)
<i>of which writedowns and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies, net</i>	(1,616)	(465)
Other income and (expense), net	(3,452)	(5,637)
Total financial expense, net and other income and expense, net	(7,407)	(7,800)

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Total financial expense, net and other income and expense, net increased from a net expense of 7,407 million in 2001 to a net expense of 7,800 million in 2002, a 5.3% increase.

Financial expense (which includes interest expense on financial indebtedness and income or loss from equity investees) decreased by 1,632 million or 32.4%. The decrease is attributable principally to the following:

- a decrease in interest expense, from 1,460 million in 2001 to 1,226 million in 2002, due to lower average borrowings outstanding during 2002 as well as lower interest rates and fees;
- the increase in losses on foreign exchange due to the negative performance of the rates of exchange which impacted certain Latin American companies, in particular Venezuela and Brazil;
- the reduction in net write-downs and equity in losses in unconsolidated subsidiaries, affiliated and other companies ( 1,151 million), mainly as a result of:
  - the reduction of 236 million in amortization of goodwill arising at the time of the purchase of the investments in companies accounted for using the equity method ( 80 million compared to 316 million in 2001) substantially due to the write-down of goodwill recorded in 2001;
  - the decrease of 914 million in value adjustments to financial assets for the Telecom Italia Group's share of the equity in the earnings and losses of the unconsolidated companies accounted for using the equity method (a loss of 386 million compared to a loss of 1,300 million in 2001). Such value adjustments refer to the losses of Stream of 246 million ( 241 million in 2001), of Is TIM of 171 million ( 334 million in 2001) and the earnings balance of 31 million relating to the earnings (losses) of the other unconsolidated companies.

In 2001 financial expense was affected by the negative results of the investments in the Nortel Inversora group ( 238 million) and in the Auna group ( 203 million) and the write-down of Astrolink ( 259 million) by

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Telespazio as the related project was interrupted. The investment in the Nortel Inversora group, the carrying value of which was written-off in the consolidated financial statements at December 31, 2001, has remained unchanged. In 2001 we also recorded a provision of 569 million for the forward purchase commitment of Seat Pagine Gialle shares based on the estimated non recoverability of the original price to exercise the option. The provision for the year 2002 was recorded in other income and expense, net.

Other income and expense, net increased from a net expense of 3,452 million in 2001 to a net expense of 5,637 million in 2002.

This significant increase ( 2,185 million) was mainly due to the increase of extraordinary provisions and write-downs of goodwill and equity investees ( 3,253 million), partly offset by the growth in gains on the disposal of equity investments, fixed and intangible assets ( 2,021 million), as described below.

Other income ( 2,814 million) in 2002 included:

- gains on the disposal of equity investments, fixed and intangible assets ( 2,413 million) arising from:
  - the sale of the 26.89% interest held by the Telecom Italia Group in Auna ( 1,245 million);
  - the sale of the 19.61% interest held by the Mobile Business Unit in Bouygues Decaux Telecom ( 484 million);
  - the acceptance of the tender offer for Lottomatica shares by the Information Technology Market Business Unit ( 133 million);
  - the sale of the 25% interest held by the Mobile Business Unit in the Mobilkom Austria group ( 115 million);
  - the sale of the 40% interest held in Telemaco Immobiliare ( 110 million);
  - the sale of the 100% interest held in Telespazio ( 70 million);
  - the concentration of the real-estate assets through the companies IMSER, Emsa and Telimm into Tiglio I ( 159 million);
  - the transfer of Telecom Italia's Asset Management unit to Tiglio II ( 60 million);
  - the transfer by Telecom Italia of its real estate services units (excluding facilities management) to the Pirelli & C. Real Estate group ( 15 million);
  - the sale of the 45% interest held by the Telecom Italia Group in Immsi ( 1 million);

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- the disposal of other equity investments, fixed assets and business segments ( 21 million); and
- income arising from the recovery of pre-amortization interest on the expenses for employee benefit obligations under Law 58/1992 that were paid, with reserve, to INPS up to 1999 following the termination of litigation after the courts ruled in Telecom Italia s favor ( 131 million);
- the release of certain reserves ( 77 million), primarily to absorb a portion of the reserve for risks and charges set up in 2001 by Telecom Italia to cover the expenses connected with the agreement to sell Stream to New Corporation and Vivendi Universal/Canal+ after the parties did not go through with the agreement; and
- grants ( 9 million) and other income ( 184 million).

Other expense ( 8,451 million) in 2002 included:

- extraordinary provision and write-downs of goodwill and equity investees ( 6,237 million), detailed as follows:
  - write-down of the investment held in Is TIM ( 1,491 million) and provision added to the reserve for risks and charges related to Is TIM ( 850 million) against the guarantees provided by the Telecom Italia Group to financial institutions as creditors of Is TIM and the loans to Is TIM by the Telecom Italia Group. Telecom Italia concluded that the value of its investments was permanently impaired, since, starting from the awarding of the license, some measures which should have fostered effective competition and guaranteed the full operability of the new entrant, did not effectively take place. These measures are essential in the light of international experience and pursuant to applicable legislation in Turkey. Is TIM made repeated and formal efforts but was de

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facto prevented from entering the Turkish mobile telephony market, thereby infringing the terms and conditions of the tender pursuant to which its license was awarded. Due to the above mentioned difficulties, no conditions enabling the return of investment seem to be granted;

- write-down of Seat Pagine Gialle goodwill ( 1,544 million) and provision added to the reserve for forward purchase commitments of Seat Pagine Gialle Shares ( 1,942 million) for the estimated non recoverability of the original price of the put option. These write-downs were taken as the Telecom Italia Group no longer considers its Directories business to be a core, strategic business. The write-down and the provision were made on the basis of the average Seat Pagine Gialle ordinary share price on the Italian Stock Exchange over the second half of 2002;
- other write-downs of investments of 46 million and of goodwill of 321 million (of which: 103 million for Blu, 75 million for Corporacion Digital, 96 million for Netco Redes and 47 million for other minor companies);
- provision to reserve ( 43 million), made by Seat Pagine Gialle, for the estimated losses arising from the exercise of put options by the founding shareholders of Consodata S.A.;
- charges as required under Law n. 58/1992 ( 155 million);
- restructuring costs related to expenses and provisions for employee cutbacks and layoffs ( 494 million, of which 379 million relates to Telecom Italia);
- the provisions made in conjunction with the disposal of the investment in the 9Telecom group ( 316 million). In particular, in view of the loss reported prior to sale, the French group 9Telecom reduced results of operations of the Telecom Italia Group by a total of 389 million;
- losses from the sale of the 15% stake in Telekom Austria ( 135 million);
- expenses connected with the disposal of equity investments ( 235 million);
- the extraordinary contributions to INPS established by the 2000 Finance Bill for the three years 2000-2002 to meet the higher financial requirements covered by the rules of the Fondo Previdenza Telefonici (FPT) that was abolished and became part of the general Employee Pension Fund ( 74 million);
- write-downs of fixed assets and intangibles ( 190 million, of which 142 million related to Brazilian companies);
- provisions to the reserves for risks and charges ( 194 million, of which 135 million is for guarantees provided for the disposal of certain equity investments and business segments);
- adjustment to Telecom Italia s payable to customers relating to telephone prepaid cards ( 158 million); and
- other losses on disposals of equity investments, fixed assets and intangibles ( 38 million) and other expenses ( 225 million).

Other income ( 852 million) in 2001 included:

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- gains on the sale of the 70% holding in Mirror International Holding (the company through which the satellite companies were contributed to the Lehman Brothers group) for 170 million and the 30% holding in Mediterranean Nautilus S.A. to the Israeli company F.T.T. Investments for 94 million;
- income ( 32 million) deriving from the partial cancellation, by the Council of State of resolution No. 7553/1999 by the Italian Antitrust Authority, under which TIM and Vodafone Omnitel were levied administrative fines for the alleged violation of antitrust laws relating to the price fixing of fixed-mobile rates;
- income from the release of reserves by Telecom Italia recorded in prior years for risks which did not materialize ( 120 million, mainly relating to the reserve for a contract with Iraq of 62 million and the reserve for corporate restructuring of 50 million).

Other expense ( 4,304 million) in 2001 included:

- 2,984 million for the extraordinary provisions and write-down of goodwill and equity investees, detailed as follows:
  - 1,303 million for the write-down of goodwill relating to consolidated companies (9Telecom group, Entel Bolivia, Entel Chile group, Maxitel group, Tele Celular Sul group, Tele Nordeste



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Celular group, TIM Brasil (TIM Celular Centro Sul, TIM Rio Norte and TIM Sao Paulo, into which were merged the two other companies and was renamed TIM Celular), Med-1 group and certain companies in the SEAT Pagine Gialle group);

- 1,078 million for the write-down of goodwill relating to companies accounted for by the equity method (GLB Serviços Interativos, Solpart Participacoes, Telekom Austria and the Nortel Inversora group); and
- 603 million for other provisions relating to investments;
- 248 million relating to the provision for expenses connected with the Vivendi/Canal Plus agreement for the transfer of Telecom Italia's investment in Stream;
- 380 million of expenses for employee cutbacks and layoffs (of which 203 million relates to Telecom Italia);
- 155 million for social security charges under Law 58/1992 to guarantee uniform status under the former Telephone Employees Pension Fund (FPT) which, as required by the 2000 Finance Bill, has become part of the general Employees Pension Fund;
- 77 million of extraordinary contributions to INPS established by the 2000 Finance Bill for the three years 2000-2002 to meet the higher financial requirements covered by the rules of the fund that was abolished; and
- 85 million resulting from the decision to reposition the broadcasting station La7 as a consequence of the closing of a series of contracts.

## ***Income Taxes***

Income taxes represented a benefit of 716 million in 2002 compared to a tax expense of 925 million in 2001. The statutory income tax rate for 2002 and 2001 was stable at 40.25%.

The 2002 decrease in income taxes (1,641 million) was due to a reduction in the taxable base caused mainly by the write-downs of equity investments which involved an increase in prepaid income taxes, as well as to the benefits arising from the merger of Blu into TIM.

## ***Net Income (loss)***

Net income (loss) before minority interest increased from a loss of 1,658 million in 2001 to net income of 297 million in 2002. The improvement in net income before minority interest in 2002 was principally attributable to the increase in operating income, the reduction in total financial expense, net and the income tax benefit in 2002, offset in part by the increase in other expense, net. Net loss after minority interest was 322 million in 2002 compared to a net loss of 2,068 million in 2001. Minority interest increased from 410 million in 2001 to 619 million in 2002 mainly due to higher levels of profit at TIM group, which is partially owned by the Telecom Italia Group.

*Results of Operations of Business Units for the Year Ended December 31, 2002 compared to the Year Ended December 31, 2001.***Domestic Wireline**

The following table sets forth for the periods indicated certain financial and other data for Domestic Wireline.

<u>Domestic Wireline</u>	<u>Year ended December 31,</u>	
	<u>2001(1)</u>	<u>2002</u>
	<u>(millions of Euro, except employees)</u>	
Gross operating revenues	17,168	17,022
Gross Operating Profit	7,750	7,965
Operating income	4,361	4,700
Number of employees at year-end	57,895	53,682

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(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

The following table sets forth for the periods indicated certain statistical data for Domestic Wireline.

	<b>Year ended December 31,</b>	
	<b>2001</b>	<b>2002</b>
<b>Subscription and Customers:</b>		
Subscriber fixed lines at period-end (thousands)(1)	27,353	27,142
Subscriber fixed line growth (%)	0.7	(0.8)
Subscriber fixed lines per employee at period-end(2)	448	496
ISDN equivalent lines at period-end (thousands)(3)	5,403	5,756
<b>Retail Traffic(4):</b>		
Average minutes of use per fixed line subscriber during period(5)	4,739	4,292
Of which:		
Local traffic during period (in average minutes)(6)	3,575	3,198
Long distance traffic during period (domestic and international) (in average minutes)	1,163	1,094
Growth in international incoming and outgoing traffic in minutes(7)	12.1	5.7

- (1) Data include multiple lines for ISDN and excludes internal lines.
- (2) Ratio is based on employees of the Company only.
- (3) Data exclude internal lines.
- (4) Retail traffic consists of traffic from Telecom Italia customers for local calls, long distance national and international calls (including calls to mobile phones).
- (5) Includes total fixed outgoing traffic (including international outgoing traffic and fixed outgoing traffic to the mobile networks).
- (6) Including district and internet dial up traffic.
- (7) Data include incoming and outgoing wholesale traffic and retail outgoing traffic.

Revenues from Domestic Wireline services in Italy consists of revenues from domestic and international traffic and fees from subscribers (including retention programs, like Teleconomy) and from other operators for interconnection to Telecom Italia's network. In 2002 gross operating revenues from Domestic Wireline decreased by 146 million or 0.9% compared to a reduction of 251 million or 1.4% in 2001 when compared to 2000. The 2002 decrease is attributable principally to a reduction in traffic revenues (a decrease of 533 million) and sales revenues in spite of an increase from charges and fees (an increase of 539 million).

Traffic revenues decreased due to the continued fall in prices despite an increase in overall minutes as a result of the following effects:

- commercial policies aimed at customer retention with offers (mainly Teleconomy and Alice) which provide discounted tariffs with a monthly fee;
- further reductions in traffic tariffs partially offset by an increase in subscription fees due to the price cap system (on July 1, 2001 and on February 1, 2002); the price cap mechanism ended as of December 31, 2002. The National Regulatory Authority is now studying a new price cap mechanism; and
- competition.

Minutes of total traffic increased by 2.4% compared to 2001 primarily due to interconnection charges from other operators traffic and international traffic which more than offset the reduction in retail traffic (a decrease of 9.4% compared to 2001). The decrease in retail traffic volumes is evident from the overall decline in average minutes of use per line for local traffic (including district and internet dial up traffic) and long distance traffic (including international outgoing from retail customers and fixed to mobile traffic):

- local traffic usage decreased from average minutes of use of 3,575 in 2001 to 3,198 in 2002, due principally to the substitution of internet dial up traffic with innovative internet traffic (ADSL); and
- long distance traffic usage decreased from average minutes of use of 1,163 in 2001 to 1,094 in 2002, due to the substitution effect of fixed to mobile traffic and competition.

Telecom Italia's market share in retail traffic at December 31, 2002 was 72.2% in line with December 31, 2001 (72.1%). As of December 31, 2002, market share in local traffic remained unchanged with respect to

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December 31, 2001 (73.1%). Market share has been gained in long distance traffic (from 68.2% at December 31, 2001 to 70.7% at December 31, 2002), offsetting losses in fixed to mobile (from 70.0% at December 31, 2001 to 69.2% at December 31, 2002) and international traffic from retail customers (from 68.2% at December 31, 2001 to 62.5% at December 31, 2002). This result reflects retention and win back policies supported by new Teleconomy offers, combined with selective marketing strategies for high value customers. Flat Voice Offers (Teleconomy offers and other business customized offers) had 5.2 million users at the end of 2002 compared to 4.1 million users at the end of 2001.

The gross average return on traffic was 3.9 cents per minute in 2002 compared to 4.2 cents per minute in 2001, a decrease of 8.3% which translates into a revenue loss of approximately 533 million. The decrease is attributable to the tariff reductions in domestic wholesale traffic due to the Italian Telecommunication Authority encouraging competition combined with decreased prices in international wholesale traffic.

The gross average return on retail traffic was 5.44 cents per minute, substantially in line with 2001, due to the significant increase of revenues in value added traffic services (+30% compared to 2001).

Included in gross operating revenues is other income which includes revenues for data services and data equipment (1,570 million compared to 1,530 million in 2001), other equipment (885 million compared to 920 million in 2001), access from other operators (1,180 million compared to 1,160 million in 2001) and other revenues.

The number of fixed line subscribers in Italy decreased by 0.8% to approximately 27,142 million at December 31, 2002 representing a telecommunications density (fixed line subscribers to total population of Italy) of approximately 48% at December 31, 2002, which remained unchanged with respect to December 31, 2001. Such decrease takes into account the increase in ISDN lines (5,403,000 lines at the end of 2001 and 5,756,000 lines at the end of 2002).

Gross operating revenues from international traffic decreased to 1,598 million in 2002 compared to 1,652 million in 2001 despite a 17.9% increase in total international traffic volume, to 10,243 million minutes in 2002 from 8,685 million minutes in 2001. The volume increase was largely driven by outgoing traffic from OLOs and traffic carried. The revenue trend is mainly due to the impact of continuing tariff reductions and increasing competition.

Consolidated operating revenues were 15,220 million and 15,091 million in 2001 and 2002, respectively.

Despite the revenue decline, Gross Operating Profit increased from 7,750 million in 2001 to 7,965 million in 2002, a 2.8% increase compared to 2001, due to significant reductions in personnel costs (85 million) and expenses (255 million) as the result of an efficiency plan that brought savings in discretionary operating expenses of approximately 500 million.

Gross operating margin improved by 1.7%, from 45.1% in 2001 to 46.8% in 2002 as cost savings made up for the small decline in revenues.

Operating income increased from 4,361 million in 2001 to 4,700 million in 2002, a 7.8% increase, as a result of efforts to contain costs and improve the level of efficiency of invested capital. Operating Margin increased to 27.6% in 2002 compared with 25.4% in 2001, also due to a

significant reduction of 265 million in depreciation and amortization.

## Mobile

The following table sets forth, for the periods indicated, certain financial and other data for Mobile.

<u>Mobile</u>	Year ended December 31,	
	<u>2001</u>	<u>2002</u>
	(millions of Euro, except employees)	
Gross operating revenues	10,250	10,867
Gross Operating Profit	4,760	5,039
Operating income	3,136	3,358
Number of employees at year-end	16,721	18,702

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The following table sets forth for the periods indicated, certain statistical data for TIM.

	<u>Year ended December 31,</u>	
	<u>2001</u>	<u>2002</u>
TIM lines at period-end (thousands)	23,946	25,302
TIM lines growth per annum(%)	10.9	5.7
Average revenue per mobile line per month( ) <sup>(1)</sup>	29.1	28.8
Cellular penetration at period-end (TIM customers per 100 inhabitants)(%)	41.6	43.9
Cellular market penetration at period-end (customers for the entire market per 100 inhabitants)(%)	89.0	95.0
Total mobile outgoing traffic per month (millions of minutes)	1,795	1,960

(1) Including Prepaid Customers revenues and excluding equipment sales.

Gross operating revenues from mobile services increased by 6% in 2002 compared to 2001, despite the impact of adverse exchange rates which impacted certain companies included in the Latin America Mobile Business Unit, in particular Venezuela and Brazil. Excluding the effect of changes in exchange rates, organic growth of revenues would have been 11.9% compared to 2001.

This increase was primarily due to TIM's performance in the Italian market (an increase of 6.7%), despite increasing competition, and was mainly attributable to the increase of revenues relating to value added services, with some contribution from international companies. In addition, the operating revenues of Stet Hellas amounted to approximately 689 million in 2002, a 31.7% increase compared to 2001 mainly due to growth of outgoing traffic and value added services. In addition the number of mobile lines at Stet Hellas increased 17.8%.

Consolidated operating revenues were 9,963 million in 2001 and 10,595 million in 2002, respectively.

Gross Operating Profit amounted to 5,039 million, up 279 million, or 5.9% as compared to 2001. The gross operating margin however remained flat at 46.4%. Excluding the effect of changes in the exchange rates, the growth of Gross Operating Profit would have been 8.6% and is mainly attributable to the good performance of TIM and Stet Hellas as well as the improved results of TIM Perù, partially offset by the start-up costs of certain Latin American companies.

Operating income amounted to 3,358 million, an increase of 222 million, or 7.1%, compared to 2001. Operating margin improved from 30.6% in 2001 to 30.9% in 2002. Growth in operating income is mainly attributable to the increase in Gross Operating Profit.

***TIM (parent company)***

TIM, which during 2002 merged Blu S.p.A., the fourth Italian GSM operator, had operating revenues in 2002 of 9,022 million, an increase of 8.0% over 2001 (8,915 million net of the merger impact, representing an increase of 6.7% over 2001). Revenues from services increased by 6.5% (net of the merger impact) with the same percentage of 2001 on total revenues (94.3%). The impact of lower prices was more than offset by greater traffic in minute terms (an increase of 7.8%).

TIM lines increased to 25,302,000 lines at December 31, 2002, a 5.7% increase compared to December 31, 2001. TIM's total GSM lines increased by 9.4% in 2002, to 24,307,000 lines at December 31, 2002, while TIM's total TACS lines decreased by 42.6% in 2002, to 995,000 lines at December 31, 2002, in each case compared to December 31, 2001. Due to the termination of the TACS services over the next few years, customer transfer to the GSM service is in progress. Approximately 96% of TIM's lines are now GSM lines. The continuing significant growth in GSM lines was attributable principally to the continuing growth of the GSM TIM Card (a prepaid rechargeable GSM card) launched in October 1996, which had 21,622 thousand lines by December 31, 2002 compared to 19,674 thousand lines at December 31, 2001. Prepaid lines grew by 6.3% in 2002.

At December 31, 2002, TIM had a market share in Italy of approximately 46.1% (including TACS and GSM) compared to 46.7% at December 31, 2001, and a market share of approximately 45.1% for GSM only compared to 44.8% in 2001. The overall market grew by 6.8% in 2002 from 51.3 million lines at the end of 2001 to 54.8 million lines at the end of 2002. The aggregate number of customers at December 31, 2002 for TIM's analog and GSM services represented a penetration rate of 43.9% compared to 41.6% at December 31, 2001.



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TIM traffic volumes increased by 7.8% in terms of minutes and mobile traffic revenues (net of the Blu merger impact) increased by 3.5% in 2002 ( 6,845 million) compared to 2001 ( 6,613 million). The net increase in lines (up 5.7% compared to 2001) was partially offset by the continuing decline in average revenues per line and a decline in average revenue per minute due to increasing competitive pressures and the effect on prices. Average monthly revenue per mobile line (which includes traffic revenues and subscription fees) decreased from approximately 29.10 in 2001 to 28.80 in 2002 (including visitors).

TIM revenues from equipment sales increased by 9.3% in 2002 ( 505 million) compared to 2001 ( 462 million) as a result of the launch of Multimedia Messaging Services (MMS services). Mobile subscription fees decreased by 5.6% in 2002 ( 203 million) compared to 2001 ( 215 million) due to the continuing sharp expansion in the prepaid service customer base, where no subscription fees are paid.

TIM revenues from Value Added Services (VAS) ( 752 million in 2002) increased by 41.4% compared to 2001. Due to the continuing introduction of new services and the particular success of SMS services, the VAS business grew significantly with revenues from value added services representing 8.9% of services revenues and 8.4% of total revenues in 2002, compared to 6.7% and 6.4%, respectively in 2001. In 2002 TIM actively marketed the increase in use of VAS through promotional campaigns.

The TIM churn rate, as a result of increased competition, rose to 1.5% per month, up from the 1.3% rate recorded in 2001.

TIM Gross Operating Profit was 4,404 million. Excluding a loss of 125 million due to the merger effect Gross Operating Profit reached 4,529 million, a growth of 7.2% compared with the previous year ( 4,225 million) as a result of the increase in operating revenues and the actions taken for the containment of operating costs. Excluding the merger impact, gross operating profit accounted for 50.8% of overall revenues (50.6% in 2001).

TIM operating income was 3,153 million. Excluding a loss of 170 million due to the merger impact operating income was 3,323, a 2.8% increase compared with 2001. Excluding the merger impact, operating margin was 37.3% in 2002 and 38.7% in 2001.

TIM operating income was impacted by the increase in depreciation and amortization, as a result of the following:

- the amortization only for fiscal purposes of the UMTS licence ( 121 million gross of tax effects of 49 million);
- the higher depreciation of fixed assets (an increase of 53 million) due to the revision of the estimate of the useful life of the depreciable assets.

### ***Mobile Latin America***

The following table sets forth for the periods indicated certain financial and other data for Mobile business unit in Latin America, coordinated by the Latin America Operations (LAO).

<b>Mobile Latin America</b>	<b>Year ended December 31,</b>	
	<b>2001(1)</b>	<b>2002</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	1,403	1,298
Gross Operating Profit	355	274
Operating income (loss)	(72)	(98)
Number of employees at year-end	5,678	7,050

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

The operating revenues of the Mobile Business Unit in Latin America amounted to 1,298 million in 2002 compared with 1,403 million in 2001, a decrease of 7.5%. The decrease was mainly due to the weakening of the Brazilian and Venezuelan currencies against the Euro.

Gross Operating Profit amounted to 274 million, a decrease of 81 million, or 22.8%, compared to 2001, mainly due to the start-up costs of certain companies.

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Operating loss amounted to 98 million compared to an operating loss of 72 million in 2001.

**South America**

In May 2002, the International Operations (IOP) Operating Activity was disbanded. As a result of this reorganization, all the companies based in Latin America are now coordinated by LAO.

The following table sets forth, for the periods indicated, certain financial and other data for the Entel Chile group, the Entel Bolivia group, the company Telecom Italia America Latina and the South America business segment of Telecom Italia. Certain financial and other data of the Mobile Latin America Business Unit are described in the section pertaining to the Mobile Business Unit.

	Year ended December 31,	
	2001(1)	2002
	(millions of Euro, except employees)	
Gross Operating revenues	1,534	1,409
Gross Operating Profit	527	450
Operating income	187	146
Number of employees at year-end	5,746	5,461

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

Gross operating revenues were 1,409 million in 2002, a decrease of 8.1% compared to 2001. The decrease was mainly due to the adverse effect of the change in exchange rates (a decrease of 212 million, of which 182 million relates to the Chilean peso and 29 million for the Bolivian currency). On a constant currency basis, gross operating revenues would have increased by 5.7%, primarily due to an increase in the revenues of the Entel Chile group (+12.3% in local currency). This was partially offset by the effects of deregulation in the Bolivian market (Entel Bolivia reported a reduction in revenues of approximately 4.5% in local currency). In addition revenues also declined due to the suspension as of April 1, 2002 of the management fee under the terms of the contract with Telecom Argentina. Telecom Argentina has experienced significant financial difficulties and is currently in the process of restructuring its debts.

Consolidated operating revenues were 1,531 million in 2001 and 1,369 million in 2002, respectively.

The fluctuations in exchange rates described affected profitability. In particular, Gross Operating Profit decreased by 77 million, or 14.6%, compared to 2001, of which approximately 65 million was attributable to the weakening exchange currencies. Excluding the exchange effects, the reduction in the Gross Operating Profit would have been 2.3%, due primarily to the suspension of the management fee from Telecom

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Argentina and the lower profit margins in Bolivia partially offset by a recovery in profit margins in the Chilean mobile sector. As a percentage of revenues, Gross Operating Profit was 31.9% in 2002 (34.4% in 2001).

Operating income is consistent with the trends already described with regard to Gross Operating Profit. As a percentage of revenues, in 2002 operating income was 10.4% in 2002 (compared to 12.2% in 2001).

\* \* \* \*

In order to give an overall view of Latin America Operations (LAO), the following table sets forth, for the periods indicated, certain financial and other data for all the companies operating in South America, providing both wireline and mobile phone services.

<u>South America</u>	<b>Year ended December 31,</b>	
	<b>2001(1)</b>	<b>2002</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	2,937	2,706
Gross Operating Profit	882	724
Operating income	115	48
Number of employees at year-end	11,424	12,511

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

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The following table sets forth, for the periods indicated, certain financial and other data for the Internet and Media business unit (the SEAT group).

<b>Internet and Media</b>	<b>Year ended December 31,</b>	
	<b>2001(1)</b>	<b>2002</b>
	(millions of Euro, except employees)	
Gross operating revenues	1,957	1,991
Gross Operating Profit	444	593
Operating income	31	232
Number of employees at year-end	9,264	7,715

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

Gross operating revenues increased by 1.7% from 1,957 million in 2001 to 1,991 million in 2002. The Directories business Area made the largest contribution to growth; the related revenues increased by 3.4%.

Consolidated operating revenues were 1,880 million in 2001 and 1,900 million in 2002.

Gross Operating Profit increased by 33.6% to 593 million (with a gross margin of 29.8%), while operating income increased to 232 million in 2002 compared to 31 million in 2001. These improvements were achieved, despite the poor advertising market, due to implementation of rationalization measures and the improvements achieved in efficiency, especially in the Internet, Directories and Directory Assistance areas (which together represented 73% of the combined revenues). In 2002, for the first time, all the business areas made a positive contribution to the consolidated Gross Operating Profit (with the sole exception of television, where reduced losses were recorded compared to 2001).

Total Internet users have grown from 5 million at the end of 2001 to 6.6 million at the end of 2002, of whom 2.2 million remained active after 45 days. Average connection time increased by 5.6% in 2002 compared to 2001.

**Information Technology Market**

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The Information Technology Market Business Unit was created early in 2002 with the aim of focusing the activities previously concentrated in the Information Technology Services Business Unit by type of customer. The Business Unit is responsible for organizing the information technology activities of the Telecom Italia Group oriented towards the external market, in particular, central and local administrations moving towards decentralization and e-government, as well as banks and businesses.

The following table sets forth, for the periods indicated, certain financial and other data for the Information Technology Market business unit.

	<b>Year ended December 31,</b>	
<b>Information Technology Market</b>	<b>2001(1)</b>	<b>2002(2)(3)</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	1,198	912
Gross Operating Profit	166	104
Operating income	123	61
Number of employees at year-end	6,441	4,493

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

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- (2) On July 31, 2002, Finsiel disposed of its 100% stake in Sogei S.p.A. to the Ministry of Economy and Finance - Fiscal Policy Department. As result of this, the 2002 statement of operations items presented include Sogei only for the first six months.
- (3) On October 3, 2002, Finsiel disposed of its 100% stake in Consiel S.p.A. to World Investment Partners S.A.; as a result of this, the 2002 statement of operations items presented include Consiel only for the first eight months.

Gross operating revenues decreased by 23.9% from 1,198 million in 2001 to 912 million in 2002. On a comparable consolidation basis, gross operating revenues decreased by 48 million, or 5.0%, compared to 2001.

Other than the effects due to the changes in the scope of consolidation (mainly for the sale of Sogei S.p.A. and Consiel S.p.A.), a contributory factor to the decrease in revenues was a contraction in the revenues of Finsiel, Consiel and Banksiel, resulting from both lower volumes and a reduction in prices paid by important customers. This was offset by an increase at Intersiel and Insiel of the acquisition of new orders and new customers.

Consolidated operating revenues were 1,135 million in 2001 and 876 million in 2002.

The profitability of the IT Market Business Unit, both in terms of Gross Operating Profit and operating income, decreased, in addition to the effects due to the changes in the scope of consolidation, as a result of the already-mentioned reduction of prices on some contracts which were renewed during the year 2002, and the new bids won with lower contract prices, that were only partly offset by cost cuts and improved levels of efficiency.

The Gross Operating Profit decreased by 37.3% from 166 million in 2001 to 104 million in 2002. On a comparable consolidation basis, Gross Operating Profit decreased by 33 million, or 24.1%, compared to 2001.

Operating income decreased by 50.4% from 123 million in 2001 to 61 million in 2002. On a comparable consolidation basis, operating income decreased by 39 million, or 39.0%, compared to 2001.

**Information Technology Group**

The Information Technology Group Operating Activity was created early in 2002 as a result of the rationalization of activities previously carried out in the Information Technology Services Business Unit. The entity also incorporates the operations of TILAB group. The Operating Activity is responsible for organizing technological innovation and service information technology activities within the Telecom Italia Group, pursuing objectives that will augment efficiency, improve quality and stimulate innovation.

The following table sets forth, for the periods indicated, certain financial and other data for the Information Technology Group.

Year ended December 31,

Information Technology Group	2001(1)	2002
	(millions of Euro, except employees)	
Gross operating revenues	1,198	1,215
Gross Operating Profit	188	140
Operating income	22	(21)
Number of employees at year-end	6,844	7,327

(1) The 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

Gross operating revenues were stable and mainly affected by a reduction of prices on the services rendered principally to the domestic Wireline Business Unit, continuing with the price reduction policy of the previous year.

Consolidated operating revenues were 156 million in 2001 and 111 million in 2002.

Gross Operating Profit decreased by 25.5% from 188 million in 2001 to 140 million in 2002. Operating income decreased by 43 million from 22 million in 2001 to a loss of 21 million in 2002.



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The decrease in profitability reflects the aforementioned reduction in prices, only partially offset by a fall in outside services and labor costs, which can be attributed essentially to the measures to improve efficiency begun at the start of the year 2002.

In 2002, operating income was also impacted by higher levels of amortization of software licenses as a result of acquisitions made during the year.

**Other Telecom Italia Group Activities**

The Other Activities of the Telecom Italia Group consist mainly of the Real Estate and General Services Operating Activity, the companies which previously reported to the former International Operations Business Unit and which, following the 2002 reorganization of international activities, were transferred to the Foreign Holdings Function and the Satellite Business Unit.

***Real Estate and General Services***

Until December 31, 2002, the range of services offered by the Real Estate and General Services operating activity was directed mainly towards other Telecom Italia Corporate Functions/Business Units. The activities managed by Real Estate and General Services consisted of the following: to provide asset and property management services and to leverage the value of the real estate properties of the Telecom Italia Group, to carry out the project design and work on properties and to provide project and facility management services.

As a result of the finalization of the Tiglio Project (See Item 4. Information on the Telecom Italia Group Description of Property ), in February 2003, the Real Estate and General Services operating activity was eliminated and the related activities and resources were transferred to the other Telecom Italia Corporate Functions.

The following table sets forth, for the periods indicated, certain financial and other data for the Real Estate and General Services.

	<b>Year ended December 31,</b>	
	<b>2001</b>	<b>2002</b>
<b>Real Estate and General Services</b>		
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	953	846
Gross Operating Profit	145	88
Operating income (loss)	(65)	(92)
Number of employees at year-end	1,889	1,393

Gross operating revenues decreased by 107 million, or 11.2%, from 953 million in 2001 to 846 million in 2002. Such decrease was mainly due to the adjustment of internal charges to other Telecom Italia Group companies to match market rates and the rationalization of premises occupied by clients.

Gross Operating Profit decreased by 57 million, or 39.3%, from 145 million in 2001 to 88 million in 2002. Gross Operating Profit benefited from 51 million of costs savings arising from actions taken to contain operating costs (external charges and personnel costs) which partially offset the reduction in revenues.

Operating loss increased by 27 million, or 41.5%, from 65 million in 2001 to 92 million in 2002.

#### ***Foreign Holdings Corporate Function***

In May 2002, the International Operations (IOP) Operating Activity was disbanded. As a result of this reorganization, the corporate function, Foreign Holdings, is responsible for Telecom Italia International, 9Telecom group (disposed of in August 2002 and consolidated up to June 30, 2002 in the statement of operations) and the BBNed group, as well as Telekom Austria group, Telekom Srbija, Etec S.A. and Netco Redes. The function ensures the coordination, leveraging and rationalization of the foreign holdings held by Telecom Italia operating in the fixed and integrated fixed-mobile TLC business.

The following table sets forth, for the periods indicated, certain financial data for the Foreign Holdings Corporate Function.

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	<u>Year ended December 31,</u>	
	<u>2001(1)</u>	<u>2002</u>
<b>International Subsidiaries</b>		
	(millions of Euro)	
Gross operating revenues	292	214
Gross Operating Profit (Loss)	(149)	(49)

(1) The 2001 financial data have been reclassified and presented consistent with the presentation of 2002 financial data.

The data refer to BBNed group, Telecom Italia International and 9Telecom group which, due to its sale, was consolidated on a line by line basis only until June 2002. The data is, therefore, not comparable.

**Satellite Services**

The former business unit, Satellite Services (the Telespazio group), was disposed of during the 4th quarter of 2002 and consolidated in the statement of operations only for the first nine months of 2002. The Satellite Services (the Telespazio group and the Satellite Telecommunications business segment of Telecom Italia) was responsible for developing satellite communication systems for phone and data, radio and television broadcasting and earth-observation.

The following table sets forth, for the periods indicated, certain financial data for the Satellite Services.

	<u>Year ended December 31,</u>	
	<u>2001(1)</u>	<u>2002(1)</u>
<b>Satellite Services</b>		
	(millions of Euro)	
Gross operating revenues	648	237
Gross Operating Profit	159	12
Operating income (loss)	60	(6)

(1) The 2002 financial data are related only to the first nine months, while the 2001 financial data refer to the entire year.

*Year ended December 31, 2001 compared with Year ended December 31, 2000.*

*Consolidated Operating Revenues*

The Telecom Italia Group's consolidated operating revenues grew by 13.4% in 2001 compared to 2000 (an increase of 2.7% on a comparable consolidation basis).

The increase in consolidated operating revenues of 13.4% over 2000 was primarily due to the following:

- the positive performance of mobile telephone services which offset a reduction in wireline telephone services in Italy, where revenues from traffic, in spite of a significant increase in terms of minutes, evidenced a reduction in the average return on traffic (retail and wholesale) that went from 5.5 cents to 3.9 cents per minute; and
- the contribution made by the new companies included in the scope of consolidation, especially the Entel Chile group (1,247 million) and the Seat Pagine Gialle group (1,707 million), that was partly offset by the exclusion of the companies in the manufacturing and installation sector (Sirti and Italtel groups) which were included in the statement of operations only through September 30, 2000.

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The table below sets forth, for the periods indicated, gross operating revenues and consolidated operating revenues by Business Unit and the percentage contribution of such Business Unit to the Telecom Italia Group's consolidated operating revenues.

	Year ended December 31,					
	2000(1)(2) (pro forma)			2001(2)		
	Gross Operating Revenues(3)	Consolidated Operating Revenues(4)	% of Consolidated Operating Revenues	Gross Operating Revenues(3)	Consolidated Operating Revenues(4)	% of Consolidated Operating Revenues
	(millions of Euro, except percentages)					
Domestic Wireline(5)(7)	17,419	15,327	56.4%	17,168	15,220	49.4%
Mobile	9,418	9,090	33.5%	10,250	9,963	32.3%
South America(6)	312	247	0.9%	1,534	1,531	5.0%
Internet and Media	263	179	0.7%	1,957	1,880	6.1%
IT Market(7)	1,135	1,039	3.8%	1,198	1,135	3.7%
IT Group(7)	1,332	145	0.5%	1,198	156	0.5%
Other activities(8)(9)(10)	2,821	1,142	4.2%	2,009	933	3.0%
<b>Total operating revenues</b>	<b>32,700</b>	<b>27,169</b>	<b>100.0%</b>	<b>35,314</b>	<b>30,818</b>	<b>100.0%</b>

- (1) Beginning with the consolidated financial statements for the year ended December 31, 2001, Nortel Inversora and the controlled Telecom Argentina group (Nortel Inversora group), which in 2000 were consolidated proportionally, have been accounted for using the equity method. Prior to 2000 the Nortel Inversora group was accounted for on the equity method. For such reason, the 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.
- (2) 2000 and 2001 gross operating revenues and consolidated operating revenues for each major business area and other activities of the Telecom Italia Group are reclassified and presented consistent with the presentation of 2002 gross operating revenues and consolidated operating revenues.
- (3) Gross operating revenues are total revenues of the various business areas of the Telecom Italia Group before elimination of intercompany sales (but after elimination of sales between companies within the same major business area).
- (4) Consolidated operating revenues are revenues recorded by each business area on a consolidated basis after elimination of intercompany sales.
- (5) The data presented includes the following companies, which due to the 2002 reorganization, are part of the Domestic Wireline Business Unit: Intelcom San Marino and Golden Lines.
- (6) The data refers to Entel Chile group (only for 2001, the year in which the Telecom Italia Group acquired its control), Entel Bolivia group, the company Telecom Italia do Brasil (in 2002 renamed Telecom Italia America Latina) and the business segment South America of Telecom Italia.
- (7) The data presented reflects the split into two distinct units of the IT Services Business Unit which occurred in early 2002: IT Market and Information Technology Group. Furthermore, Saritel S.p.A. has been consolidated in the IT Group Operating Activity instead of the Domestic Wireline Business Unit.
- (8) The data presented includes the operations of the Foreign Holdings Corporate Function (9Telecom Reseau, Jet Multimedia and Mageos Explorer groups – these two groups have been fully consolidated in the statement of operations only starting from January 1, 2001, the BB Ned group and what remains of the former International Operations) and the former Business Unit Satellite Services.
- (9) In December 2000, 80.1% of Italtel's capital stock was sold to a group of foreign investors headed by Clayton, Dubilier & Rice and Cisco System. In connection with this sale, Sogerim SA (merged in 2002 into Telecom Italia Finance), a wholly-owned subsidiary of Telecom Italia, retained approximately a 19% stake in Italtel. Only the economic results for the first nine months of 2000 have been included in the 2000 consolidated financial statements of the Telecom Italia Group.
- (10) In December 2000, Telecom Italia disposed of its interest in Sirti. Only the economic result for the first nine months of 2000 have been included in the 2000 consolidated financial statements of the Telecom Italia Group.



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The table below sets forth, for the periods indicated, consolidated operating revenues by geographic area:

<b>Geographic Area</b>	<b>Year ended December 31,</b>			
	<b>2000(1) (pro forma)</b>		<b>2001</b>	
	<b>(millions of Euro, except percentages)</b>			
Italy	23,033	84.8%	24,456	79.4%
Other European countries	1,809	6.7%	2,169	7.0%
North America	174	0.6%	968	3.1%
Central and South America	1,555	5.7%	2,592	8.4%
Australia, Africa and Asia	598	2.2%	633	2.1%
<b>Total operating revenues</b>	<b>27,169</b>	<b>100.0%</b>	<b>30,818</b>	<b>100.0%</b>

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

**Operating Expenses**

The table below sets forth, for the periods indicated, total consolidated operating expenses by major components and expressed as a percentage of total consolidated operating revenues.

	<b>Year ended December 31,</b>			
	<b>2000(1) (pro forma)</b>		<b>2001</b>	
	<b>(millions of Euro, except percentages)</b>			
Cost of materials	2,132	7.8%	1,972	6.4%
Other external charges	10,130	37.3%	12,171	39.5%
Personnel costs (salaries and social security contributions)	4,745	17.5%	4,666	15.1%
Changes in inventories	(255)	(0.9)%	58	0.2%
Capitalized internal construction costs	(831)	(3.1)%	(581)	(1.9)%
Depreciation and amortization	5,209	19.2%	6,275	20.4%
<b>Total operating expenses</b>	<b>21,130</b>	<b>77.8%</b>	<b>24,561</b>	<b>79.7%</b>

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

The Telecom Italia Group's operating expenses increased by 16.2% in 2001 compared to 2000 mainly due to the changes in the scope of consolidation (principally the Entel Chile group and the SEAT group) and the expansion of mobile telecommunications services, as well as the increase in the amortization of goodwill. The increase in operating expenses, mainly due to the expansion of the Telecom Italia Group's

activities, was also reflected in the 1,619 million increase in costs of external services rendered (included in other external charges).

As a percentage of the Telecom Italia Group's operating revenues, such operating expenses represented 77.8% and 79.7% in 2000 and 2001, respectively.

***Cost of Materials***

Cost of materials decreased by 7.5% in 2001 compared to 2000, principally due to the exclusion of the companies in the manufacturing and installation sector (Sirti and Italtel groups) which were included in the statement of operations only through September 30, 2000 as well as lower costs of sale for products at Telecom Italia since, beginning with the second half of 2000, for some customers, Telecom Italia only plans the telecommunications systems, leaving manufacturers with the costs of supplying the equipment. Such decrease was partly offset by the inclusion in the scope of consolidation of the SEAT group and the Entel Chile group.



**Table of Contents****Other External Charges**

The table below sets forth, for the periods indicated, consolidated other external charges broken down by major components.

	Year ended December 31,	
	2000(1)	2001
	(pro forma)	
	(millions of Euro)	
Costs of external services rendered	7,933	9,552
Write-downs of fixed assets and intangibles	48	16
Provision for bad debts	394	439
Rent and lease payments	751	1,069
TLC license fee	543	524
Provision for risk	108	189
Other provisions and operating charges	353	382
<b>Other external charges</b>	<b>10,130</b>	<b>12,171</b>

(1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

Other external charges increased by 2,041 million in 2001 compared to 2000 or 20.1%.

- Costs of external services rendered increased by 20.4% in 2001 compared to 2000 mainly due to the inclusion of the Entel Chile group and the SEAT group in the scope of consolidation, the increase in the costs of operating and developing mobile telecommunications services and the increase in the operations of certain foreign companies.
- Write-downs of fixed assets and intangibles decreased by 66.7% in 2001 compared to 2000.
- Rent and lease payments increased by 42.3% in 2001 compared to 2000, mainly due to higher costs sustained by the Company for rentals on buildings sold to IM.SER ( 252 million) as well as the inclusion of the SEAT group in the scope of consolidation.
- TLC license fee, which is principally payable to the Italian Government and is proportional to revenues, decreased by 3.5% in 2001 compared to 2000 due to a reduction in the revenue base and a reduction in the rate (the aggregate rate for Telecom Italia and TIM declined from 2.7% in 2000 to 2.5% in 2001).
- Other provisions and operating charges, which include losses on disposals and write-offs of fixed assets and intangibles ( 29 million) and taxes other than income taxes ( 120 million), increased by 8.2% in 2001 compared to 2000.

**Personnel Costs**

Personnel costs (salaries and social security contributions) decreased by 79 million or 1.7% to 4,666 million in 2001 from 4,745 million in 2000; personnel costs declined to 15.1% of the Telecom Italia Group's operating revenues in 2001 compared to 17.4% in 2000. The decrease was due to the following:

- the exclusion from the scope of consolidation of the Sirti and Italtel groups ( 383 million), and
- the decrease in Telecom Italia costs following employee layoffs.

These decreases were only partly offset by the inclusion in the scope of consolidation of the Seat group ( 360 million) and the Entel Chile group ( 114 million). Employees at December 31, 2001 numbered 109,956 (107,171 as of December 31, 2000). The breakdown is as follows:

	<b>As of December 31,</b>	
	<b>2000(1)</b>	
	<b>(pro forma)</b>	<b>2001</b>
Italy	93,817	90,628
Abroad	13,354	19,328
<b>Total employees</b>	<b>107,171</b>	<b>109,956</b>

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

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At December 31, 2001 the Telecom Italia Group employed 109,956 persons, an increase of 2,785 employees compared to a pro forma 107,171 at December 31, 2000. The increase of 2,785 units is principally due to the changes in the scope of consolidation (in particular increases of 1,749 units in Internet Media and 1,464 units in Mobile Services as well as the inclusion of the Entel Chile group which led to an increase of 4,681 employees) and a reduction of 5,460 units at Telecom Italia owing to personnel turnover.

The dispute with INPS concerning the calculation of social security charges to be paid by the companies operated in Italy's telecommunications services of the Telecom Italia Group has been ongoing for many years. At December 31, 2001, Telecom Italia's potential range of liability for principal contribution was estimated to be between 960 million and 1,284 million (334 million of which had already been paid).

***Capitalized Internal Construction Costs***

Capitalized internal construction costs represent sales of equipment and installations at market prices by Telecom Italia Group companies, principally to Telecom Italia and TIM. Capitalized internal construction costs decreased from 831 million in 2000 to 581 million in 2001 (or 30.1% decrease) principally due to lower levels of capital expenditures spent on products purchased from subsidiaries within the Telecom Italia Group as well as the disposal of Sirti and Italtel groups.

***Gross Operating Profit***

The table below sets forth, for the periods indicated, the Telecom Italia Group's Gross Operating Profit (see Business Unit Financial Data Note 5 above for calculation of Gross Operating Profit) and gross operating margin (Gross Operating Profit as a percentage of operating revenues).

	Year ended December 31,			
	2000(1) (pro forma)		2001	
	(millions of Euro, except percentages)			
Gross Operating Profit	12,217	45.0%	13,619	44.2%

(1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

Gross Operating Profit increased by 11.5% in 2001 compared to 2000 (an increase of 6.6% on a comparable consolidation basis) but gross operating margin decreased to 44.2% in 2001 from 45.0% in 2000. The overall increase in Gross Operating Profit was primarily attributable to the changes in consolidation to include the SEAT group (444 million) and the Entel Chile group (374 million) and improved Gross Operating Profit from mobile telecommunications (313 million).

***Depreciation and Amortization***

Depreciation and amortization which is calculated on a straight line basis over the estimated useful lives of the assets, increased by 1,066 million or 20.5% in 2001 to 6,275 million compared to 5,209 million in 2000. Depreciation of fixed assets decreased by 97 million or 2.3% to 4,034 million in 2001 compared to 4,131 million in 2000. The decrease in depreciation of fixed assets was principally attributable to the change in the scope of consolidation and a reduction in the depreciation expense of Telecom Italia ( 415 million), owing to a lower amount of depreciable assets following the contribution of real estate assets to IM.SER, and a change in the mix of depreciable assets.

Amortization of intangible assets increased by 1,163 million or 107.9%, from 1,078 million in 2000 to 2,241 million in 2001. Goodwill represented 1,022 million of intangibles in 2001 compared to 168 million in 2000. The increase in amortization of goodwill which represented 73.4% of the total increase in amortization of intangible assets was mainly due to the acquisition of SEAT Pagine Gialle ( 574 million), the acquisition of Jet Multimedia ( 102 million) as well as other companies within the SEAT group ( 99 million).

As a result primarily of the transactions which resulted in Telecom Italia acquiring a controlling stake in the SEAT group as well as certain other international investments made at the end of 2000, Telecom Italia recorded a significant increase in goodwill (goodwill as of December 31, 2000 was 10,171 million compared to 1,020 million as of December 31, 1999). At year end 2001 goodwill had declined to 9,141 million due to the amortization described above as well as the extraordinary write-downs of goodwill ( 1,303 million) offset by additions ( 1,174 million, of which 731 million was attributable to the acquisition of the additional stake in Entel Chile).

**Table of Contents****Operating Income**

The table below sets forth, for the periods indicated, the Telecom Italia Group's operating income (total revenues less total operating expenses, including depreciation and amortization and other charges).

	<u>Year ended December 31,</u>	
	<u>2000(1)</u>	
	<u>(pro forma)</u>	<u>2001</u>
	<u>(millions of Euro)</u>	
Operating income	6,441	6,674

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

Operating income for the Telecom Italia Group increased by 3.6% in 2001 compared to 2000. The increase in operating income is mainly attributable to improvement in Telecom Italia (an increase of 388 million), improved results of TIM group (operating income increased by 148 million) and positive effects from changes in consolidation area, partly offset by the higher goodwill amortization charges (854 million). As a percentage of operating revenues, operating income decreased in 2001 to 21.7% from 23.7% in 2000 due principally to the higher goodwill amortization.

**Financial Income, Financial Expense, and Other Income and Expense, Net**

The table below sets forth, for the periods indicated, the components of financial and other income and expense, net.

	<u>Year ended December 31,</u>	
	<u>2000(1)</u>	
	<u>(pro forma)</u>	<u>2001</u>
	<u>(millions of Euro)</u>	
Financial income	806	1,076
Financial expense	(2,261)	(5,031)
<i>of which writedowns and equity in losses in unconsolidated subsidiaries, affiliated companies and other companies, net</i>	<i>(1,011)</i>	<i>(1,616)</i>
Other income and (expense), net	(184)	(3,452)
Total financial expense, net and other income and expense, net	(1,639)	(7,407)

- 
- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

Total financial expense, net and other income and expense, net increased from a net expense of 1,639 million in 2000 to a net expense of 7,407 million in 2001, a 351.9% increase.

Financial expense (which includes interest expense on financial indebtedness and income or loss from equity investees) increased by 122.5%. The increase was attributable to the following principal factors:

- higher average borrowings outstanding during 2001 principally attributable to financing the acquisition of SEAT as well as other acquisitions made during 2000 and 2001 which resulted in an increase of interest expense of 698 million ( 762 million in 2000 and 1,460 million in 2001). See also Liquidity and Capital Resources ;
- the provision relating to the forward commitment to purchase SEAT Pagine Gialle shares for a total of 569 million in connection with the estimate of the non recoverability of the original price to exercise the option;
- higher levels of equity losses of investments in unconsolidated subsidiaries, affiliated and other companies ( 1,616 million in 2001 compared to 1,011 million in 2000) which reflects primarily the results of operations for the Telecom Italia Group s equity method investments, including amortization of goodwill that arose upon the acquisition of these investments ( 316 million in 2001 and 462 million in 2000).

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The higher expenses in 2001 were particularly affected by:

- the losses of Is TIM (Turkey) of 334 million due not only to expenses incurred in conjunction with the start-up phase but also the effects of the currency crisis in Turkey and the application of inflation accounting principles;
- the writedown of Stream ( 241 million);
- the losses of the Nortel Inversora group ( 238 million), which were related to the economic crisis in Argentina and due mainly to exchange losses on financial payables.

Other income and expense, net increased from a net expense of 184 million in 2000 to a net expense of 3,452 million in 2001.

This significant increase was mainly due to the extraordinary provisions and write-downs of goodwill and equity investees which are described in more detail below.

Other income in 2001 included:

- gains on the sale of the 70% holding in Mirror International Holding (the company through which the satellite companies were contributed to the Lehman Brothers group) for 170 million and the 30% holding in Mediterranean Nautilus S.A. to the Israeli company F.T.T. Investments for 94 million;
- income ( 32 million) deriving from the partial cancellation, by the Council of State of resolution No. 7553/1999 by the Italian Antitrust Authority under which TIM and Omnitel (now Vodafone-Omnitel) were levied administrative fines for the alleged violation of antitrust laws relating to the price fixing of fixed-mobile rates;
- income from the release of reserves by Telecom Italia recorded in prior years for risks which did not materialize ( 120 million, mainly relating to the reserve for a contract with Iraq of 62 million and the reserve for corporate restructuring of 50 million).

Other expense in 2001 included:

- 2,984 million for the extraordinary provisions and write-down of goodwill and equity investees, detailed as follows:
  - 1,303 million for the write-down of goodwill relating to consolidated companies (9Telecom group, Entel Bolivia, Entel Chile group, Maxitel group, Tele Celular Sul group, Tele Nordeste Celular group, TIM Brasil (TIM Celular Centro Sul, TIM Rio Norte and TIM Sao Paulo, into which were merged the two other companies and which was renamed TIM Celular), Med-1 group and certain companies in the Seat Pagine Gialle group);

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- 1,078 million for the write-down of goodwill relating to companies accounted for by the equity method (GLB Serviços Interativos, Solpart Participações, Telekom Austria and the Nortel Inversora group); and
- 603 million for other provisions relating to investments;
- 248 million relating to the provision for expenses connected with the Vivendi/Canal Plus agreement for the transfer of Telecom Italia's investment in Stream;
- 380 million of expenses for employee cutbacks and layoffs (of which 203 million relates to Telecom Italia);
- 155 million for social security charges under Law 58/1992 to guarantee uniform status under the former Telephone Employees Pension Fund (FPT) which, as required by the 2000 Finance Bill, became part of the general Employees Pension Fund;
- 77 million of extraordinary contributions to INPS established by the 2000 Finance Bill for the three years 2000-2002 to meet the higher financial requirements covered by the rules of the fund that was abolished; and
- 85 million resulting from the decision to reposition the broadcasting station La7 as a consequence of the closing of a series of contracts.



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In 2000, other income and expense, net was significantly lower due to significant gains on the disposal of investments ( 1,146 million) offset by:

- provisions made by TIM to reserve for technological risk ( 400 million);
- expenses and provisions connected to the transactions for the disposal of investment holdings and the real estate portfolio ( 180 million);
- restructuring costs ( 480 million) principally related to Telecom Italia's costs for its corporate reorganization plan;
- the social security charges ( 153 million) pursuant to Law No. 58/92 to guarantee uniform status under the former Telephone Employees Pension Fund (FPT);
- the extraordinary annual contribution to INPS ( 77 million) to meet the higher financial requirements covered by the rules of the Telephone Employees Pension Fund (FPT).

## ***Income Taxes***

Income taxes were 925 million in 2001 compared to 1,910 million in 2000. The statutory income tax rate for 2001 and 2000 was 40.25% and 41.25%, respectively. The 2001 decrease in income taxes ( 985 million) was primarily due to a reduction in the taxable base caused by the extraordinary expenses associated with the extraordinary write-downs of Telecom Italia and TIM regarding the valuation of foreign investments.

## ***Net Income (loss)***

Net income (loss) before minority interest decreased from an income of 2,892 million in 2000 to a loss of 1,658 million. The loss in 2001 was principally attributable to the increase in total financial expense, net and other expense, net described above, offset in part by lower income taxes. Net loss after minority interest was 2,068 million in 2001 compared to income of 2,028 million in 2000. Minority interest decreased from 864 million in 2000 to 410 million in 2001 mainly due to lower levels of profit at TIM group.

## ***Results of Operations of Business Units for the Year Ended December 31, 2001 compared to the Year Ended December 31, 2000.***

### **Domestic Wireline**

The following table sets forth, for the periods indicated, certain financial and other data for Domestic Wireline.

<b>Domestic Wireline</b>	<b>Year ended December 31,</b>	
	<b>2000(1)</b>	<b>2001(1)</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	17,419	17,168
Gross Operating Profit	7,403	7,750
Operating income	3,904	4,361
Number of employees at year-end	62,366	57,895

- (1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

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The following table sets forth for the periods indicated certain statistical data for Domestic Wireline.

	Year ended December 31,	
	2000	2001
<b>Subscription and Customers:</b>		
Subscriber fixed lines at period-end (thousands)(1)	27,153	27,353
Subscriber fixed line growth (%)	2.5	0.7
Subscriber fixed lines per employee at period-end(2)	409	448
ISDN equivalent lines at period-end (thousands)(3)	4,584	5,403
<b>Retail Traffic(4):</b>		
Average minutes of use per fixed line subscriber during period(5)	4,722	4,739
Of which:		
Local traffic during period (in average minutes)(6)	3,621	3,575
Long distance traffic during period (domestic and international) (in average minutes)	1,101	1,163
Growth in international incoming and outgoing traffic in minutes(7)	5.4	12.1

- (1) Data include multiple lines for ISDN and excludes internal lines.
- (2) Ratio is based on employees of the Company only.
- (3) Data exclude internal lines.
- (4) Retail traffic consists of traffic from Telecom Italia customers for local calls, long distance national and international calls (including calls to mobile phones).
- (5) Includes total fixed outgoing traffic (including international outgoing traffic and fixed outgoing traffic to the mobile networks).
- (6) Including district and internet dial up traffic.
- (7) Data include incoming and outgoing wholesale traffic and retail outgoing traffic.

Revenues from Domestic Wireline services in Italy consists of revenues from domestic and international traffic and fees from subscribers (including retention programs, like Teleconomy) and from other operators for interconnection to Telecom Italia network. Gross operating revenues from Domestic Wireline decreased by 1.4% in 2001 compared to 2000. This decrease resulted principally from a decline of 6.9% in revenues from traffic, inspite an increase in minutes of use of 22.5%. Although usage increased, the reduction in tariffs for long distance and international calls, the discount policies aimed at customer retention and the application of new interconnection rates to traffic to and from the mobile network, more than offset the increased usage and the increase in basic subscription charges (an increase of 12% (plus 426 million), mainly due to tariff increases effective August 1, 2000 and February 1, 2001). The gross average return on traffic was 4.2 cents per minute in 2001 compared to 5.5 cents per minute in 2000, a 23.6% decrease which translates into a revenue loss of approximately 655 million. Included in gross operating revenues is other income which includes revenues for data services and data equipment ( 1,530 million), other equipment ( 920 million), access from other operators ( 1,160 million) and other revenues.

The number of fixed line subscribers in Italy rose by 0.7% to approximately 27,353 million at December 31, 2001 representing a telecommunications density (fixed line subscribers to total population of Italy) of approximately 48% at December 31, 2001, compared to approximately 47% at December 31, 2000. The increase is mainly attributable to the increase in ISDN lines (4,584,000 lines at the end of 2000 and 5,403,000 lines at the end of 2001).

The average retail traffic minutes of use per fixed line subscriber increased 0.3% during 2001 due to the growth of Internet traffic (included in local traffic). Telecom Italia's market share on December 31, 2001 was approximately 73.1% for local traffic (Internet traffic included), down from approximately 87% on December 31, 2000, and approximately 68.2% for long distance traffic, down from approximately 75% on December 31, 2000. Telecom Italia took certain initiatives during 2000 and 2001 to slow the loss of market share in long distance traffic and high level of market share loss of local traffic. A selective marketing strategy and focus on service had stabilized the fixed line segments market

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shares at the end of 2001. These targeted marketing strategies included introduction of Teleconomy, an innovative bundled voice and Internet service offered on a unitary or flat fee basis. The offer, which was launched in the second half of 2000, was subscribed to by 2.1 million customers by the end of 2000 and by 4.2 million customers at December 31, 2001. Telecom Italia's market share of fixed to mobile traffic declined from 74% on December 31, 2000 to 70% on December 31, 2001.

Gross operating revenues from international traffic was unchanged at 1,652 million in 2001 compared to 1,642 million in 2000 despite a 16.9% increase in total international traffic volume, to 8,685 million minutes in

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2001 from 7,432 million minutes in 2000. The volume increase was largely driven by incoming and mobile (incoming and outgoing) traffic growth. The revenue trend was mainly due to the impact of continuing tariff reductions and increasing competition.

Consolidated operating revenues were 15,327 million and 15,220 million in 2000 and 2001, respectively.

Despite the revenue decline, Gross Operating Profit increased from 7,403 million in 2000 to 7,750 million in 2001, a 4.7% increase compared to 2000.

Domestic Wireline improved Gross Operating Profit despite the decrease in revenues during 2001 compared to the same period in 2000, as the decline in average per-minute prices for voice call traffic in the retail and wholesale market (a decline from 5.5 cents to 4.2 cents per minute) was partially offset:

- by a significant increase in wireline traffic volumes (an increase of 22.5%), access fees by subscribers and other operators (an increase of 14%) and data transmission (an increase of 6.1%);
- by major cost reductions (a reduction of 590 million) exceeding 5.8% due to rationalization and ongoing network efficiency gains.

The gross operating margin improved by 2.6%, from 42.5% in 2000 to 45.1% in 2001 as cost savings made up for the small decline in revenues.

Operating income increased from 3,904 million in 2000 to 4,361 million in 2001, a 11.7% increase. Operating Margin was 22.4% in 2000 and 25.4% in 2001. This significant improvement was mainly due to a reduction in amortization.

**Mobile**

The following table sets forth, for the periods indicated, certain financial and other data for Mobile.

<b>Mobile</b>	<b>Year ended December 31,</b>	
	<b>2000</b>	<b>2001</b>
	(millions of Euro, except employees)	
Gross operating revenues	9,418	10,250
Gross Operating Profit	4,447	4,760
Operating income	2,988	3,136

Number of employees at year-end	15,257	16,721
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The following table sets forth for the periods indicated, certain statistical data for TIM.

	Year ended December 31,	
	2000	2001
TIM lines at period-end (thousands)	21,601	23,946
TIM lines growth per annum(%)	16.6	10.9
Average revenue per mobile line per month( )(1)	30.5	29.1
Cellular penetration at period-end (TIM customers per 100 inhabitants)(%)	37.5	41.6
Cellular market penetration at period-end (customers for the entire market per 100 inhabitants)(%)	73.3	89.0
Total mobile outgoing traffic per month (millions of minutes)	1,569	1,795

(1) Including Prepaid Customers revenues and excluding equipment sales.

Gross operating revenues from mobile services increased by 8.8% in 2001 compared to 2000. This increase is attributable principally to the strong performance of TIM in Italy, despite increasing competition with increasing levels of revenues attributable to value added services. The increase is also due to the changes in the scope of consolidation which occurred in 2001 within the Latin America Mobile Business Unit which was also impacted by the deterioration of the exchange rates in Brazil.

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The operating revenues of STET Hellas amounted to 523 million and remained substantially stable compared to 2000.

Consolidated operating revenues were 9,090 million in 2000 and 9,963 million in 2001.

Gross Operating Profit increased by 7.0% to 4,760 million in 2001 from 4,447 million in 2000. The gross operating margin, however, declined to 46.4% for 2001 against 47.2% in 2000. Such decrease was mainly attributable to the start-up international operations partially offset by containment of operating costs at TIM which grew more slowly than operating revenues.

Operating income increased from 2,988 million in 2000 to 3,136 million in 2001, a 5% increase. The increase in operating income was less than Gross Operating Profit due to higher depreciation.

***TIM (parent company)***

TIM operating revenues in 2001 were 8,357 million, an increase of 5.4% over 2000. Revenues from services increased by 7.9%. The impact of lower prices was more than offset by greater traffic in minute terms (an increase of 13.6%).

TIM lines increased to 23,946,000 at December 31, 2001, a 10.9% increase compared to December 31, 2000. TIM's GSM lines increased by 16.0% in 2001, to 22,213,000 lines at December 31, 2001, while TIM's TACS lines decreased by 29.1% in 2001, to 1,733 thousand lines at December 31, 2001, in each case compared to December 31, 2000. Approximately 93% of TIM's lines are now GSM lines. The growth in GSM lines was attributable principally to the continuing growth of the GSM TIM Card (a prepaid rechargeable GSM card) launched in October 1996, which had 19,674,000 lines by December 31, 2001 compared to 16,671,000 lines at December 31, 2000. 98.3% of the 3.1 million new GSM lines activated by TIM during 2001 were prepaid cards.

At December 31, 2001, TIM had a market share in Italy of approximately 46.7% (including TACS and GSM) compared to 51% at December 31, 2000 and 61% at December 31, 1999, and a market share of approximately 44.8% for GSM only compared to 48% in 2000 and 57% in 1999. The market share decrease was due to increased competition from the third mobile operator (Wind) and a fourth operator Blu, that stopped its telecommunications business during 2002 due to strong competition and was ultimately acquired by TIM. The overall market grew in 2001 from 42.2 million customers at the end of 2000 to 51.3 million customers at the end of 2001. The aggregate number of customers at December 31, 2001 for TIM's analog and GSM services represented a penetration rate of 41.6% compared to 37.5% at December 31, 2000.

TIM traffic volumes increased by 13.6% in terms of minutes and mobile traffic revenues (which for 2001 and 2000 have been reclassified in order to exclude VAS traffic, consistent with the reclassification made by TIM in 2002) increased by 5.3% in 2001 (6,613 million) compared to 2000 (6,281 million). The net increase in lines (up 10.9% compared to 2000) was partially offset by the continuing decline in average revenues per customer and a decline in average revenue per minute due to increasing competitive pressures and the effect on prices. Average monthly revenue per mobile line (which includes traffic revenues and subscription fees) decreased from approximately 31 in 2000 to 29 in 2001, as low-usage customers, principally non-business customers and GSM and TACS TIM Cardholders, grew further in 2001, making up almost 93.8% of the customer base. 98.3% of TIM's net new additions for its GSM service came from Prepaid Customers.

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TIM revenues from equipment sales decreased by 24.1% in 2001 ( 462 million) compared to 2000 ( 609 million). The mobile subscription fees decreased by 6.5% in 2001 ( 215 million) compared to 2000 ( 230 million) due to the continuing sharp expansion in the prepaid service customer base, where no subscription fees are paid.

TIM revenues from VAS ( 532 million in 2001) increased by 56.5% compared to 2000. Due to the continuing introduction of new services and the particular success of SMS services, the VAS business grew significantly with revenues from value added services representing 8.0% of traffic revenues and 6.4% of total revenues in 2001, compared to 6.4% and 4.3%, respectively in 2000. In 2001 TIM promoted the increase in use of VAS through promotional campaigns. Such promotions entailed offers of free SMS services and the extension of SMS to TACS users.

In 2001, TIM launched its GPRS offer to the corporate and retail market.



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The TIM churn rate, inspite of increased competition, remained at the same rate recorded in 2000, approximately 1.3% per month.

TIM Gross Operating Profit was 4,225 million, an increase of 9.9% compared with the previous year ( 3,845 million) as a result of greater operating efficiency. Gross Operating Profit accounted for 50.6% of overall revenues (48.5% during 2000).

TIM operating income ( 3,231 million) grew by 12.9% compared with 2000. Operating income as a percentage of operating revenues was 38.7% in 2001 and 36.1% in 2000.

**Mobile Latin America**

The following table sets forth for the periods indicated certain financial and other data for Mobile business unit in Latin America, coordinated by LAO.

	Year ended December 31,	
	2000(1)	2001(1)
<b>Mobile Latin America</b>		
	(millions of Euro, except employees)	
Gross operating revenues	1,350	1,403
Gross Operating Profit	453	355
Operating income (loss)	(18)	(72)
Number of employees at year-end	4,417	5,678

(1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

The operating revenues of the Mobile Business Unit in Latin America amounted to 1,403 million in 2001 compared with 1,350 million in 2000, an increase of 3.9% mainly due to the changes in the scope of consolidation which occurred in 2001 within the Latin America Mobile Business Unit. Operating revenues were also impacted by the deterioration of the exchange rate in Brazil.

The increase in revenues of the Latin America Mobile Business Unit was mainly due to the first time consolidation of the start-up subsidiaries (Maxitel and Digitel which, prior to January 1, 2001, weren't consolidated line by line, and TIM Perù which started its activities in January 2001). The Maxitel and Digitel operating revenues in 2001 were 277 million and 255 million, respectively. The operating revenues of TIM Perù in 2001 were 34 million.

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Gross Operating Profit amounted to 355 million, a decrease of 98 million, or 21.6%, compared to 2000, mainly due to the start-up costs of certain companies.

Operating loss amounted to 72 million compared to an operating loss of 18 million in 2000.

### South America

The following table sets forth, for the periods indicated, certain financial and other data for the Entel Chile group (only for 2001, the year in which the Telecom Italia Group acquired control), the Entel Bolivia group, the company, Telecom Italia do Brasil (in 2002 renamed Telecom Italia America Latina), and the South America business segment of Telecom Italia. Certain financial and other data of the Mobile Latin America Business Unit are described in the section pertaining to the Mobile Business Unit.

	Year ended December 31,	
	2000(1)	2001(1)
	(millions of Euro, except employees)	
Gross Operating revenues	312	1,534
Gross Operating Profit	172	527
Operating income	99	187
Number of employees at year-end	1,087	5,746

(1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

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Gross operating revenues increased by 391.7% in 2001, compared to 2000, benefiting mainly from the first time consolidation of the Entel Chile group.

Consolidated operating revenues were 247 million in 2000 and 1,531 million in 2001, respectively.

The growth in revenues was principally attributable to the inclusion in the scope of consolidation of the Entel Chile group which had revenues of 1,251 million in 2001. In 2000 the Entel Chile group was accounted for on the equity basis.

Gross Operating Profit was 527 million in 2001 compared to 172 million in 2000. The growth in Gross Operating Profit was mainly due to the additional contribution of Entel Chile.

Operating Income was 187 million in 2001 compared to 99 million in 2000. The Operating Income showed an increase by 88.9% in spite of the new goodwill amortization associated with the Entel Chile group, amounting to 59 million.

\* \* \* \*

In order to give an overall view of LAO, the following table sets forth, for the periods indicated, certain financial and other data for all the companies operating in South America, providing both wireline and mobile phone services.

<u>South America</u>	<u>Year ended December 31,</u>	
	<u>2000(1)</u>	<u>2001(1)</u>
	(millions of Euro, except employees)	
Gross operating revenues	1,284	2,937
Gross Operating Profit	613	882
Operating income	218	115
Number of employees at year-end	5,504	11,424

(1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

**Internet and Media**

The following table sets forth for the periods indicated certain financial and other data for the Internet and Media business unit (the SEAT group). During 2000 Telecom Italia completed the merger of Tin.it, its internet service provider, with SEAT, in a transaction which resulted in the Telecom Italia Group acquiring control of SEAT. Although SEAT was fully consolidated for balance sheet purposes at December 31, 2000, SEAT's results of operations were included in the Telecom Italia Group's statement of operations only beginning January 1, 2001. For such reason, information for the two periods discussed below is not comparable.

<b>Internet and Media</b>	<b>Year ended December 31,</b>	
	<b>2000</b>	<b>2001</b>
	(millions of Euro, except employees)	
Gross operating revenues	263	1,957
Gross Operating Profit	(35)	444
Operating income	(73)	31
Number of employees at year-end	7,515	9,264

SEAT was consolidated with Telecom Italia's results of operations for the first time during 2001.

In 2001, gross operating revenues were 1,957 million, compared with 263 million in 2000. On a comparable consolidation basis, gross operating revenues increased by 2.6% from 1,908 million in 2000 to

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1,957 million in 2001. The Directories business Area made the largest contribution to growth; these results were achieved largely due to a strong increase in number of customers of Seat Pagine Gialle (plus 3.6%; 670,000 at the end of 2001), accompanied by a strong performance of new directory products.

Consolidated operating revenues were 1,799 million in 2000 and 1,880 million in 2001.

Gross operating profit in 2001 amounted to 444 million, compared with a loss of 35 million in 2000. Gross operating profit increased by 23% over 2000 on a comparable consolidation basis. This improvement can be attributed to the continuing rationalization of costs and to the improved profitability of the Directories business.

Operating Income in 2001 was 31 million compared with a loss of 73 million in 2000. On a comparable consolidation basis, operating income was 31 million as opposed to the operating loss of 1 million in 2000.

Total Internet users have grown from 2 million in 1999 to 4 million in 2000 and 5 million in 2001. At the end of March 2002 SEAT had 5.4 million Internet users, of whom 1.9 million remained active after 45 days. Average connection time increased by 40% in 2001 compared to 2000.

**Information Technology Market**

The Information Technology Market Business Unit was created early in 2002 with the aim of focusing the activities previously concentrated in the Information Technology Services Business Unit according to the type of customer. The Business Unit is responsible for organizing the information technology activities of the Telecom Italia Group oriented towards the external market, in particular, central and local government administrations moving towards decentralization and e-government, as well as banks and businesses.

The following table sets forth, for the periods indicated, certain financial and other data for Information Technology Market.

<b>Information Technology Market</b>	<b>Year ended December 31,</b>	
	<b>2000(1)</b>	<b>2001(1)</b>
	<b>(millions of Euro, except employees)</b>	
Gross operating revenues	1,135	1,198
Gross Operating Profit	136	166
Operating income	105	123

Number of employees at year-end	7,400	6,441
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- (1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

Gross operating revenues increased by 5.6% from 1,135 million in 2000 to 1,198 million in 2001. Such increase was mainly due to higher volumes of Sogei, Tele Sistemi Ferroviari, Insiel, Banksiel and Aspasiel, partially offset by a contraction in the revenues of Finsiell and EIS, which were impacted by the disposal of some business segments, the lower volumes of Krenesiell as well as the decrease due to the changes in the scope of consolidation.

Consolidated operating revenues were 1,039 million in 2000 and 1,135 million in 2001.

Gross Operating Profit increased by 22.1% from 136 million in 2000 to 166 million in 2001. The growth in Gross Operating Profit was mainly due to the reduction in labour costs.

Operating income increased by 17.1% from 105 million in 2000 to 123 million in 2001, also as a result of the lower levels of depreciation of fixed assets due to a reduction of capital expenditures.

### **Information Technology Group**

The Information Technology Group Operating Activity was created early in 2002 as a result of the rationalization of activities previously carried out in the Information Technology Services Business Unit. The entity also incorporates the operations of the TILAB group. The Operating Activity is responsible for organizing

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technological innovation and service information technology activities within the Telecom Italia Group, pursuing objectives that will augment efficiency, improve quality and stimulate innovation.

The following table sets forth, for the periods indicated, certain financial and other data for the Information Technology Group.

<b>Information Technology Group</b>	<b>Year ended December 31,</b>	
	<b>2000(1)</b>	<b>2001(1)</b>
	(millions of Euro, except employees)	
Gross operating revenues	1,332	1,198
Gross Operating Profit	203	188
Operating income	(15)	22
Number of employees at year-end	6,385	6,844

- (1) The 2000 and 2001 financial and other data have been reclassified and presented consistent with the presentation of 2002 financial and other data.

Gross operating revenues decreased by 10.1% from 1,332 million to 1,198 million. Such decrease was mainly due to the reduction of prices on services rendered to the Domestic Wireline Business Unit as a result of a new service agreement in force.

Consolidated operating revenues were 145 million in 2000 and 156 million in 2001.

Gross Operating Profit decreased by 7.4% from 203 million in 2000 to 188 million in 2001. The decrease in profitability reflects the aforementioned reduction in prices, and was only partially offset by a fall in outsourced professional services.

Operating income increased by 37 million from a loss of 15 million in 2000 to an income of 22 million in 2001, mainly as a result of the lower levels of depreciation of fixed assets.

**Other Telecom Italia Group Activities***Real Estate and General Services*

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The activities managed by the Real Estate and General Services operating activity consisted of the following: to provide asset and property management services and to leverage the value of the real estate properties of the Telecom Italia Group, to carry out the project design and work on properties and to provide project and facility management services. The operating activity comprised the internal structures of Telecom Italia (Telecom Italia's Real Estate and General Services business segment), as well as the consolidated companies Emsa, Telimm and Immsi and the affiliates IM.SER and Telemaco Immobiliare. The two latter companies became operational from December 1, 2000 and from May 1, 2001, respectively, following the real-estate spin-off transactions carried out by the parent company Telecom Italia at the end of 2000.

The following table sets forth, for the periods indicated, certain financial and other data for Real Estate and General Services.

	Year ended December 31,	
Real Estate and General Services	2000	2001
	(millions of Euro, except employees)	
Gross operating revenues	980	953
Gross Operating Profit	147	145
Operating income (loss)	(55)	(65)
Number of employees at year-end	2,073	1,889

Gross operating revenues decreased by 27 million, or 2.8%, from 980 million in 2000 to 953 million in 2001. Such decrease was mainly due to the adjustment of internal charges to other Telecom Italia Group companies according to the best market conditions.



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The Gross Operating Profit amounted to 145 million in 2001 and remained substantially stable with respect to 2000.

Operating loss increased by 10 million, or 18.2%, from 55 million in 2000 to 65 million in 2001.

**Foreign Holdings Corporate Function**

The following table sets forth, for the periods indicated, certain financial data for the Foreign Holdings Corporate Function (Telecom Reseau, Jet Multimedia and Mageos Explorer groups - these two groups have been fully consolidated in the statement of operations only starting from January 1, 2001, the BBNet group and what remains of the ex IOP).

<u>International Subsidiaries</u>	<u>Year ended December 31,</u>	
	<u>2000(1)</u>	<u>2001(1)</u>
	(millions of Euro)	
Gross operating revenues	213	292
Gross Operating Profit (Loss)	(166)	(149)

(1) The 2000 and 2001 financial data have been reclassified and presented consistent with the presentation of 2002 financial data.

Gross operating revenues increased by 79 million, or 37.1%, from 213 million in 2000 to 292 million in 2001 mainly as a result of the changes in the scope of consolidation. In 2000 and 2001, profitability was affected by the start-up phase of certain companies.

**Satellite Services**

The following table sets forth, for the periods indicated, certain financial and other data for the Satellite Services business unit which was disposed of in the fourth quarter of 2002.

<u>Satellite Services</u>	<u>Year ended December 31,</u>	
	<u>2000</u>	<u>2001</u>
	(millions of Euro, except employees)	
Gross operating revenues	340	648

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Gross Operating Profit	50	159
	—	—
Operating income	(52)	60
	—	—
Number of employees at year-end	1,206	1,196
	—	—

Operating revenues from Satellite Services increased by 90.6% from 340 million in 2000 to 648 million in 2001. This increase was principally due to the results of Telespazio's space activities, offset by the early termination of the important Astrolink program. In the Media & Communications segment of activities, the revenues generated by the Television sector partly offset the fall in volumes of the Telecommunications sector. The growth of gross operating profit (an increase of 218% in 2001 compared to 2000) and operating income reflected the conclusion of the Astrolink program, whereas Media & Communications recorded a slight fall due to a declining price trend in telecommunication services. The suspension of the Astrolink project, on the other hand, involved an extraordinary write-down of the related financial investment. Overall, the negative extraordinary effects deriving from Astrolink were partly absorbed by the gains realized on the sale of shares in portfolio.

### Liquidity and Capital Resources

#### Liquidity

The Telecom Italia Group's primary source of liquidity is cash generated from operations, particularly from telecommunications services, and its principal uses of funds are the payment of operating expenses, capital expenditures and investments, the servicing of debt, the payment of dividends to shareholders and strategic investments, such as international acquisitions.

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The table below summarizes, for the periods indicated, the Telecom Italia Group's cash flows.

	Year ended December 31,		
	2000 (1)	2001	2002
	(pro forma)		
	(millions of Euro)		
Net cash provided by operating activities	5,309	9,602	10,909
Net cash used in investing activities	(15,113)	(9,779)	(1,230)
Net cash provided by (used in) financing activities	10,412	(363)	(9,134)
Net increase (decrease) in cash and cash equivalents	608	(540)	545
Cash and cash equivalents:			
Beginning of year	678	1,305	765
End of year	1,286	765	1,310

- (1) The 2000 pro forma amounts give effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.

**Net Cash Provided by Operating Activities.** Net cash provided by operating activities was 10,909 million in 2002, 9,602 million in 2001 and 5,309 million in 2000.

The increase in 2002 compared to 2001 was primarily due to higher levels of net income before minority interest (297 million of income in 2002 compared to a loss of 1,658 million in 2001), the significant level of write-downs of fixed assets, intangibles and other long-term assets (4,384 million in 2002 compared to 4,039 million in 2001), the net change in other liabilities (with a positive contribution of 2,038 million in 2002 compared to a positive contribution of 1,232 million in 2001) as well as the changes in operating assets and liabilities which increased cash from operating activities by 670 million in 2002 compared with a positive contribution of 372 million in 2001. Such effects were only partially offset by lower levels of depreciation and amortization in 2002 (5,877 million) compared to 2001 (6,275 million) and net gains on disposals of fixed and intangible assets and other long-term assets (2,210 million in 2002 compared with 330 million in 2001).

The increase in 2001 compared to 2000 was primarily due to higher levels of depreciation and amortization in 2001 (6,275 million) compared to 2000 (5,647 million) and the significant level of write-downs of fixed assets, intangibles and other long-term assets (4,039 million in 2001 compared to 1,120 million in 2000) as well as the net change in operating assets and liabilities which reduced cash from operating activities by 3,993 million in 2000 compared with a positive contribution of 372 million in 2001. Such effects were only partially offset by lower levels of net income before minority interest (2,892 million of income in 2000 compared to a loss of 1,658 million in 2001) and net gains on disposals of fixed and intangible assets and investments.

**Net Cash Used in Investing Activities.** Net cash used in investing activities was 1,230 million in 2002, 9,779 million in 2001 and 15,113 million in 2000. Investments in fixed assets, which consisted for the most part of telecommunications installations acquired by Telecom Italia and TIM, were 3,258 million in 2002, 4,254 million in 2001 and 3,405 million in 2000. Investments in intangible assets (including goodwill of 369 million in 2002, 1,174 million in 2001 and 9,109 million in 2000) were 1,953 million in 2002, 3,910 million in 2001 and 13,079 million in

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2000. The decrease in 2002 compared to 2001 was principally due to the reduced level of acquisitions in 2002. The significant decrease in 2001 compared to 2000 mainly reflects the reduced level of acquisitions in 2001 compared to 2000, in particular when compared to the SEAT acquisition in 2000 which resulted in high levels of goodwill. In addition, 2000 included the initial payments on TIM's UMTS license in Italy. Investments in other long-term assets were 1,708 million in 2002, 3,093 million in 2001 and 3,000 million in 2000; in 2002 such investments include 1,325 million of equity investments (of which 287 million related to Telecom Italia treasury stock); in 2001 such investments include 1,906 million of investments made by TIM International in the associated company Is TIM (this entire investment was written off in 2002); in 2000 such investments include 871 million for a 30% stake of GLB Servicos Interativos (Globo.com), 662 million relating to the Savings Shares bought back by Telecom Italia and 307 million for setting up Is TIM which won the third GSM 1800 license in Turkey.

In 2000 the outflows due to investing activities were partially offset by the net proceeds arising from the disposal of intangible assets, fixed assets and long-term investments (4,276 million). In 2001 and 2002 proceeds from such sales were 1,439 million and 5,698 million (mainly relating to the disposal of equity investments),

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respectively. Net proceeds in 2002 are largely responsible for the net cash used as it offset the levels of investment in fixed assets, intangible assets and other long-term assets.

**Net Cash Provided by (Used in) Financing Activities.** Net cash provided by (used in) financing activities was a net cash use of 9,134 million in 2002 and 363 million in 2001 compared to net cash provided of 10,412 million in 2000. Net cash used in financing activities in 2002 reflected an increase of 3,878 million in long-term debt as the Telecom Italia Group continued its program begun in 2000 to replace short term debt with long term debt to extend the average life of its debt. The proceeds of such long term debt and those arising from the disposal of equity investments as well as part of the cash provided by operating activities was primarily used to retire indebtedness, including 4,025 million of short term debt and to fund the pay-out of dividends and the extraordinary distribution of reserves totaling 4,945 million (such payments relating to the 2001 year as well as 1,698 million in anticipation of the dividend to be paid for the 2002 year). Net cash used in financing activities in 2001 reflected a significant increase in long term debt ( 10,816 million) as the Telecom Italia Group replaced short term debt with long term debt to extend the average life of its debt. The proceeds of such long term debt was primarily used to retire indebtedness, including 6,068 million of short term debt and to fund the dividend payout ( 3,097 million relating to the year 2000). The inflow of cash in 2000 was due to the increases in short-term debt ( 9,842 million) and in long-term debt ( 1,707 million) as well as to capital contributions ( 4,174 million, almost entirely related to the conversion of TIM s savings shares), partly offset by repayments of long-term debt and the dividend payments of 3,049 million. The significant increase in short-term debt was primarily incurred to finance the acquisitions of equity investments, including, among others, the SEAT and Globo.com acquisitions.

**Capital Resources**

On a consolidated basis, at December 31, 2002 Telecom Italia s outstanding long-term debt was 15,018 million ( 16,083 million at December 31, 2001) and its short-term debt was 5,089 million (including current portion of long-term debt) compared to 9,114 million at December 31, 2001. Interest on such debt totaled 1,226 million in 2002 compared with 1,460 million in 2001.

The Telecom Italia Group s short-term debt due to banks, including the current portion of long-term debt, was 3,225 million at December 31, 2002 ( 6,895 million at December 31, 2001). As of December 31, 2002 the amount of unutilized short-term bank facilities was 9,832 million ( 10,295 million as of December 31, 2001); 5,813 million ( 4,561 million as of December 31, 2001) was related to Telecom Italia. Approximately 67% of these facilities were denominated in Euro and had varying interest rates.

In addition, at December 31, 2002, the Telecom Italia Group had cash and marketable securities in excess of 1,759 million ( 2,956 at December 31, 2001). The Telecom Italia Group believes that its bank facilities, together with its portfolio of marketable securities and cash, are sufficient to meet its present working capital needs.

The following table aggregates Telecom Italia s contractual obligations and commitments with definitive payment terms which will require significant cash outlays in the future. The amounts payable are as of December 31, 2002.

Year ended December 31,						
2003	2004	2005	2006	2007	After 2007	Total
(millions of euros)						

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Long-term debt (including current portion)	2,289	1,849	2,230	5,302	1,830	3,679	17,179
Finance lease	388	28	15	12	11	62	516
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total long-term debt	2,677	1,877	2,245	5,314	1,841	3,741	17,695
Operating lease	22	8	2	1		1	34
SEAT Put Option (1)			2,417				2,417
Rental obligations to IM.SER60, TIGLIO I, TIGLIO II (2)	209	209	209	209	209	2,773	3,818
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	2,908	2,094	4,873	5,524	2,050	6,515	23,964
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

(1) Assumes that J.P. Morgan Chase exercises put option on 710,777,200 SEAT ordinary shares at renegotiated option price of 3.40 at maturity in December 2005. See Note 18 to Notes to Consolidated Financial Statements included elsewhere herein.

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(2) Aggregate rental payments due under 21 year contracts.

The table above does not include short-term financial debt of 2,412 million (excluding current portion of long-term debt) outstanding at December 31, 2002. For a discussion of the Telecom Italia Group's capital expenditures in 2000, 2001 and 2002 and the Telecom Italia Group's proposed capital expenditure commitments over the next three years, see Capital Expenditures .

The Telecom Italia Group's long-term debt (excluding current portion) was 15,018 million at December 31, 2002 and 16,083 million at December 31, 2001. The decrease in long term debt from 2001 to 2002 was primarily due to the repayment of notes which had come due, although new bond issues were carried out in 2002 and the share of long-term debt as a percentage of total financial indebtedness increased from 64% to 75%.

As of December 31, 2002 approximately 91% of the Telecom Italia Group's long-term debt was denominated in Euro, while the remainder was primarily denominated in U.S. Dollars, Pound Sterling, Brazilian Reais and Chilean Peso. At December 31, 2002 approximately 32% of the long-term debt carried a floating rate.

In the year ended December 31, 2002, the Telecom Italia Group incurred new long-term debt of 3,878 million and reduced short-term debt (including current portion of long-term debt) by 4,025 million, compared to an incurrence of 10,816 million and a reduction of 6,068 million of long-term and short-term debt, respectively, in the year ended December 31, 2001. In 2002 such long-term indebtedness was incurred largely to refinance indebtedness coming due and to retire short-term indebtedness as the Telecom Italia Group extended the average maturity of its total financial indebtedness.

Long-term indebtedness of 2,677 million, 11,277 million and 3,741 million is scheduled to become due for repayment during 2003, in the years 2004-2007 and beyond 2007, respectively.

The Telecom Italia Group's short-term debt (including current portion of long-term debt) was 5,089 million at December 31, 2002 and 9,114 million at December 31, 2001. The significant decrease in short-term debt reflects the policy of Telecom Italia to reduce its dependence on short-term financing and extend the average maturity of its debt. The Telecom Italia Group has achieved this result either through the policy of divestiture or through issuances of debt in the capital markets as described below.

In order to reduce its dependence on short-term debt, extend the average life of its financial indebtedness and expand its investor base, Telecom Italia established a US\$ 10 billion global medium term note program (the Global Note Program ) at the end of 2000; on December 18, 2001 the Board of Directors approved the increase of the above mentioned Global Note Program up to US\$ 12 billion. The Global Note Program includes a shelf registration statement filed with the U.S. Securities and Exchange Commission permitting it to sell up to US\$ 10 billion in debt securities (in any currency) which registration statement was declared effective on October 12, 2000. The Global Note Program also includes a Euro-Tranche which permits the Telecom Italia Group to offer debt securities outside the United States. Since January, 2001 the Telecom Italia Group has issued an aggregate principal amount of 12.5 billion in long-term debt in the capital markets under its Global Note Program, the net proceeds of which have been used to repay short-term indebtedness. The debt issued consisted of:

- 2.5 billion of 1% exchangeable notes due 2006 (on September, 2002 the notes decreased by 536 million, becoming 1,964 million, due to the buy-back of the notes by Sogerim, merged in 2002 into Telecom Italia Finance, and their subsequent cancellation);

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- 3.0 billion of 6.125% fixed rate notes due 2006;
- 1.0 billion of floating rate notes due 2004;
- 2.0 billion of 7% fixed rate notes due 2011;
- 1.5 billion of floating rate notes due 2005;
- 1.25 billion of 5.625% notes due 2007; and
- 1.25 billion of 6.25% notes due 2012.

The Telecom Italia Group's debt to equity ratio, calculated as the ratio of consolidated net financial indebtedness to total stockholders' equity, was 141.3% and 113.6% as of December 31, 2002 and December 31, 2001, respectively.

**Centralized Treasury.** Telecom Italia has a centralized treasury that provides financial assistance to the Telecom Italia Group including TIM, and generally operates as the Telecom Italia Group's principal banker,



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allocating cash where needed and collecting the liquid resources of the members of the Telecom Italia Group. As a result, Telecom Italia is able to ensure that its subsidiaries have adequate liquidity to satisfy their requirements. Telecom Italia also acts on behalf of its subsidiaries in negotiating bank lines of credit and provides financial consultancy services to its subsidiaries.

The central treasury function reduces the need of the members of the Telecom Italia Group to utilize banks, enables members of the Telecom Italia Group to obtain more favorable terms from banks when needed and enables Telecom Italia to maintain control over cash flows and to assure better utilization of surplus liquidity.

**Cash Management.** Telecom Italia utilizes short-term credit lines to support expenses and disbursements that occur in the ordinary course of business, using free cash flow generated by its business to fund capital investments and acquisitions and to repay long-term debt.

**Lines of Credit.** Short-term lines of credit granted to the Telecom Italia Group by banks, according to standard money market terms and conditions, consist partly of lines of credit with specified maturities and partly of lines of credit callable upon notice. All of the Company's medium and long-term lines of credit relate to specific loans drawn down to fund the Company's activities.

**Capital Expenditures**

The table below sets forth, for the periods indicated, the Telecom Italia Group's total investments (including capital expenditures) based on the organization by Business Unit at December 31, 2002.

	Year ended December 31,		
	2000(1)(2) (pro forma)	2001(2)	2002
	(millions of Euro)		
Fixed assets:			
Domestic Wireline(3)(5):			
Local and long distance networks	697	903	819
Investment in subscribers' equipment	335	299	169
Exchange equipment	449	528	552
Buildings and land	9	10	4
Other fixed assets	327	209	284
	1,817	1,949	1,828
Mobile:			
Radio and transmission equipment	542	713	468
Exchange equipment	395	519	143
Buildings and land	31	52	70
Other fixed assets	225	246	394
	1,193	1,530	1,075
South America(4)	67	351	201

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Internet and Media	17	82	28
IT Market(5)	25	19	11
IT Group(5)	101	109	85
Other activities(6)(7)(8)	185	214	30
	<u>          </u>	<u>          </u>	<u>          </u>
Total fixed assets	3,405	4,254	3,258
Goodwill	9,109	1,174	369
Other intangible assets(9)	3,970	2,736	1,584
	<u>          </u>	<u>          </u>	<u>          </u>
Total capital expenditures(10)	16,484	8,164	5,211
	<u>          </u>	<u>          </u>	<u>          </u>
Financial investments(11)	3,000	3,093	1,708
	<u>          </u>	<u>          </u>	<u>          </u>
Total investments	19,484	11,257	6,919
	<u>          </u>	<u>          </u>	<u>          </u>

- (1) Beginning from the consolidated financial statements for the year ended December 31, 2001, Nortel Inversora and the controlled Telecom Argentina group (Nortel Inversora group), which in 2000 were consolidated proportionally, have been accounted for using the equity method. Prior to 2000 the Nortel Inversora group was accounted for on the equity method. For such reason, the 2000 pro forma amounts give

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- effect to the consolidation of the Nortel Inversora group using the equity method instead of the proportional consolidation method.
- (2) The data relating to 2001 and 2000 have been restated for purposes of comparison.
  - (3) In May 2002, the International Operations (IOP) Operating Activity was disbanded, as a result the following companies became part of the Domestic Wireline Business Unit: Intelcom San Marino and Golden Lines.
  - (4) The data refer to Entel Chile group, Entel Bolivia group, the company Telecom Italia America Latina and the business segment South America of Telecom Italia.
  - (5) In early 2002, the IT Services Business Unit was split into two distinct units: Information Technology Market and Information Technology Group. Beginning January 1, 2002, Saritel S.p.A. has been consolidated in the Information Technology Group Operating Activity instead of the Domestic Wireline Business Unit.
  - (6) The data presented include the additions to fixed assets of the Foreign Holdings Corporate Function (9Telecom Reseau group disposed of in August 2002 and consolidated in the financial statements for the first six months of 2002, the BBNed group and what remains of the ex IOP) and the former Business Unit Satellite Services (the Telespazio group) which was disposed of during the 4th quarter of 2002 and consolidated in the financial statements only for the first nine months of 2002.
  - (7) In December 2000, 80.1% of Italtel's capital stock was sold to a group of foreign investors headed by Clayton, Dubilier & Rice and Cisco System. In connection with this sale, Sogerim SA (merged in 2002 into Telecom Italia Finance), a wholly-owned subsidiary of Telecom Italia retained approximately a 19% stake in Italtel not sold by Telecom Italia. Therefore the figures presented include Italtel only for the first nine months of 2000.
  - (8) In December 2000, Telecom Italia disposed of its interest in Sirti. Therefore the figures presented include Sirti only for the first nine months of 2000.
  - (9) Other intangible assets include investments such as software for telecommunications systems and licenses.
  - (10) Intercompany capital expenditures are adjusted to eliminate intercompany profit.
  - (11) Financial investments include also the Group's investment in international activities.

The decrease in capital expenditures in 2002 ( 5,211 million) compared to 2001 ( 8,164 million) was due to a reduction both in fixed assets and in intangibles assets and the decrease in goodwill due to the significantly reduced levels of acquisitions of equity investments.

The decrease in capital expenditures in 2001 ( 8,164 million) compared to 2000 ( 16,484 million) was almost entirely due to the reduction in investments in intangible assets and included:

- 1,174 million of goodwill (of which 731 million was attributable to the acquisition of the controlling interest in Entel Chile) and 2,736 million of other intangible assets (of which 1,080 million arose from the acquisition of new mobile telecommunications licenses in Brazil and Greece); and
- 4,254 million of fixed assets mainly associated with telecommunications systems and equipment, machinery and installations.

Cash flows from operating activities in 2002 ( 10,909 million) exceeded capital expenditures in fixed and intangible assets ( 5,211 million) and total investments ( 6,919 million). Excess cash was largely used to repay short-term debt and fund dividend payments.

Cash flows from operating activities in 2001 ( 9,602 million) exceeded capital expenditures in fixed and intangible assets ( 8,164 million) but was lower than total investments ( 11,257 million).

Cash flows from operating activities in 2000 ( 5,309 million) were lower than capital expenditures in fixed and intangible assets ( 16,484 million) and total investments ( 19,484 million).

*Capital expenditures under Business Plan*

Capital expenditures over the three-year period 2003-2005 are forecast to range between 14 billion and 16 billion, essentially matching the targets set in the 2002-2004 Industrial Plan ( 16 billion).

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The capital expenditures, by industry segments, are detailed as follow (as a percentage of the total value):

Domestic Wireline