

Registered Number 1743099

Telefónica UK Limited

Annual Report and Financial Statements

Year ended 31 December 2012

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Directors and advisers

Directors

Ronan Dunne
Mark Evans
Robert Harwood
Edward Smith
Paul Whelan

Secretary

O2 Secretaries Limited

Registered office

260 Bath Road
Slough
Berkshire
SL1 4DX

Auditor

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Directors' report

The Directors have pleasure in presenting to shareholders their report and the audited financial statements of Telefónica UK Limited for the year ended 31 December 2012

Introduction

Telefónica UK Limited ("the Company") is a private limited company registered in England and Wales under the number 1743099. The registered address is 260 Bath Road, Slough, Berkshire, SL1 4DX. It is a wholly owned subsidiary of Telefónica Europe plc, its ultimate UK parent, incorporated in England and Wales, which is itself a wholly owned subsidiary of Telefónica, S.A. ("Telefónica"), a company incorporated in Spain. The Company also trades under the brand name "O2".

References to "Group" refer to Telefónica Europe plc and its subsidiaries of which the Company is a part.

Principal activities

The principal activities of the Company during the year were the operation of a cellular communications network, and the sale of fixed and mobile, voice and data services to the Company's customer base.

The Company provides mobile communications services using spectrum held under licences granted in 1994 and 2001.

Strategy

The Company aims to excel in its traditional mobile and fixed communications businesses through customer experience leadership and innovative value propositions, whilst playing a wider role in the digital and online world. This means providing the best possible experience for customers every time they come into contact with the Company and its service, whilst adopting a business model to allow it to focus on what customers truly value.

The Company has a constant focus on financial value creation and is constantly looking to free up available resources to re-invest in growth initiatives. The Company continues to leverage Telefónica's European and global scale, simplify its processes, product portfolio, IT systems and network infrastructure. The Company has continued to extend network sharing arrangements with other players, so that it can deliver the best connectivity experience at a reasonable cost to the business. At the same time it works together with Telefónica's Global Resources as one flexible European team.

Customers increasingly access the internet however, wherever and whenever they want through internet connected devices. The Company helps make this possible through partnerships with smartphone vendors, its mobile and fixed broadband services and by providing customers with seamless connectivity between different types of network (e.g. between mobile broadband and WiFi).

In order to grow its business in an increasingly 'Digital World' the Company aims to extend its customer relationships into new areas where it can leverage its existing assets such as go-to-market capabilities and billing, along with its communications capability. The Company leverages on the scale and global reach of Telefónica Digital to develop new products and services beyond connectivity thereby expanding its product offering. The Company has signed a joint venture agreement with other industry players to build a mobile marketing platform. Further areas of development include, but are not limited to, financial services, eHealth and Machine-to-Machine.

The Company will continue to embrace customer behavioural changes to meet customers' evolving needs.

Directors' report (continued)**Business review and results****Operating review**

The operating review for the Company for the year ended 31 December 2012 contains a discussion of relevant key performance measures including

- Customer numbers – These are customers who are active. Customers are treated as being active if they have used the network in the preceding three months
- ARPU – Average revenue per user is calculated by dividing total monthly service revenue (excluding inbound roaming) from sales to customers for the preceding 12 months by the weighted average number of active customers for the same period. ARPU is calculated using gross service revenue before deduction of wholesale discounts. Total ARPU is a combination ratio incorporating both pre-pay and post-pay revenues
- Churn – This represents the percentage of average accesses which have been disconnected in a period. It is calculated by dividing disconnections in the period (excluding migrations) by the average customers for the same period
- Traffic – This is defined as minutes used by the customers, both outbound and inbound. On-net traffic is only included once outbound roaming and promotional traffic is excluded. Traffic not associated with the mobile customers (roaming-in, MVNOs, interconnection of third parties and other business lines) is excluded

The Company's revenue for the year ended 31 December 2012 was £5,609 million (2011 £5,968 million). The Company's operating profit for the year ended 31 December 2012 was £395 million (2011 £728 million)

The Company's total mobile customer base increased to reach 22.9 million (+3.1% year-on-year), as continued growth in the contract segment of +8.8% year-on-year offset a decline in prepay of -2.4% year-on-year. Mobile net additions stood at +697,000 in 2012, which was driven by the strong net additions in postpay of +961,000 partly offset by prepay net additions of -264,000. This reflected the rapid smartphone adoption and continuing strength in the competitive market of the Company, particularly in the postpay segment. At the end of 2012, contract customers represented 52.1% of the base (+2.7 percentage points year-on-year)

Total ARPU was down -9.3% year-on-year to £18.24, and excluding mobile termination rate cuts, total ARPU decreased -6.0% year-on-year

Voice ARPU declined -18.3% year-on-year to £8.98 in 2012, and excluding the impact from mobile termination rate cuts, voice ARPU in 2012 fell -12.2% year-on-year

Data ARPU increased +1.5% year-on-year to £9.27 in 2012, driven by strong demand from mobile broadband and higher penetration of smartphone users with data bolt-ons

Churn totalled 2.7% in 2012 (+0.4 percentage points year-on-year), and contract churn remained market leading at 1.0% for the year (+0.1 percentage points year-on-year)

Mobile traffic volume carried in the UK declined by -7.7% year-on-year to 48,250 million minutes in 2012 (-6.1% year-on-year in the fourth quarter) due to lower base and usage per customer in the prepay segment

Financial position of the Company as at 31 December 2012

The net assets of the Company as at 31 December 2012 were £11,060 million compared to £11,172 million at 31 December 2011

Directors' report (continued)**Business review and results (continued)****Financial risk management objectives, policies and exposure**

Details of the Company's approach to financial risk management are set out in the financial statements in note 1 'Accounting Policies'

Going concern

The Company's business activities together with the factors likely to affect the future development, performance and position are set out in the business review section of this report

The financial position of the Company is described above. In addition, note 1 to the financial statements includes the Company's objectives, policies and processes for managing its capital, its financial risk management objectives, details of its financial instruments and hedging activities, and its exposures to credit risk and liquidity risk. As a consequence, the Directors believe that the Company is well placed to manage its business risk successfully despite the current uncertain economic outlook.

The Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future, and thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Risks and uncertainties

The Company has a comprehensive risk management framework in place which is designed to identify, manage and mitigate significant risks that could adversely affect its future performance.

The principal risks and uncertainties in the Company are

Regulatory Intervention New or more onerous regulatory obligations imposed by the National Regulatory Authorities and the European Commission on wholesale and retail pricing and the exercise of commercial freedom, which could negatively affect the Company's profitability.

Erosion of Core Services The Company already operates in a competitive market but as well as traditional mobile networks, it is increasingly competing against new mobile service providers, virtual network operators, resellers of mobile services and 'all you can eat' IP-based services such as VOIP, WAP app, Viber etc.

Economy The Company's business is impacted by general economic conditions which remain weak and could undermine customer demand.

Managed Services/Outsourcing The Company relies on outsourcing for the delivery of various services. Failure to manage outsourced services could result in reduced control over the quality and consistency of services.

Breach of Data Security A failure to maintain sufficient information security processes could lead to a data protection breach, resulting in loss of customer confidence, fines and damage to brand reputation.

Network Infrastructure Inadequate resilience in critical systems could negatively affect service delivery to customers in the event of a lengthy outage.

Directors' report (continued)**Business review and results (continued)****Risks and uncertainties (continued)**

Pension The Group has a defined benefit pension scheme for a limited number of employees which is affected by fluctuating actuarial assumptions. Please refer to note 15 of these financial statements for further detail. This defined benefit scheme closed to future accrual with effect from 28 February 2013.

The Company has a series of controls in place to mitigate these risks, both within its internal operations and in the wider external market.

Mandatory Service Level Agreements and security controls are written into outsourcing contracts and the 'Customer Plan' focuses on positively differentiating customer experience.

The Company monitors products, prices and customer preferences so that it can compete with new products and services introduced by competitors and offers fair, pre-emptive pricing strategies which successfully deliver the cost-versus-service balance that its customers demand.

The wider Telefónica Group includes an operating unit called Telefónica Digital, which focuses on protecting value in the Telefónica Group's operating businesses by driving new incremental value through digital products and building capability and positions of power in digital markets.

The Company uses external experienced professionals to provide actuarial valuations based on demographic and financial assumptions.

Joint ventures***Digital Mobile Spectrum Limited***

On 17 October 2012, the Company formed a joint venture, Digital Mobile Spectrum Limited, with Everything Everywhere Limited, Hutchison 3G UK Limited and Vodafone Limited. The purpose of the joint arrangement is to mitigate possible interference with the digital terrestrial television network which may be caused when establishing the 4G mobile network during 2013.

Cornerstone Telecommunications Infrastructure Limited

On 10 October 2012, the Directors approved a reconstruction of the Company and the creation of a joint venture company with Vodafone Mobile Network Limited. Part of the transaction included the transfer of certain assets of the Company relating to the network infrastructure, with a net book value of £470m and with a fair value of £480m, in consideration for the issue of 50% of the share capital of Cornerstone Telecommunications Infrastructure Limited to the parent companies of the Company.

Weve Limited

On 28 September 2012, the Company entered into a joint venture, Weve Limited, with Everything Everywhere Limited and Vodafone UK Limited. Weve Limited is a mobile advertising, loyalty and payments company.

Directors' report (continued)

Results and proposed dividend

During the year, as part of a joint venture arrangement with the Vodafone group, the Company made a non-cash distribution to the fair value of £480 million

The Company's total comprehensive income for the year ended 31 December 2012 was £370 million (2011 £558 million)

The Directors do not recommend the payment of a final dividend for the year ended 31 December 2012 (2011 £nil)

Directors and secretary

The Directors who held office during the year were as follows

Ronan Dunne
Mark Evans (appointed on 3 January 2012)
Robert Harwood
Edward Smith
Paul Whelan

The Secretary who held office during the year was O2 Secretaries Limited

Subsequent events

Strategic partnership

On 21 May 2013, the Company announced a new 10 year strategic partnership with Capita plc ("Capita") to outsource the Company's customer service centres. The agreement builds on Capita's existing long-term partnership with the Company and will provide it with further support as it enhances and expands its digital service offering to its customer base. The 10 year contract will be worth approximately £1.2 billion and commenced on 1 July 2013.

Divestment

On 30 April 2013, the Company disposed of part of its operations and 100% of Be Un Limited, one of its wholly owned subsidiaries, which collectively resulted in the transfer of the UK consumer broadband and fixed-line telephony business, to British Sky Broadcasting Limited. Under the terms of the agreement, British Sky Broadcasting Limited paid a consideration of £185m for 100% of the share capital of Be Un Limited. An additional contingent amount, not exceeding £20m, may also be payable by way of further consideration for the sale of the shares, dependent upon the successful delivery and completion of the customer migration process.

As part of the pre-completion steps of the disposal, certain assets and liabilities of the home phone & broadband business that were operated under the O2 brand and reported into the financial results of the Company, were acquired by Be Un Limited for a consideration of £10m. Additional pre-completion steps included the acquisition of certain assets and liabilities by the Company from Be Un Limited that were outside the scope of the disposal to British Sky Broadcasting Limited, the consideration for which was £25m. Also pre-completion all existing intercompany balances with Be Un Limited were settled for cash and a dividend of £59m was received by the Company from Be Un Limited.

Directors' report (continued)**Subsequent events (continued)*****Spectrum***

Following the completion of the spectrum auction on 19 February 2013, OFCOM announced that the Company had successfully secured the licence to 20MHz of 800MHz spectrum which can be used by the Company to build a 4G mobile network in the UK. The Company paid a total of £550m for two separate lots of the auction, one of these lots has a coverage obligation attached, under which the Company is obliged to provide a mobile broadband service for indoor reception to at least 98% of the UK population (expected to cover at least 99% when outdoors) and at least 95% of the population of each of the UK nations – England, Northern Ireland, Scotland and Wales – by the end of 2017 at the latest.

Directors' liability insurance and indemnities

Telefónica Europe plc, the Company's ultimate UK parent company, has granted an indemnity in the form permitted by UK Company Law to Directors appointed to subsidiary companies. This indemnity remains in place and continues until such time as any relevant limitation periods for bringing claims (as defined in the indemnity) against the Director has expired, or for so long as the past Director, where relevant, remains liable for any losses (as defined in the indemnity).

Employees

The Company has a wide range of communication channels with employees including face-to-face meetings, team briefings, audio conferences and a comprehensive intranet with tailored content dependent on employee segmentation. The aim of all these channels is to ensure employees fully understand the Company's objectives and its operational and financial performance as well as our latest products and services, whilst creating an inclusive employee culture. In addition the Company conducts an annual engagement survey with additional regular temperature checks and maintains a constructive dialogue with unions, employee representative bodies and works councils.

The employee experience is paramount and the Company continues to be committed to the development of all people in the organisation, actively promoting this through many training and development initiatives. People are encouraged and supported in maintaining personal development plans. The Company has invested in e-learning technology to give people better access to a wide range of learning opportunities.

The Company is committed to employment policies that follow best practice, based on equal opportunities for all, and recognises the diversity of its people. This approach includes the fair treatment of people with disabilities in relation to their recruitment, training and development. The Company has also invested in researching age, gender and disability diversity across the organisation, seeking to support all employees and their career development at every level of the organisation.

Policy and practice on payment of suppliers

The Company aims to pay all of its creditors promptly. The payment terms for major contracts are agreed at the same time as other terms are negotiated with individual suppliers. It is the Company's policy to make payments for other purchases within 45 calendar days from the date of receipt of invoice (2011: 45 days) provided that the relevant invoice is presented in a timely fashion and is complete.

The Company had 57 calendar days' purchases outstanding as at 31 December 2012 (2011: 51 days), calculated using the average daily amount invoiced by suppliers during the year.

Directors' report (continued)

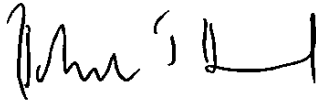
Political and charitable contributions

The Company made no political contributions during the year ended 31 December 2012 (2011 £nil). Donations to charities during the year ended 31 December 2012 amounted to £692,773 (2011 £1,435,400), all of which went to charities in the United Kingdom.

Statement as to disclosure to auditor

So far as each Director is aware, there is no relevant audit information of which the Company's auditor was unaware. The Directors have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

By Order of the Board



Robert Harwood
for and on behalf of O2 Secretaries Limited
Company Secretary
12 August 2013

Statement of Directors' responsibilities
Year ended 31 December 2012

The Directors are responsible for preparing the Annual Report and the Company financial statements in accordance with applicable United Kingdom law and regulations

Company law required the directors to prepare Company financial statements for each financial year. Under that law the Directors are required to prepare Company financial statements under IFRSs as adopted by the European Union. Under Company Law, the directors must not approve the Company financial statements unless they are satisfied that they present fairly the financial position, financial performance and cash flows of the Company for that period. In preparing the Company financial statements the Directors are required to

- present fairly the financial position, financial performance and cash flows of the company
- select suitable accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and then apply them consistently,
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information,
- provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance,
- state that whether the Company financial statements have been prepared in accordance with IFRSs as adopted by the European Union
- make judgements and estimates that are reasonable

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the Company financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Independent auditor's report to the members of Telefónica UK Limited Year ended 31 December 2012

We have audited the financial statements of Telefónica UK Limited for the year ended 31 December 2012 which comprise the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Changes in Equity, the Statement of Cash Flows, and the related notes 1 to 27. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditor

As explained more fully in the Directors' Responsibilities Statement on page 9, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Financial Statements to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 December 2012 and of its profit for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Independent auditor's report to the members of Telefónica UK Limited
Year ended 31 December 2012

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit

ERNST & YOUNG LLP

Marcus Butler (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
London
14 August 2013

Statement of comprehensive income
For the year ended 31 December 2012

	Note	2012 £m	2011 £m
Revenue		5,609	5,968
Cost of sales		(3,237)	(3,424)
Gross profit		2,372	2,544
Administrative expenses		(1,977)	(1,816)
Operating profit	2	395	728
Financial income	3	117	89
Financial expense	3	(23)	(23)
Profit before taxation		489	794
Taxation	4	(119)	(236)
Profit for the year attributable to equity shareholders		370	558
Total comprehensive income for the year		370	558

The accompanying notes on pages 16 to 49 are an integral part of these financial statements


There were no other recognised income or expenses other than those shown above

**Statement of financial position
As at 31 December 2012**

	Note	2012 £m	2011 £m
Non-current assets			
Property, plant and equipment	5	2,004	2,394
Intangible assets	7	1,129	1,264
Investments	8	4,207	4,205
Deferred tax assets	16	2	6
Other financial assets	10	71	156
		7,413	8,025
Current assets			
Inventories		56	64
Trade and other receivables	9	6,170	5,470
Other financial assets	10	11	32
Cash and cash equivalents	11	610	603
		6,847	6,169
Current liabilities			
Borrowings	12	(318)	(174)
Trade and other payables	13	(2,722)	(2,548)
Current tax liabilities		(43)	(74)
Provisions	14	(5)	(14)
		(3,088)	(2,810)
Net current assets		3,759	3,359
Total assets less current liabilities		11,172	11,384
Non-current liabilities			
Borrowings	12	(53)	(146)
Deferred tax liabilities	16	(19)	(31)
Provisions	14	(40)	(35)
		(112)	(212)
Net assets		11,060	11,172
Equity			
Ordinary share capital	17	10	10
Share premium		8,799	8,799
Retained earnings	18	2,251	2,363
Total equity		11,060	11,172

The accompanying notes on pages 16 to 49 are an integral part of these financial statements

These financial statements were approved by the Board of Directors on 12 August 2013 and were signed on its behalf by


Mark Evans
Director

Statement of changes in equity
Year ended 31 December 2012

	Ordinary share capital Note 17	Share premium	Retained earnings Note 18	Total equity
	£m	£m	£m	£m
At 1 January 2011	10	8,799	1,805	10,614
Total comprehensive income for the year	-	-	558	558
At 31 December 2011	10	8,799	2,363	11,172
Total comprehensive income for the year	-	-	370	370
Dividend in specie (Note 5)	-	-	(480)	(480)
Deferred tax related to employee share schemes	-	-	(2)	(2)
At 31 December 2012	10	8,799	2,251	11,060

The accompanying notes on pages 16 to 49 are an integral part of these financial statements

Statement of cash flows
Year ended 31 December 2012

	Note	2012 £m	2011 £m
Operating profit		395	728
Depreciation and amortisation charges	5,7	638	625
Gain on disposal of property, plant and equipment	5	(10)	-
Decrease/(Increase) in inventories		8	(2)
(Increase)/Decrease in trade and other receivables		(194)	79
Increase/(Decrease) in trade and other payables		291	(117)
Decrease in provisions		(7)	(43)
Corporation tax paid		(72)	(170)
Net cash flow from operating activities		1,049	1,100
Investment in group companies	8	(2)	(1)
Purchase of property, plant and equipment		(588)	(509)
Purchase of intangible assets	7	(56)	(89)
Net cash flow used in investing activities		(646)	(599)
Proceeds from new borrowings including finance leases		9	-
Increase in loans receivable		(410)	(600)
Interest received		7	2
Interest paid		(13)	(6)
Net cash flow used in financing activities		(407)	(604)
Net decrease in cash and cash equivalents		(4)	(103)
Cash and cash equivalents at 1 January		557	660
Cash and cash equivalents at 31 December	11	553	557

The accompanying notes on pages 16 to 49 are an integral part of these financial statements

Notes to the financial statements

1. Accounting policies

Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and International Financial Reporting Interpretations Committee ("IFRIC") interpretations, as adopted for use in the EU. In addition the financial statements have been prepared in accordance with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. The financial statements have been prepared using historical cost principles except that, as disclosed in the accounting policies below, certain items including derivative instruments are measured at fair value.

The principal accounting policies of the Company applied in the preparation of these financial statements are set out below. The IFRS accounting policies have been applied consistently to all periods presented.

In accordance with s400 of the Companies Act 2006, consolidated financial statements have not been prepared as the Company and its subsidiaries are included in the group financial statements of mmO2 plc, an intermediate parent, for the year ended 31 December 2012.

Presentation of financial information

Operating items in the statement of comprehensive income are derived from the primary operations of the Company as a telecommunications provider. Items in the statement of comprehensive income recognised below operating profit represent activities that are not directly attributable to the Company's primary operations.

Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation. The cost of property, plant and equipment includes directly attributable incremental costs incurred in their acquisition and installation. Subsequent costs are included in the assets' carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably.

Depreciation is provided on property, plant and equipment from the date they are brought into use over their estimated useful lives on a straight-line basis. The lives assigned to property, plant and equipment are:

Freehold buildings	40 years
Leasehold land and buildings	unexpired portion of lease or 40 years, whichever is the shorter
Network assets	5 to 15 years
Computers and office equipment	2 to 5 years

The assets' useful lives and residual values are reviewed, and adjusted if appropriate, at each statement of financial position date. No depreciation is provided on freehold land or assets in the course of construction.

An item of property, plant and equipment and any significant part initially recognised is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between net disposal proceeds and the carrying amount of the asset) is included in the statement of comprehensive income when the asset is derecognised.

Notes to the financial statements**1. Accounting policies (continued)****Intangible assets****Licences**

Licence fees paid to the Government, which permit telecommunications activities to be operated for defined periods, are capitalised at cost less impairment losses and are amortised from the date of commercial launch of the service to the end of the licence period on a straight line basis. Their remaining estimated useful lives are 9 years.

Software

Software is capitalised and measured at the cost incurred to acquire and bring into use the specific software. These costs are amortised over their estimated useful lives of between 2 and 6 years on a straight line basis. Costs that are directly associated with the production of identifiable unique software products controlled by the Company, which are expected to generate economic benefits over a period of more than one year, are recognised as intangible assets. Such computer software development costs recognised as intangible assets are amortised over their estimated useful lives not exceeding 6 years on a straight line basis.

Impairment of non-financial assets

Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment. Assets with a definite useful life are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows ("cash-generating units").

Revenue

Revenue, which excludes value added tax and other sales taxes, comprises the value of services provided, equipment sales and other revenue.

Mobile telecommunications service revenue includes revenue earned for usage of the Company's wireless network for voice and data transmission by the Company's customers, subscription fees, inbound roaming, outbound roaming and interconnect revenue. Post-pay customers are billed in advance for their monthly subscription fees and in arrears for call and other charges. Revenue is recognised when the service is rendered with deferred revenue recognised on the statement of financial position to the extent of the services paid but not used. Revenue not yet billed is accrued and recognised on the statement of financial position. Revenue for pre-pay customers is recorded as deferred revenue prior to commencement of services and is recognised as the pre-pay services are rendered. Inbound roaming revenue, earned from foreign mobile operators whose customers roam onto the O2 network, and outbound roaming revenue, earned from the Company's customers roaming outside their domestic coverage area, is recognised based upon usage. Subscription fees are recognised evenly throughout the periods to which they relate.

Interconnect revenue earned from other telecommunications operators whose customers terminate calls on the Company's network, is recognised based on usage.

Hardware revenue principally consists of revenue from the sale of handsets. The revenue and related expenses associated with the sale of wireless handsets and accessories are recognised when the products are delivered and accepted by the customer.

Promotional offers and packages including different elements are assessed to determine whether it is necessary to separate out each component and apply a revenue recognition policy to each element. Total revenue is split among the identified elements based on their respective fair values.

Notes to the financial statements**1. Accounting policies (continued)****Revenue (continued)**

Revenue is recognised on a gross basis where the Company's role is that of principal in a transaction. The gross basis represents the gross value of the billing to the customer after trade discounts, with any related costs being charged to operating expenses. Where the Company acts as agent in a transaction, the net revenue earned is recognised as revenue.

Deferred income, included in trade and other payables, includes the amounts relating to purchases made by customers of prepaid costs that at the period end had still not been earned and recognised as revenue since the customers had not consumed the total amount of minutes relating to their cards.

Subscription fee revenue is deferred to the extent it relates to unused minutes received by customers in a monthly bundle until such minutes are utilised or expire.

Subscriber acquisition and retention costs

Subscriber acquisition and retention costs, other than loyalty programme costs, are recognised as an expense for the period in which they are incurred. Advertising, promotion, sponsoring, communication and brand marketing costs are also expensed as incurred.

Research and development

Expenditure on research activities is recognised in the statement of comprehensive income as an expense as incurred. Development expenditure is written off as incurred unless the Company can demonstrate the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale,
- its intention to complete and its ability to use or sell the asset,
- the asset will generate future economic benefits,
- the availability of resources to complete the asset and
- the ability to measure reliably the expenditure during the development.

Where these recognition criteria are met, development expenditure is capitalised as an intangible asset and amortised over its useful economic life.

Foreign currencies

Transactions denominated in foreign currencies are translated into sterling at the average year to date rates. Monetary assets and liabilities denominated in foreign currencies are translated at the rates ruling at the statement of financial position date.

Foreign exchange differences arising on translation are recognised in the statement of comprehensive income. Non-monetary assets and liabilities denominated in foreign currencies are translated at the foreign currency exchange rate ruling at the dates the non-monetary assets and liabilities are recognised.

Notes to the financial statements**1. Accounting policies (continued)****Employee benefits****Pension obligations**

A defined benefit plan is a pension plan that sets the amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation. A defined contribution plan is a pension plan under which the Company pays fixed contributions on behalf of employees and under which there is no legal or constructive obligation to pay further contributions for employees' service in the current and prior periods.

The Company participates in the Telefónica UK Pension Plan ("Telefónica PP"), a scheme sponsored by Telefónica Europe plc that provides benefits for the majority of UK employees in the Telefónica Europe plc Group. During the reporting year, the Telefónica PP had both defined benefit and defined contribution sections. On 28 February 2013 the defined benefit sections of the Telefónica PP closed to further benefit accrual. Members' of the defined benefit sections of the Telefónica PP will continue to be increased in deferment by reference to the Consumer Prices Index but will not retain the link to any future increases in salary. Upon closure, members of the defined benefit sections of the Telefónica PP were given the option to become members of the defined contribution section of the Telefónica PP. The defined contribution sections of the Telefónica PP remain open to new entrants and further accrual. The assets of the Telefónica PP are held independently of the Company's finances.

In its capacity as a participating employer of the defined contribution section of the Telefónica PP, the Company pays contributions into the Plan on behalf of employees. The Company has no further payment obligations once the contributions have been paid. The contributions are recognised as employee benefit expense when they are due.

The Company accounts for the defined benefit section of the Telefónica PP as though it were a defined contribution plan as there is no arrangement for charging out the net defined benefit cost between participating employers. The net defined benefit cost of the defined benefit sections, as assessed in accordance with the advice of a qualified, independent actuary using the projected unit method and taking assets at market value, is recognised by the sponsoring employer. Accordingly the defined benefit deficit of the Telefónica PP is not recognised on the statement of financial position of the Company because the sponsoring employer is Telefónica Europe plc. Disclosures over the defined benefit sections of the Telefónica PP are provided in note 15. Additional disclosure in line with the requirements of IAS 19 for both the current and previous accounting periods is provided in the Annual Report and Financial Statements of Telefónica Europe plc for the year ended 31 December 2012.

Share based payments

The Company recognises an expense for share awards and share options, which are both equity and cash settled, based on the fair value of the share awards or share options granted as compensation for the services rendered by employees. The fair value is calculated at the grant date using an adjusted statistical model and excludes the impact of non-market conditions. Instead, the expense is adjusted for the effect of non-market conditions at each reporting date through the number of share awards or share options expected to be exercisable. The effect of market and non-vesting conditions is included in the fair value at the date of grant and is recognised as an expense irrespective of whether the market or non-vesting condition is satisfied. Any proceeds received are credited to share capital and share premium when the share option or award are exercised. In addition, for cash-settled share based payment transactions, the Company measures the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the Company re-measures the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognised in the statement of comprehensive income for the period.

Notes to the financial statements**1. Accounting policies (continued)****Taxation**

The charge for current tax is based on the results for the period as adjusted for items which are non-assessable or disallowed

Deferred income tax is provided in full, using the statement of financial position liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax and current tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the statement of financial position date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Income tax relating to items recognised directly in equity is recognised in equity.

Cash and cash equivalents

Cash and cash equivalents are carried in the statement of financial position at cost. Cash and cash equivalents includes cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts are shown within borrowings in current liabilities on the statement of financial position.

Other financial assets

Other financial assets are carried in the statement of financial position at amortised cost. Other financial assets are held in trust to meet hire purchase obligations. These are not considered highly liquid investments and are not held for the purpose of meeting the Company's short-term cash commitments.

Inventories

Inventories comprise mainly handsets and are stated at the lower of cost and net realisable value on a first-in, first-out basis, after provisions for obsolescence. Cost comprises costs of purchase and costs incurred in bringing inventory to its current location and condition.

Trade and other receivables

Trade and other receivables are carried at original invoice amount less provision for doubtful debts. A provision for doubtful debts is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Provisions are made based on an analysis of balances by age, previous losses experienced, disputes and ability to pay. The amount of the provision is the difference between the carrying amount and the present value of estimated future cash flows. Changes in the provision against receivables are recognised in the statement of comprehensive income within cost of goods sold.

Notes to the financial statements**1. Accounting policies (continued)****Provisions**

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate of the amount can be made. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance expense.

The Company recognises a provision for onerous contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract. Restructuring provisions comprise employee termination payments and future obligations under onerous property leases. These are recognised in the period in which the Company becomes legally or constructively committed to payment. A provision is made for the present value of the cost of restoration of mast sites at the date of acquisition of the site.

Borrowings

Borrowings are recognised initially at the proceeds received, less attributable transaction costs. Subsequent to initial recognition, borrowings are stated at amortised cost with any difference between the cost and the redemption value being recognised in the statement of comprehensive income over the period of the borrowings on an effective interest basis. Accrued interest on borrowings is included within the carrying value.

Leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Rentals under operating leases are charged to the statement of comprehensive income in equal annual instalments over the periods of the leases.

Leases in which the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. Assets held under finance leases are capitalised at the lower of the present value of the minimum lease payments and the fair value of the asset at the inception of the lease, and are depreciated over the estimated useful lives of the assets. Finance charges are allocated over the period of the leases in proportion to the capital amount outstanding and are charged to the statement of comprehensive income.

Accounting for derivative financial instruments and hedging activities

Derivatives are initially recognised at fair value on the date the derivative contract is entered into and are subsequently re-measured at their fair value at each reporting date.

Derivatives which are not designated as hedges

Derivative financial instruments which are used as economic hedges of foreign exchange exposures on recognised monetary assets or liabilities are not designated as hedges. In these circumstances, hedge accounting is not applied and gains or losses arising on the derivatives are recognised in the statement of comprehensive income and offset the movement in value of the monetary asset or liability also recognised in the statement of comprehensive income.

Dividends

Dividend distributions to the Company's shareholders are recognised as a liability in the Company's financial statements in the period in which the dividends are approved by the Company's shareholders.

Notes to the financial statements**1. Accounting policies (continued)****Capital management**

The Company's capital comprises share capital and retained earnings

The Company's objectives when managing capital are to safeguard the Company's ability to continue to operate as a going concern, to maintain optimal capital structure commensurate with risk and return and to reduce the cost of capital

In order to maintain or adjust the capital structure, the Company may pay dividends to its shareholder, return capital to its shareholder, issue new shares or sell assets to reduce debt or draw down more debt

Financial risk factors and management

The Company's operations expose it to a variety of financial risks including currency risk, credit risk and liquidity risk. The principal financial risks of the Company and how the Company manages these risks are discussed below

Credit risk

The Company's principal credit risks are attributable to its trade receivables

Trade receivables as presented in the statement of financial position are net of provision for doubtful debts, estimated by the Company's management based on prior experience and their assessment of the current economic environment. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis.

At the statement of financial position date there were no significant concentrations of credit risk, with exposure spread over a large number of counter-parties and customers. The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivative financial instruments, in the statement of financial position. The Company does not require collateral in respect of financial assets.

Liquidity risk

Management of the Company's liquidity risk is achieved mostly through being a part of the larger Telefónica group, which operates group wide policies in this area. The Company holds financial assets primarily in short-term deposits with a central Telefónica group company that are readily convertible to known amounts of cash. These measures help keep liquidity risk low.

Foreign currency risk

The Company is exposed to transactional foreign exchange risks arising from various currency movements, primarily with respect to the Euro and US dollar that can affect its results and financial position. Significant exposures are managed through the use of foreign exchange controls and the Telefónica group managing positions on a group wide basis.

Notes to the financial statements

1. Accounting policies (continued)

New IFRS and interpretations of the International Financial Reporting Interpretations Committee (IFRIC)

The accounting policies adopted are consistent with those of the previous financial year

At the date of preparation of the financial statements, the following IFRS and IFRIC interpretations have been published, but their application is not mandatory

Effective for annual periods beginning after 31 December 2012		
New Standards		Effective date: annual periods beginning on or after
IFRS 9	<i>Financial Instruments</i>	1 January 2015
IFRS 10	<i>Consolidated Financial Statements</i>	1 January 2013
IFRS 11	<i>Joint Arrangements</i>	1 January 2013
IFRS 12	<i>Disclosure of Interests in Other Entities</i>	1 January 2013
IFRS 13	<i>Fair Value Measurement</i>	1 January 2013
IAS 19 (Revised)	<i>Employee Benefits</i>	1 January 2013
IAS 27 (Revised)	<i>Separate Financial Statements</i>	1 January 2013
IAS 28 (Revised)	<i>Investments in Associates and Joint Entities</i>	1 January 2013
Amendments to standards		Effective date: annual periods beginning on or after
Amendments to IAS 1	<i>Presentation of Items of Other Comprehensive Income</i>	1 July 2012
Amendments to IFRS 7	<i>Disclosures - Offsetting Financial Assets and Financial Liabilities</i>	1 January 2013
Amendments to IFRS 7 and IFRS 9	<i>Mandatory Effective Date and Transition Disclosures</i>	1 January 2015
Amendments to IAS 32	<i>Offsetting Financial Assets and Financial Liabilities</i>	1 January 2014
Annual Improvements to IFRSs	<i>2009-2011 Cycle</i>	1 January 2013

The Company is currently analysing the potential impact of the application of the aforementioned standards, amendments and interpretations. As there are a significant number of changes, it is possible that such application may have some impact on its financial statements in the initial period of application. The standards will be adopted on the effective date mentioned in the table above.

Fair value estimation

The fair value of trade and other receivables, other financial assets, trade and other payables, cash at bank and short-term borrowings approximates to the book carrying value due to the short-term or on demand maturity of these instruments. The fair value of finance lease liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Company for similar instruments. The fair value of finance lease liabilities approximates their book value at 31 December 2012 and 31 December 2011.

Notes to the financial statements**1. Accounting policies (continued)****Critical accounting estimates and judgements**

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise judgement in the process of applying the Company's accounting policies. A significant change in the facts and circumstances on which these estimates are based could have a material negative impact on the Company's earnings and financial position. The areas involving a higher degree of judgement or complexity and areas where assumptions and estimates are significant to the Company's financial statements are discussed below.

Property, plant and equipment and UMTS licences

Accounting for property, plant and equipment and UMTS licences involves the use of estimates and judgements for determining the useful lives over which they are to be depreciated or amortised and the existence and amount of any impairment.

Property, plant and equipment and UMTS licences are depreciated or amortised on a straight line basis over their estimated useful lives and taking into account their expected residual values. When the Company estimates useful lives, various factors are considered including expected technological obsolescence and the expected usage of the asset. The Directors regularly review these asset lives and change them as necessary to reflect the estimated current remaining lives in light of technological changes, future economic utilisation and physical condition of the assets concerned. A significant change in asset lives can have a significant change on depreciation and amortisation charges for the period.

It is not practicable to quantify the impact of changes in property, plant and equipment asset lives on an overall basis as asset lives are individually determined and there are a significant number of asset lives in use. The impact of any change would vary significantly depending on the individual changes in assets and the classes of assets impacted. A reduction in the estimated useful life of the Company's UMTS licence from 18 years to 9 years at the start of the asset's life would have increased the UMTS licence amortisation charge for the year ended 31 December 2012 by approximately £114 million (2011: £114 million).

The Company assesses the impairment of property, plant and equipment and UMTS licences whenever there is reason to believe that the carrying value may not exceed the fair value and where a permanent impairment in value is anticipated. The determination of whether the impairment of these assets is necessary involves the use of estimates that includes, but is not limited to, the analysis of the cause of potential impairment in value, the timing of such potential impairment and an estimate of the amount of the impairment. The Company considers technological obsolescence, discontinuance of services and other changes in circumstances as indications of the need to perform an impairment test. A significant change in the facts and circumstances that were relied upon in making the estimates may trigger the requirement for recording impairment and may have a material adverse impact on the operating results and financial condition of the Company.

Deferred tax assets and liabilities

The Company evaluates the recoverability of deferred tax assets based on estimates of future earnings. The ability to recover these taxes depends ultimately on the Company's ability to generate taxable earnings over the course of the period for which the deferred tax assets remain deductible. This analysis is based on the estimated reversal of deferred taxes as well as estimates of taxable earnings, which are sourced from internal projections and are updated to reflect the latest trends.

The appropriate classification of tax assets and liabilities depends on a number of factors, including estimates as to the timing and materialisation of deferred tax assets and the forecast tax payment schedule. Actual income tax receipts and payments could differ from the estimates made by the Company as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

Notes to the financial statements

1. Accounting policies (continued)

Critical accounting estimates and judgements (continued)

Provisions

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate of the amount can be made. This obligation may be legal or constructive deriving from regulations, contracts, normal practices or public commitments that lead third parties to reasonably expect that the Company will assume certain responsibilities. The amount of the provision is determined based on the best estimate of the outflow of resources required to settle the obligation, taking into account all available information.

No provision is recognised if the amount of liability cannot be estimated reliably. In this case, the relevant information is disclosed in the notes to the financial statements.

Given the uncertainties inherent in the estimates used to determine the amount of provision, actual outflows of resources may differ from the amounts recognised originally on the basis of the estimates.

Trade receivables provision for doubtful debts

The Company provides services to individuals and business customers on credit terms. The Company expects that some debts due will not be paid as a result of the default of a small number of customers. The Company uses estimates based on historical results and future expectations, the economic and competitive environment and other relevant factors to determine the provision for doubtful debts. A significant, unanticipated downturn in the economy that the Company operates in or negative industry trends could require an increase in the estimated level of debts that will not be collected, which would negatively impact operating results. The level of provision required is reviewed on an ongoing basis.

2. Operating profit

The following items have been included in arriving at operating profit

	2012 £m	2011 £m
Depreciation of property, plant and equipment (note 5)	447	382
Amortisation of intangible assets (note 7)	191	243
Gain on disposal of property, plant and equipment	10	-
Staff costs (note 24)	486	489
Auditor's remuneration (note 22)		
Audit	0.6	0.9
Other audit related fees	0.4	0.5
Inventories		
Cost of inventories recognised as an expense (included in cost of sales)	1,041	1,005
Net write down of inventories recognised in the year	1	2
Operating lease rentals payable	136	146
Restructuring costs/(credits) (note 14)	7	(8)
Provision for doubtful debts (note 9)	182	190
Provision for amounts owed by Group companies	49	30

Notes to the financial statements

3. Net financial income

	2012 £m	2011 £m
Financial income		
Interest income on cash, cash equivalents and other financial assets	12	15
Interest income from other group companies	105	74
Total financial income	117	89
Financial expense		
Interest payable on cash, cash equivalents and other financial liabilities	(4)	(6)
Interest payable to other group companies	(12)	(6)
Other financial costs	(7)	(11)
Total financial expense	(23)	(23)
Net financial income	94	66

4. Taxation

Analysis of charge in the year

	2012 £m	2011 £m
Current tax - current year	137	207
Current tax - adjustment in respect of prior years	(8)	(17)
Deferred tax - current year (note 16)	(28)	27
Deferred tax - adjustment in respect of prior years (note 16)	20	21
Effect of change in tax rate (note 16)	(2)	(2)
Taxation	119	236

The tax assessed for the year varied from the amount computed by applying the corporation tax standard rate to profit on ordinary activities before taxation. The difference was attributable to the following factors

	2012 £m	2011 £m
Profit before taxation	489	794
Profit before taxation multiplied by rate of corporation tax in the UK of 24.5% (2011: 26.5%)	120	210
Effects of		
Expenses not deductible for tax purposes	21	24
Non-taxable income	(10)	-
Changes in recognised deductible temporary differences relating to a transfer of assets	(22)	-
Effect of change in tax rate	(2)	(2)
Adjustments in respect of prior years	12	4
Total taxation	119	236

The main rate of corporation tax will reduce from 24% to 23% effective from 1 April 2013. This change was enacted on 17 July 2012. As a result the disclosure of deferred tax has been adjusted to reflect the enactment with no significant impact on these financial statements.

Notes to the financial statements**4. Taxation (continued)**

The main rate of corporation tax will reduce from 23% to 21% effective from 1 April 2014, and will reduce further to 20% effective from 1 April 2015. These changes were enacted on 17 July 2013. As this legislation was not enacted or substantively enacted by the balance sheet date it has not been reflected within these financial statements. However it is expected that the changes would not have a significant impact on the value of the company's deferred tax balances at the balance sheet date.

5. Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Assets in the course of construction £m	Total £m
Cost				
At 1 January 2011	502	4,566	516	5,584
Additions	-	-	541	541
Reclassifications	28	236	(264)	-
Disposals	-	(10)	-	(10)
At 31 December 2011	530	4,792	793	6,115
Additions	-	-	527	527
Reclassifications	27	655	(682)	-
Disposals	(254)	(1,016)	(30)	(1,300)
At 31 December 2012	303	4,431	608	5,342
Depreciation				
At 1 January 2011	305	3,044	-	3,349
Charge for the year	41	341	-	382
Disposals	-	(10)	-	(10)
At 31 December 2011	346	3,375	-	3,721
Charge for the year	38	409	-	447
Disposals	(173)	(657)	-	(830)
At 31 December 2012	211	3,127	-	3,338
Net book value				
At 31 December 2012	92	1,304	608	2,004
At 31 December 2011	184	1,417	793	2,394

Included within plant and equipment are assets held under finance leases with a net book value of £109 million (2011: £135 million).

Cornerstone Telecommunications Infrastructure Limited

During the year the Company transferred certain assets relating to its network infrastructure, with a net book value of £470m and with a fair value of £480m, in consideration for the issue of 50% of the share capital of Cornerstone Telecommunications Infrastructure Limited to the parent companies of the Company. In consequence a distribution in specie of £480m has been recorded in the results of the Company.

Notes to the financial statements

6. Goodwill

	Goodwill £m
Cost	
At 1 January 2011, 31 December 2011 and 31 December 2012	196
Amortisation and impairment	
At 1 January 2011, 31 December 2011 and 31 December 2012	196
Net book value	
At 31 December 2011 and 31 December 2012	-

7. Intangible assets

	UMTS licence £m	Software £m	Assets in the course of construction £m	Total £m
Cost				
At 1 January 2011	4,030	1,070	19	5,119
Additions	-	-	89	89
Reclassifications	-	53	(53)	-
At 31 December 2011	4,030	1,123	55	5,208
Additions	-	-	56	56
Reclassifications	-	63	(63)	-
At 31 December 2012	4,030	1,186	48	5,264
Amortisation				
At 1 January 2011	2,780	921	-	3,701
Charge for the year	114	129	-	243
At 31 December 2011	2,894	1,050	-	3,944
Charge for the year	114	77	-	191
At 31 December 2012	3,008	1,127	-	4,135
Net book value				
At 31 December 2012	1,022	59	48	1,129
At 31 December 2011	1,136	73	55	1,264

The UMTS licence is an individual asset permitting the Company to operate its "3G" network. The remaining life of this asset is 9 years.

Notes to the financial statements

8. Investments

	Shares in subsidiary undertakings £m
Cost	
At 1 January 2011 and 31 December 2011	4,205
Additions	2
At 31 December 2012	4,207
Amortisation and impairment	
At 1 January 2011, 31 December 2011 and 31 December 2012	-
Net book value	
At 31 December 2012	4,207
At 31 December 2011	4,205

Investments in subsidiaries are held at historical cost less any provisions for impairment

On 28 September 2012, the Company acquired a 33% shareholding in Weve Limited, a mobile advertising, loyalty and payments company. The value of the investment held in Weve at 31 December 2012 is £1.7 million.

A list of principal subsidiary undertakings at 31 December 2012 is given below

Name	Country of incorporation and operation	Activity	Portion of ordinary shares held %
Be Un Limited	England & Wales	Trading	100% ordinary
giffgaff Limited	England & Wales	Trading	100% ordinary
O2 Third Generation ⁽¹⁾	England & Wales	Non trading	76.5% ordinary
Telefónica Financial Services UK Limited	England & Wales	Trading	100% ordinary
Wayra UK Limited	England & Wales	Trading	100% ordinary

⁽¹⁾ Held through an intermediate holding company

A list of joint ventures is given below

Name	Country of incorporation and operation	Activity	Portion of ordinary shares held %
Weve Limited	England & Wales	Trading	33.33% ordinary
Digital Mobile Spectrum Limited	England & Wales	Non Trading	25% ordinary

Notes to the financial statements

9. Trade and other receivables

	2012 £m	2011 £m
Trade receivables	539	548
Amounts owed by other group companies	5,098	4,438
Amounts owed by associates	1	-
Amounts owed by other related parties	53	2
Prepayments	326	306
Accrued income	153	176
	6,170	5,470

Amounts owed by other group companies are unsecured, interest free and repayable on demand with the exception of three amounts. The first is an amount of £810 million (2011 £793 million) that bears an effective rate of interest of 2.2% (2011 1.95%). The second is an amount of £1,225 million (2011 £1,193 million) that bears an effective rate of interest of 2.65% (2011 2.4%). The third is an amount of £2,762 million (2011 £2,303 million) that bears an effective rate of interest of 2.04% (2011 1.8%).

In accordance with IFRS 7 "Financial Instruments Disclosures", the following disclosures are presented regarding the trade receivable balances

	Carrying Amount £m	Neither impaired nor overdue at the reporting date £m	Not impaired but overdue on the reporting date			
			Less than 90 days £m	Between 90 to 180 days £m	Between 180 to 360 days £m	Over 360 days £m
Trade receivables as at 31 December 2012	539	426	44	28	18	23
Trade receivables as at 31 December 2011	548	384	62	26	17	59

Amounts above are presented including VAT, which is reclaimable from Her Majesty's Revenue and Customs ("HMRC") upon write off of the underlying trade receivable

For the debtors which are not impaired and which are overdue at the reporting date, there has been no indication that their payment obligations will not be met

The movement in the trade receivables provision for doubtful debts during the year is as follows

	£m
Doubtful debt provision at 1 January 2011	188
Additions	190
Reductions / amount paid	(206)
Doubtful debt provision at 31 December 2011	172
Additions	182
Reductions / amounts paid	(181)
Bad debt provision at 31 December 2012	173

Additions and reductions in the provision are recognised in administrative expenses within the statement of comprehensive income

Notes to the financial statements

10. Other financial assets

	2012 £m	2011 £m
Current other financial assets		
Hire purchase contract deposits	10	32
Other financial assets	1	-
	11	32
	2012 £m	2011 £m
Non-current other financial assets		
Hire purchase contract deposits	52	142
Other financial assets	19	14
	71	156

Other assets related to hire purchase contracts total £82 million (2011 £188 million) and are held in trust to meet the Company's hire purchase obligations disclosed in note 12. These financial assets are measured using an amortised cost basis under a loans and receivables classification. Other financial assets mature at various dates until 2014.

During the year ended 31 December 2012, two out of the four remaining tranches of the structure were terminated, which resulted in a reduction of the financial assets and the corresponding hire purchase obligations.

11. Cash and cash equivalents

	2012 £m	2011 £m
Short term deposits	610	603
Cash and cash equivalents	610	603
Bank overdraft included in borrowings (note 12)	(57)	(46)
Cash and cash equivalents included in cash flow statement	553	557

12. Borrowings

	2012 £m	2011 £m
Current unsecured borrowings		
Bank overdrafts	57	46
Amounts owed to joint ventures	10	10
Amounts owed to other group companies	232	85
	299	141
Obligations under finance leases	19	33
	318	174
Non-current unsecured borrowings		
Obligations under finance leases	53	146

The amounts owed to other group companies bears an effective rate of interest of 2.09% (2011 1.89%).

Notes to the financial statements

12. Borrowings (continued)

Obligations under finance leases

The minimum lease payments under finance leases fall due as follows

	Minimum lease payments	Finance charges	Present value	Minimum lease payments	Finance charges	Present value
	2012	2012	2012	2011	2011	2011
	£m	£m	£m	£m	£m	£m
Within one year	19	-	19	33	-	33
Between one and five years	57	(4)	53	162	(16)	146
	76	(4)	72	195	(16)	179

Obligations under finance leases and hire purchase contracts are mainly in respect of hire purchase agreements for plant and equipment

On 30 March 2001 and 9 April 2001 hire purchase financing contracts were signed between the Company and a number of US leasing trusts. Under the contracts the Company sold and repurchased material portions of its GSM radio and switching equipment. The Company deposited sufficient funds with a trust company to meet the future hire purchase obligations. The deposit account is included in current other financial assets. For further details on the other financial assets see note 10. As a result of exercising an early buy out option, obligations under finance leases and hire purchase contracts fall due at various dates until 2014.

The hire purchase agreement is for 16 years with an early buy out option after 12 years. In accordance with the Separation Agreement signed on demerger, BT Group Plc continues to guarantee all future hire purchase obligations of the Company. The Company has provided a counter indemnity to BT Group Plc for this guarantee.

During the year ended 31 December 2012, two out of the four remaining tranches of the structure were terminated, which resulted in a reduction of the hire purchase obligations and the corresponding financial assets.

The Company has also entered into further agreement in respect of certain computer equipment, which are included in the figures above.

13. Trade and other payables

	2012	2011
	£m	£m
Trade payables	592	388
Amounts owed to other group companies	680	596
Amounts owed to other related parties	184	13
Other taxation and social security	170	182
Other payables	68	51
Accrued expenses	844	1,118
Deferred income	184	200
	2,722	2,548

Amounts owed to other group companies are unsecured, interest free and repayable on demand.

Notes to the financial statements

14. Provisions

	Restructuring	Other provisions	2012 Total	Restructuring	Other provisions	2011 Total
	£m	£m	£m	£m	£m	£m
Current	3	2	5	9	5	14
Non-current	3	37	40	5	30	35
	6	39	45	14	35	49

	Restructuring	Other provisions	Total
	£m	£m	£m
At 1 January 2012	14	35	49
Charge for the year	3	4	7
Utilised in the year	(10)	(3)	(13)
Adjustments	(1)	1	-
Unwinding of discounts	-	2	2
At 31 December 2012	6	39	45

Restructuring provisions include the full costs of planned business restructuring programmes, entered into during the year ended 31 December 2010 and the year ended 31 December 2012. Other provisions include onerous lease contracts, future estimated site restoration costs and decommissioning costs.

15. Pension costs

The Company operates a number of pension schemes in its businesses, being either defined benefit or defined contribution arrangements. In addition, Telefónica Europe plc, its ultimate UK parent company, sponsors a group-wide defined benefit scheme, the Telefónica Pension Plan, in which employees of the Company are members and therefore the Company has been recharged the contributions payable into the scheme for the period. The retirement benefit obligation of the defined benefit scheme is recorded on the statement of financial position of Telefónica Europe plc. Telefónica UK Limited expenses the contributions payable to the Telefónica scheme for the period. The operation and accounting for the Telefónica Pension Plan is discussed further below.

The total operating charge included in the statement of comprehensive income for all the Company's entire pension schemes are as follows:

	2012	2011
	£m	£m
Telefónica Pension Plan costs	62	69
Defined contribution schemes	19	17
Total pension costs	81	86

Pension costs include an additional deficit funding payment during the year of £41 million (2011 £45 million).

The Telefónica Pension Plan

The Telefónica Pension Plan ("Telefónica PP") provides the pension benefits for the majority of UK employees and is divided into defined contribution and defined benefit sections. Since 14 March 2005, the sponsoring employer of the scheme has been Telefónica Europe plc, prior to this the sponsoring employer was mmO2 plc. As mmO2 plc was the sponsoring employer of the Telefónica PP until 14 March 2005, the full net defined benefit cost and defined benefit liability was recognised by mmO2 plc until this date. After 14 March 2005 the defined benefit liability was transferred to Telefónica Europe plc, the new sponsoring employer.

Notes to the financial statements**15. Pension costs (continued)****The Telefónica Pension Plan (continued)**

Companies within the Group account for the defined benefit sections of the Telefónica PP as though it were a defined contribution plan as there is no contractual arrangement or stated policy for charging out the net defined benefit cost between participating employers. The net defined benefit cost of the defined benefit sections, as assessed in accordance with the advice of a qualified, independent actuary, measuring actual liabilities using the projected unit method and taking assets at market value, is recognised by the sponsoring employer. Accordingly the defined benefit liability or asset of the Telefónica PP is not recognised on the statement of financial position of the Company as the sponsoring employer is Telefónica Europe plc.

With effect from 28 February 2013 the defined benefit sections of the Plan closed to further benefit accrual. Members' defined benefit pensions will continue to be increased in deferment by reference to the Consumer Prices Index but will not retain the link to any future increases in salary. Upon closure, members of the defined benefit sections of the Plan were given the option to become members of the defined contribution section of the Plan. The defined contribution sections of the Plan remain open to new entrants and further accrual. The assets of the Plan are held independently of the Company's finances.

Actuarial valuation

A full valuation of the defined benefit sections of the Telefónica PP was undertaken as at 30 September 2008 by a suitably qualified independent actuary. The valuation used the projected unit method and set a future funding plan to ensure that contributions to the Plan adequately meet future liabilities and past service liabilities.

The actuarial valuation as at 30 September 2011 has not been completed as the process was delayed by discussions over the closure of the Plan from 28 February 2013. The company and Trustee are continuing to negotiate on the funding of the Plan. The Pensions Regulator is aware of this delay and the Trustee will continue to keep the Regulator informed of progress in the discussions and negotiations.

The valuation was completed in conjunction with a change in the investment strategy of the plan from a predominantly performance asset basis to a predominantly corporate bond basis. As a result of the investment changes, inter-valuation experience and the development of actuarial assumptions the ongoing contribution rate was increased to 26.7% of defined benefit members' payroll. Based on the difference between the September 2008 pension asset value and the technical provisions a past service deficit of £187 million resulted. It was agreed that this deficit will be recovered by additional contributions over the period to 2015 totalling £243 million. £40.5 million is required to be contributed annually over the period 2012 to 2015 inclusive (2011: £45.2 million, 2010: £36 million) in accordance with the schedule of contributions contract dated 19 July 2011. These contributions are in line with the preceding schedule of contributions contract dated 24 December 2009.

The expected amount to be paid to the Telefónica PP defined benefit scheme by the company during 2013 is £42 million.

Disclosures

Disclosures of the defined benefit sections of the Telefónica PP are provided below. Additional disclosure in line with the requirements of IAS 19 for both the current and previous accounting period is provided in the Annual Report and Financial Statements of Telefónica Europe plc for the year ended 31 December 2012.

Notes to the financial statements**15. Pension costs (continued)****The Telefónica Pension Plan (continued)****Disclosures (continued)**

The actuarial valuation of the Telefónica PP as at 30 September 2008 has been updated to 31 December 2012 by an independent qualified actuary in accordance with the requirements of IAS 19. In accordance with IAS 19, the defined benefit liabilities have been measured using the projected unit method. Plan assets are stated at fair value.

In June 2011 a revised IAS19 was published which comes into effect for accounting years beginning on or after 1 January 2013. Under the Revised IAS19 (hereafter called "IAS19R") the expected return on assets and interest cost will be replaced by the "net interest on liability" calculated with respect to the discount rate, which is likely to result in a higher Income Statement charge than under the current IAS19 (estimated to be £5 million higher in 2013). The Company will adopt IAS19R for the first time for the accounting period ending 31 December 2013.

Movements in the present value of the Telefónica PP's defined benefit (funded) obligations in the current and preceding period were as follows:

	2012 £m	2011 £m
At 1 January	810	785
Total current service cost	20	22
Interest cost	40	44
Vested past service costs credit	3	-
Actuarial losses/(gains)	141	(23)
Curtailment and settlement gains	(76)	(1)
Benefits paid	(15)	(17)
At 31 December	923	810

The main assumptions adopted for the Telefónica PP (funded and unfunded) under IAS 19 are as follows:

	2012 %	2011 %
Nominal rate of increase in salaries	4.2	4.0
Nominal rate of increase of pensions in payment		
– Pension increases with inflation	3.2	3.0
– Pension increases with inflation limited to 5 per cent p.a.	3.1	2.9
Discount rate	4.6	4.9
Inflation assumption		
– RPI	3.2	3.0
– CPI	2.2	2.0
Expected long-term return for		
– Equities	7.0	7.0
– Other bonds	4.6	4.9
– Other	3.2	3.0

Mortality tables called the "00 series" have been used in both years and are based on analysis of death rates over the 4 year period from 1999 to 2002. A floor has been applied to these tables giving a minimum rate of future improvement in males and females of 0.5% per annum.

Notes to the financial statements

15. Pension costs (continued)

The Telefónica Pension Plan (continued)

Disclosures (continued)

The defined benefit sections of the Telefónica PP are closed to new entrants and therefore the current service cost is likely to increase, as a percentage of payroll, as the members approach retirement

Movements in fair value of the Telefónica PP's (funded) defined benefit scheme assets in the current and preceding period were as follows

	2012 £m	2011 £m
At 1 January	811	721
Expected return on scheme assets	43	42
Actuarial gains/(losses)	66	(12)
Employer contributions	67	77
Benefits paid	(15)	(17)
At 31 December	972	811

The amount included in the statement of financial position of Telefónica Europe plc arising from its obligations in respect of the defined benefit sections of the Telefónica PP, as well as the analysis of the scheme's assets, is as follows

	2012 £m	2011 £m
Fair value of assets comprises		
– Equities	198	160
– Other bonds	769	644
– Other	5	7
Fair value of assets	972	811
Present value of defined benefit obligations	(923)	(810)
Net surplus recognised in consolidated statement of financial position of Telefónica Europe plc	49	1

16. Deferred taxation

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 23% (2011 25%)

The movement on the deferred tax account is as shown below

	£m
At 1 January 2011	21
Prior year charge to statement of comprehensive income	(21)
Current year charge to statement of comprehensive income	(27)
Effect of change in tax rate	2
At 31 December 2011	(25)
Prior year charge to statement of comprehensive income	(20)
Current year credit to statement of comprehensive income	28
Current year charge to equity	(2)
Effect of change in tax rate	2
At 31 December 2012	(17)

Deferred tax assets have been recognised in respect of all tax losses and other temporary differences giving rise to deferred tax assets because it is probable that these assets will be recovered

Notes to the financial statements

16. Deferred taxation (continued)

Deferred tax assets and liabilities are only offset where there is a legally enforceable right of offset and there is an intention to settle the balances net

Deferred tax liabilities	Accelerated tax depreciation £m	Total £m
At 1 January 2011	-	-
Transfer from assets	(31)	(31)
At 31 December 2011	(31)	(31)
Current year credit to statement of comprehensive income	30	30
Prior year charge to statement of comprehensive income	(20)	(20)
Effect of change in tax rate	2	2
At 31 December 2012	(19)	(19)

Deferred tax assets	Accelerated tax depreciation £m	Employee share based payments £m	Other £m	Total £m
At 1 January 2011	14	5	2	21
Charge to statement of comprehensive income	(24)	(2)	(1)	(27)
Prior year (charge)/credit to statement of comprehensive income	(23)	-	2	(21)
Effect of change in tax rate	2	-	-	2
Transfer from liabilities	31	-	-	31
At 31 December 2011	-	3	3	6
Charge to statement of comprehensive income	-	-	(2)	(2)
Charge to equity	-	(2)	-	(2)
At 31 December 2012	-	1	1	2

Net deferred tax (liability)/asset	£m
At 31 December 2012	(17)
At 31 December 2011	(25)

Notes to the financial statements

17. Ordinary share capital

	Number of shares	31 December 2012 £	Number of shares	31 December 2011 £
Share capital				
Called up, allotted and fully paid				
Ordinary A shares of 20 pence each				
At end of year	10,001,000	2,000,200	10,001,000	2,000,200
Ordinary B shares of 20 pence each				
At end of year	40,004,000	8,000,800	40,004,000	8,000,800
Total shares	50,005,000	10,001,000	50,005,000	10,001,000

The Company has two classes of issued share capital comprising Ordinary A and Ordinary B shares of 20 pence each. Each share class ranks *pari passu*. Subject to the Company's Articles of Association and applicable law, the Company's shares confer on the holder the right to receive notice of and vote at General Meetings, the right to receive surplus assets on a winding up of the Company, and an entitlement to receive any dividend declared on ordinary shares.

18. Reconciliation of retained earnings to distributable reserves

On the transfer of the UMTS licence from O2 Third Generation in July 2003, the Directors revalued the UMTS licence by way of an impairment and considered the value of all of the other fixed assets of the Company to confirm that they were satisfied that the aggregate value of the fixed assets was not less than the aggregate amount at which they were stated. In these accounts the Directors have reconsidered the value of all of the fixed assets without actually revaluing those fixed assets and are satisfied that their aggregate value is not less than the aggregate amount at which they are stated. In accordance with Section 841 of the Companies Act 2006 the Company's provision against the UMTS licence is not classified as a realised loss to the extent that the UMTS licence has not been amortised. The distributable reserves of the Company are £3,330 million (2011: £3,562 million) as analysed below.

	2012 £m	2011 £m
Retained earnings	2,251	2,363
Provision against intangible fixed asset	2,068	2,068
Realisation of provision against intangible fixed assets	(989)	(869)
Distributable reserves	3,330	3,562

Notes to the financial statements

19. Financial commitments and contingent liabilities

Operating lease commitments

At 31 December 2012 the Company was committed to making the following total future lease payments in respect of operating leases for each of the following periods

	2012	2011
	£m	£m
Lease payments		
Within one year	58	115
Between one and five years	163	274
After five years	114	206
	335	595

The Company leases various offices, shops, vehicles and mast sites under non-cancellable operating lease agreements. These leases have various terms and renewal rights.

The total future minimum sublease payments expected to be received under non-cancellable subleases at the 31 December 2012 are £40 million (2011: £83 million).

Other commitments

Contracts placed for capital expenditure not provided in the accounts are as follows

	2012	2011
	£m	£m
Property, plant and equipment	319	323
Total other commitments	319	323

20. Related party disclosures

During the year the Company entered into transactions with related parties as follows

	2012	2011
	£m	£m
Revenue		
Group companies	28	20
Associates	1	-
Other related parties	70	66
Total Revenue	99	86
Purchases		
Group companies	(310)	(271)
Other related parties	(22)	(1)
Total Purchases	(332)	(272)
Total net transactions	(233)	(186)

All related party transactions relate to regular trading activities of the Company on an arm's length basis.

Notes to the financial statements**20. Related party disclosures (continued)**

Related parties include group companies, associates where the Company has a direct interest but not control and other related parties being associates of other Group companies

Additional related party transactions are detailed in notes 3, 9, 12 and 13

Related party transactions with Directors and key management are detailed in note 23

21. Financial instruments**Financial risk factors and management**

The Company's principal financial liabilities comprise bank overdrafts, finance leases and trade and other payables. The purpose of these financial liabilities is to raise finance for the Company's operations. The Company has various financial assets such as trade receivables and cash. The purpose of the Company's risk management policy is to manage the interest rate risk and currency risk that arise from the Company's operations and sources of finance.

The main sources of risk arising from the Company's financial instruments are currency risk, interest rate risk, credit risk and liquidity risk. Management of the Company's financial risks is achieved mostly through being a part of the larger Telefónica group, which operates group wide policies in each area and is able to hedge positions on a group basis.

Credit risk

Credit risk is the risk that a counterparty will not meet its obligation under a financial instrument or customer contract, leading to a financial loss.

The Company's principal credit risks are attributable to its trade receivables. Trade receivables as presented in the statement of financial position are net of provision for doubtful debts, estimated by the Group's management based on prior experience and their assessment of the current economic environment. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. At the statement of financial position date there were no significant concentrations of credit risk, with exposure spread over a large number of counter-parties and customers. The maximum exposure to credit risk is represented by the carrying amount of trade receivables as disclosed in note 9.

With respect to credit risk arising from other financial assets of the Company, which mostly comprise cash and cash equivalents, the Company's exposure to credit risk arises from default of the counterparty, with a maximum exposure equal to the carrying amount of these instruments.

The Company does not require collateral in respect of financial assets.

Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities.

Management of the Company's liquidity risk is achieved mostly through being a part of the larger Telefónica group. The Company holds financial assets primarily in short-term deposits with a central Telefónica group company that are readily convertible to known amounts of cash. These measures help keep liquidity risk low.

Notes to the financial statements**21. Financial instruments (continued)**

The following tables set out contractual undiscounted cash outflows of financial liabilities, including interest payments

31 December 2012	On demand	< 1 year	1 – 2 years	2 – 5 years	> 5 years	Total
	£m	£m	£m	£m	£m	£m
Bank overdrafts	57	-	-	-	-	57
Obligations under finance leases	-	19	57	-	-	76
Trade and other payables	-	592	-	-	-	592
	57	611	57	-	-	725

31 December 2011	On demand	< 1 year	1 – 2 years	2 – 5 years	> 5 years	Total
	£m	£m	£m	£m	£m	£m
Bank overdrafts	46	-	-	-	-	46
Obligations under finance leases	-	33	29	133	-	195
Trade and other payables	-	388	-	-	-	388
	46	421	29	133	-	629

Foreign currency risk

Foreign currency risk is the risk that fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates

The Company operates in the United Kingdom. The Company is exposed to foreign exchange risk arising from various currency movements, primarily with respect to the Euro and US dollar that can affect its results and statement of financial position.

The Company has a limited exposure to foreign currency risk. Such exposure arises from revenues and purchases by an operating unit that is in currencies other than the unit's functional currency. Significant exposures are managed through the use of foreign exchange contracts and the Telefónica group managing positions on a group wide basis.

Interest rate risk

Interest rate risk is the risk that fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Company's interest rate risk arises primarily from the interest received on cash and cash equivalents. The majority of the Company's cash and cash equivalents are deposited with a central Telefónica group company that pays interest at variable market rates.

Notes to the financial statements

21. Financial instruments (continued)

Fair value of financial instruments

The carrying and fair value of the Group's financial assets and financial liabilities at 31 December are

	31 December 2012		31 December 2011	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Liabilities				
Bank overdrafts	(57)	(57)	(46)	(46)
Obligations under finance leases	(72)	(72)	(179)	(179)
Trade and other payables	(592)	(592)	(388)	(388)
Total financial liabilities	(721)	(721)	(613)	(613)
Assets				
Cash and cash equivalents	610	610	603	603
Other financial assets	82	82	188	188
Trade and other receivables	539	539	548	548
Total financial assets	1,231	1,231	1,339	1,339

Fair value estimation

The fair value of the trade and other receivables, trade and other payables and cash and cash equivalents approximates to the book carrying value due to the short-term or on demand maturity of these instruments. The fair value of other financial assets for disclosure purposes has been calculated using market values provided by third parties and converted to Sterling where applicable.

The following tables set out the maturity analysis of financial assets that are held to manage liquidity risk.

31 December 2012	On demand £m	< 1 Year £m	1 – 2 Years £m	2 – 5 years £m	> 5 years £m	Total £m
Cash and cash equivalents	610	-	-	-	-	610
Other financial assets	-	11	76	-	-	87
Trade and other receivables	-	516	23	-	-	539
	610	527	99	-	-	1,236
31 December 2011	On demand £m	< 1 year £m	1 – 2 Years £m	2 – 5 years £m	> 5 years £m	Total £m
Cash and cash equivalents	603	-	-	-	-	603
Other financial assets	-	33	29	148	-	210
Trade and other receivables	-	489	59	-	-	548
	603	522	88	148	-	1,361

Notes to the financial statements

22. Auditor's remuneration

The aggregate fees paid to auditors during the year for audit and other services are analysed below

	2012 £'000	2011 £'000
Audit services		
UK statutory audit fees	642	860
Other assurance services	349	467
Total audit and audit-related fees	991	1,327

The fees in the current and previous year were paid to Ernst & Young LLP

23. Key management and Directors' compensation

The compensation of key management for the year ended 31 December 2012 was as follows

	2012 £000	2011 £000
Salaries and short-term employee benefits	2,074	1,510
Post-employment benefits	143	112
Share based payments	57	989
Total key management compensation	2,274	2,611

The key management of the Company are the same as the Directors of the Company

The emoluments of the Directors for the year ended 31 December 2012 was as follows

	2012 £000	2011 £000
Aggregate emoluments in respect of qualifying services	2,074	1,510
Aggregate amount of company contributions paid to a pension scheme	143	112
	2,217	1,622

During the current year, one Director (2011 two) accrued retirement benefits under a defined benefit pension plan. No Directors exercised share options during the current year (2011 nil) and three Directors received Telefónica S A shares in respect of qualifying service under long-term incentive plans (2011 four).

In respect of the highest paid Director

	2012 £000	2011 £000
Total amount of emoluments and amounts (excluding shares) receivable under long-term incentive schemes	1,265	956

The highest paid Director received shares under the Global Employee Share Plan but did not exercise share options during the reported period. The highest paid Director is a member of the TUK defined contribution pension plan.

Notes to the financial statements

24. Employees

	2012 No	2011 No
Average number of full time employee equivalents (including executive Directors)		
Technology	1,416	1,557
Customer operations	7,033	7,223
Administration	1,831	1,752
Total employees	10,280	10,532

The benefits expense incurred in respect of these employees were

	2012 £m	2011 £m
Wages and salaries	366	360
Social security costs	36	37
Pension costs (note 15)	40	41
Further pension costs (note 15)	41	45
Share based payments (note 25)	3	6
Total employee benefits expense	486	489

The Company's employees and Directors participated in a number of employee incentive share schemes operated by Telefónica Europe plc (see note 25 for further details)

25. Share based payments

There were four share schemes in operation in Telefónica UK Limited during the year ended 31 December 2012, the Telefónica Performance Share Plan, the Telefónica Performance Cash Plan, the Global Employee Share Plan and the Telefónica Performance Investment Share Plan which replaces the Performance Share Plan from 2011. These are described in more detail below.

The costs of share options and awards are charged to the statement of comprehensive income over the vesting period, based upon the fair value of the share award or option at the award date adjusted for the likelihood of non-market vesting conditions being met under the share award or option plan.

The amounts recognised in the statement of comprehensive income for share based payment transactions with employees for the year ended 31 December 2012 was as follows:

	2012 £m	2011 £m
Equity settled share based payments	3	4
Cash settled share based payments	-	2
Total share based payments	3	6

The liability recognised in the statement of financial position for share based payments at 31 December 2012 totalled £2 million (31 December 2011: £2 million).

Notes to the financial statements

25. Share based payments (continued)

Telefónica Performance Share Plan

The Telefónica Performance Share Plan was approved at the Telefónica, S A AGM held on 21 June 2006 and awards shares in Telefónica, S A to participants subject to the achievement of certain performance criteria

The plan had an expected duration of seven years which is divided into five cycles of three years each, with the first cycle commencing on 1 July 2006. At the inception of each cycle, a number of shares are awarded to each participant in the plan, with the final number of shares vesting being based on the level of achievement against the performance criteria. This plan has been superseded by the Telefónica Performance Investment Share Plan for the 2011 share grant and is closed to new entrants.

Award of shares is subject to a number of conditions

- The beneficiary must continue to work for the company throughout the three-year duration of each phase
- The actual number of shares awarded at the end of each phase will depend on success in meeting targets and the maximum number of shares assigned to each executive. Success is measured by comparing the Total Shareholder Return (TSR) offered by Telefónica shares with the TSRs offered by a basket of listed telecoms companies.

The performance criterion is the Total Shareholder Return (TSR) of Telefónica, S A against a comparator group, over a fixed three year period as follows

TSR ranking	% shares vest
Below median	0%
Median	30%
Upper quartile	100%

Vesting occurs on a straight line basis between median and upper quartile performance

The number of shares Telefónica, S A granted to directors and senior management of the company in the year ended 31 December 2012 is 496,115 (2011: nil)

As this plan will be settled by the physical delivery of Telefónica, S A shares to employees, the charge for the year ended 31 December 2012 of £2 million has been recognised against equity (2011: £2 million)

The fair value of the rights granted to the participants at the 2012 grant date is €5.87 (year ended 31 December 2011: €8.28). This value has been established by reference to the price of an instrument with the same conditions and requirements of the plan, which was acquired by Telefónica, S A from a financial institution. This is the best estimate of the fair value of the rights granted to the employees, as it results from a current market transaction.

In July 2012 the second tranche of share awards granted in 2009 vested. At the date of vesting the weighted average share price was €15.41 (2011: €15.11). The total number of shares which vested was nil (2011: 257,855).

This share plan is closed to new entrants, the share awards granted in 2010 and 2011 are due to vest in 2013 and 2014 respectively.

Notes to the financial statements**25. Share based payments (continued)****Telefónica Performance Investment Share Plan**

At the General Shareholders' Meeting held on 18 May 2011, a new long-term share-based incentive plan called "Performance and Investment Plan" was approved for Telefónica Group directors and executive officers. This plan will take effect following completion of the Performance Share Plan.

Under this plan, a certain number of shares of Telefónica, S.A. will be delivered to plan participants selected by the Company who decide to participate on compliance with stated requirements and conditions.

The plan lasts five years and is divided into three independent three-year phases (i.e. delivery of the shares for each three-year phase three years after the start date). The first phase began on 1 July 2011 (with the delivery of the related shares from 1 July 2014). The second phase began on 1 July 2012 (with delivery of the related shares from 1 July 2015). The third phase will begin on 1 July 2013 (with delivery of the related shares from 1 July 2016).

The specific number of Telefónica, S.A. shares deliverable within the maximum amount established to each member at the end of each phase will be contingent and based on the Total Shareholder Return ("TSR") of Telefónica, S.A. shares (from the reference value) throughout the duration of each phase compared to the TSRs of the companies included in the Dow Jones Global Sector Titans Telecommunications Index. For the purposes of this Plan, these companies make up the comparison group ("Comparison Group").

The TSR is the indicator used to determine the Telefónica Group's medium- and long-term value generation, measuring the return on investment for each shareholder. For the purposes of this Plan, the return on investment of each phase is defined as the sum of the increase or decrease in the Telefónica, S.A. share price and dividends or other similar items received by the shareholder during the phase in question.

At the beginning of each phase, each participant is allocated a notional number of shares. According to the plan, the number of shares to be delivered will range from:

- 30% of the number of notional shares if Telefónica, S.A.'s TSR is at least equal to the median of the Comparison Group, and
- 100% if Telefónica, S.A.'s TSR is within the third quartile or higher than that of the Comparison Group. The percentage is calculated using linear interpolation when it falls between the median and third quartile.
- No shares will be delivered if Telefónica, S.A.'s TSR is below the Comparison Group's median.

The plan includes an additional condition regarding compliance by all or part of the participants with a target investment and holding period of Telefónica, S.A. shares through each phase ("Co-Investment"), to be determined for each participant, as appropriate, by the Board of Directors based on a report by the Nominating, Compensation and Corporate Governance Committee. Participants meeting the coinvestment requirement will receive an additional number of shares, provided the rest of the requirements established in the plan are met.

In addition, and independently of any other conditions or requirements that may be established, in order to be entitled to receive the corresponding shares, each participant must be a Telefónica Group employee at the delivery date for each phase, except in special cases as deemed appropriate.

Notes to the financial statements**25. Share based payments (continued)****Telefónica Performance Investment Share Plan (continued)**

Shares will be delivered at the end of each phase (in 2014, 2015, and 2016, respectively) The specific delivery date will be determined by the Board of Directors or the committee or individual entrusted by the Board to do so

Phase	No. Shares assigned	Unit fair value	End date
1 st phase July 2011	203,840	€8.28	June 30, 2014
2 nd phase July 2012	396,885	€5.87	June 30, 2015

Telefónica Performance Cash Plan

This plan mirrors the conditions of the Telefónica Performance Investment Share Plan and awards employees a given number of notional shares in Telefónica, S A. These notional shares entitle the beneficiary to a cash payment equivalent to their market value on vesting. The cash payment is capped at three times the value of the notional shares at the date of award. The value of the notional shares is set using a weighted average trading price for the 30 days prior to the start of each cycle. As an exception, the value of those notional shares awarded in the first cycle was determined using the weighted average share price for the 30 days prior to 11 May 2006. As such their notional value is €12.83.

This plan also has an expected duration of 7 years with 5 cycles of 3 years each commencing on 1 July.

As with the Telefónica Performance Investment Share Plan, the entitlement to a payment at the end of each cycle is dependent on the TSR of Telefónica, S A in relation to the comparator group over a fixed three year period as follows:

TSR ranking	% Shares vest
Below median	0%
Median	30%
Upper quartile	100%

Vesting occurs on a straight line basis between median and upper quartile performance.

The number of notional shares awarded to employees of the Company during the year was nil (2011 139,300).

There were no shares granted during the year ended 31 December 2012. The fair value of the rights granted to the participants at the 2011 grant date was €13.39. This value has been established based on the market value of Telefónica S A shares at the measurement date, taking into consideration the expected TSR performance of Telefónica S A. This fair value is updated at each statement of financial position date to reflect current values.

In July 2012 the second tranche of share awards granted in 2009 vested. At the date of vesting the weighted average share price at vesting was €10.37 (2011 €15.72). The total number of shares vesting in the tranche was nil (2011 166,683).

Global Employee Share Plan

At the June 23, 2009 General Shareholders' Meeting of Telefónica, S A, the shareholders approved the introduction of a Telefónica, S A share incentive plan for all employees of the Telefónica Group worldwide, with certain exceptions. Under this plan, participants who meet certain requirements are offered the possibility of acquiring shares in Telefónica, S A, which takes up the obligation to give them a certain number of free shares.

Notes to the financial statements**25. Share based payments (continued)****Global Employee Share Plan (continued)**

The total term of the plan is two years. Employees joining the plan could acquire Telefónica, S A shares through maximum monthly instalments of €100 (or the local currency equivalent), up to a maximum of €1,200 over a period of 12 months (acquisition period). Shares were delivered upon vesting of the plan, as from September 1, 2012, subject to a number of conditions

- The beneficiary must continue to work for the company throughout the two-year duration of the plan (consolidation period), subject to certain special conditions related to departures
- The actual number of shares to be delivered at the end of the consolidation period depended on the number of shares acquired and retained by each employee. Each employee who is a member of the plan and remained a Group employee, and retained the shares acquired for an additional twelve-month period after the acquisition date, would be entitled to receive one free share per share acquired and retained at the end of the consolidation period

At the consolidation date of the Plan, 132,497 shares were awarded (corresponding to a total of 209,235 of gross shares of which 76,738 shares were retained at the request of the employees to meet their tax commitments) to the 3,698 employees participating in the plan who were with the company on that date

At the May 18, 2011 General Shareholders' Meeting of Telefónica, S A, the shareholders approved the introduction of a Telefónica, S A share incentive plan for all employees of the Telefónica Group worldwide, with certain exceptions. The characteristics and conditions of this plan are similar to those of the first edition of the Global Employee Share Plan. Where applicable, shares will be delivered after vesting of the plan, as of 1 December 2014

The acquisition period began in December 2012. At December 31, 2012, 1,859 employees had joined the plan. This plan will be equity-settled via the delivery of shares to the employees

A charge of £1.3 million has been recorded by the Company during the year ended 31 December 2012 in respect of these plans (2011: £1.8 million)

26. Parent company and controlling party

The Company's immediate parent companies are O2 Networks Limited and O2 Cedar Limited

At the end of the year the ultimate parent company and controlling party was Telefónica, S A, a company incorporated in Spain. Copies of the consolidated financial statements of Telefónica, S A may be obtained from Gran Vía 28, 28013, Madrid, Spain

27. Subsequent events***Strategic partnership***

On 21 May 2013, the Company announced a new 10 year strategic partnership with Capita plc ("Capita") to outsource the Company's customer service centres. The agreement builds on Capita's existing long-term partnership with the Company and will provide it with further support as it enhances and expands its digital service offering to its customer base. The 10 year contract will be worth approximately £1.2 billion and commenced on 1 July 2013

Notes to the financial statements**27. Subsequent events (continued)*****Divestment***

On 30 April 2013, the Company disposed of part of its operations and 100% of Be Un Limited, one of its wholly owned subsidiaries, which collectively resulted in the transfer of the UK consumer broadband and fixed-line telephony business to British Sky Broadcasting Limited. Under the terms of the agreement, British Sky Broadcasting Limited paid a consideration of £185m for 100% of the share capital of Be Un Limited. An additional contingent amount, not exceeding £20m, may also be payable by way of further consideration for the sale of the shares, dependent upon the successful delivery and completion of the customer migration process.

As part of the pre-completion steps of the disposal, certain assets and liabilities of the home phone & broadband business that were operated under the O2 brand and reported into the financial results of the Company, were acquired by Be Un Limited for a consideration of £10m. Additional pre-completion steps included the acquisition of certain assets and liabilities by the Company from Be Un Limited that were outside the scope of the disposal to British Sky Broadcasting Limited, the consideration for which was £25m. Also pre-completion all existing intercompany balances with Be Un Limited were settled for cash and a dividend of £59m was received by the Company from Be Un Limited.

Spectrum

Following the completion of the spectrum auction on 19 February 2013, OFCOM announced that the Company had successfully secured the licence to 20MHz of 800MHz spectrum which can be used by the Company to build a 4G mobile network in the UK. The Company paid a total of £550m for two separate lots of the auction, one of these lots has a coverage obligation attached, under which the Company is obliged to provide a mobile broadband service for indoor reception to at least 98% of the UK population (expected to cover at least 99% when outdoors) and at least 95% of the population of each of the UK nations – England, Northern Ireland, Scotland and Wales – by the end of 2017 at the latest.