

**Registered Number 1743099**

**Telefónica O2 UK Limited**

**Annual Report and Financial Statements  
Year ended 31 December 2009**



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**Directors and advisers**

**Directors**

Ronan Dunne                      Chairman  
Robert Harwood  
Kate Jarvis  
Ramon Ros  
Paul Whelan

**Secretary**

O2 Secretaries Limited

**Registered office**

260 Bath Road  
Slough  
Berkshire  
SL1 4DX

**Auditors**

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

**Business review****Introduction**

Telefónica O2 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 has a branch office registered in Northern Ireland, with the branch registration number NF004216. The Company trades under the brand name O2.

**Strategy**

The Company aims to provide an excellent customer experience every time and in whichever way they choose to interact with O2. Its ambition is to turn customers into fans by being outstanding at the basics, and surprising and delighting customer at every opportunity.

Mobile data is becoming increasingly important. The Company will continue to invest in its network and platforms to provide the best possible experience for the greatest number of customers.

The Company will launch new products and services in areas that enhance its core communications services. Examples include, but are not limited to, financial services and personalised mobile advertising.

Through the strategies outlined above, the Company aims to grow at a rate above the industry average, and achieve excellence in both customer and employee engagement, while continuing to improve the efficiency of the business.

**Operating review**

The operating review for the Company for the year ended 31 December 2009 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. Blended ARPU is a combination ratio incorporating both pre-pay and post-pay revenues.

The Company's revenue for the year ended 31 December 2009 was £5,784 million (2008: £5,568 million). The Company's operating profit for the year ended 31 December 2009 was £798 million (2008: £741 million).

The Company had total net additions of 1.3 million accesses in 2009, 41% less than its net additions in 2008. Total accesses increased 6.2% to 21.9 million accesses at 31 December 2009 compared to 20.6 million accesses at 31 December 2008.

The Company added 1.1 million contract accesses in 2009, bringing the total at 31 December 2009 to 9.6 million contract accesses, an increase of 13.6% from 31 December 2008. Pre-pay accesses decreased from 11.9 million accesses from 31 December 2008 to 11.7 million accesses at 31 December 2009. At 31 December 2009 contract accesses made up 44.9% of the Company's mobile customer base, compared to 41.5% at 31 December 2008. At 31 December 2009 the Company had 0.6 million broadband accesses compared to 0.3 million broadband accesses at 31 December 2008.

**Business review****Operating review (continued)**

Contract ARPU decreased to £36.0 in 2009 from £39.0 in 2008. Pre-pay ARPU decreased to £11.0 in 2009 from £12.0 in 2008. ARPU was £22.0 in 2009 down from £23.0 in 2008. This decrease in ARPU was caused by mobile termination rates regulation and competitive pressure.

**Financial position of the Company as at 31 December 2009**

The net assets of the Company as at 31 December 2009 were £10,015 million compared to £9,435 million at 31 December 2008. The increase in net assets is primarily a result of cash generated by the operations of the Company less cash used in investment activities.

**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 on page 2.

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 process in place, which is designed to identify, manage and mitigate business risk. The principal risks and uncertainties are as follows:

***The Company operates in highly regulated markets and action by the European Commission or Ofcom, the national regulator, could have an adverse effect on its business.***

Mobile operators must comply with an extensive range of regulatory requirements relating to their spectrum licences, the construction and operation of their networks and the provision and pricing of products and services.

New or more onerous regulatory obligations imposed by the European Commission or Ofcom could have a negative effect on the Company's profitability, particularly in respect of international roaming charges, call termination charges, spectrum allocation, tariffs, interconnection, voice over internet protocol or the provision of access to the Company's network for mobile virtual network operators and service providers.

**Business review****Risks and uncertainties (continued)*****The Company faces intense competition in most of its markets, which could result in decreases in current and potential customer numbers, revenues and profitability***

The Company faces significant competition in the UK market. Among others, the Company is competing increasingly with new mobile service providers, virtual network operators, resellers of mobile services and 'all you can eat' IP-based services.

To compete effectively with our competitors, the Company will need to successfully market our services and anticipate and respond to various competitive factors affecting the relevant markets, such as the introduction of new products and services by our competitors, pricing strategies adopted by our competitors, changes in consumer preferences and general economic, political and social conditions. If we are unable to compete effectively with our competitors, it could result in price reductions, lower revenues, under-utilization of our services, reduced operating margins and loss of market share.

***Public anxiety over alleged health risks associated with mobile phones could lead to reduced usage of the Company's services and products***

Public concern over the perceived health risks associated with radio wave emissions from mobile phones and transmitters could have a detrimental impact on the Company's business. Whilst there is currently no evidence to substantiate such concerns, claims have been brought against telecommunications companies alleging links between mobile phone usage and health problems and this could result in negative customer perception of the Company's brand, services or products, reduced usage, resistance to network rollout and potential litigation. In response, the Company continues to monitor world research and potential litigation, provide data support to long-term health studies and ensure compliance with International Commission on Non-Ionizing Radiation Protection exposure guidelines and good practice codes.

***Misuse of the Company's networks by third parties could result in brand damage and revenue loss***

The Company maintains a public network and must be alert to the possibility that isolated individuals could use the network inappropriately e.g. inappropriate content, conduct or contact with children, spamming or propagation of viruses.

As well as damaging reputation and revenue, such misuse has security implications which the Company takes extremely seriously. Measures to combat this include producing child protection information, introducing age verification and access controls and maintaining Board level representation at the UK Council for Child Internet Safety.

***Spectrum capacity may become a limiting factor***

The Company's operations may rely on our ability to acquire additional spectrum. The failure to obtain sufficient capacity or suitable spectrum for new technologies, as well as the price paid to obtain it, would have a material adverse impact on the quality and competitiveness of our services, our ability to provide new services and/or our financial conditions, results of operations and cash flow. Regulatory teams across the Company continue to monitor the local spectrum positions and are equipped to respond to regulatory consultations.

**Business review****Risks and uncertainties (continued)*****The Company's business could be adversely affected if our suppliers fail to provide necessary equipment and services on a timely basis***

The Company depends upon a small number of major suppliers for essential products and services, mainly network infrastructure and mobile handsets. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own shortages and business requirements. If these suppliers fail to deliver products and services on a timely basis, the Company's business and results of operations could be adversely affected. Similarly, interruptions in the supply of telecommunications equipment for our networks could impede network development and expansion, which in some cases could adversely affect our ability to satisfy our license requirements. In response to this risk, the Company conducts ongoing reviews and assessments of its key suppliers and local Business Continuity plans are in place should they become necessary.

***Adverse economic conditions could reduce the purchase of our products and services***

The Company's business is impacted by general economic conditions and other similar factors in the countries in which the Company operates. Current adverse economic scenarios or other market conditions may negatively affect the level of demand of existing and prospective customers, as the Company's services may not be deemed critical for these customers. Moreover, in the case of an economic downturn, the Company's corporate customers may reduce their investments in information and communications technology. However, the Company has important levers to manage its opex and capex in order to preserve the cash-flow generation, as a significant proportion of its operating expenses is variable and most of its capital expenditure is related to growth projects.

**Directors' report**

The Directors have pleasure in presenting to shareholders their report and the audited financial statements of Telefónica O2 UK Limited for the year ended 31 December 2009

**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 a GSM licence which it has held since July 1994 and a UMTS licence which it was awarded in April 2000

**Business review**

A review of the Company's operations, key performance indicators, principal business risks and likely future developments are reported in the Business Review on pages 2 to 5 and are incorporated by reference into this Directors' report

**Results and proposed dividend**

The Company's profit after taxation for the year ended 31 December 2009 was £580 million (2008 profit of £625 million)

The Directors do not recommend the payment of a final dividend for the year ended 31 December 2009 (2008 nil)

**Directors and secretary**

The Directors who held office during the year were as follows

Ronan Dunne  
Robert Harwood  
Kate Jarvis  
Ramon Ros  
Paul Whelan

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

**Directors' liability insurance and indemnity**

Telefonica 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 that includes a regular newsletter. The aim of all these channels is to ensure employees fully understand the Company's objectives and its operational and financial performance. In addition the Company conducts annual engagement surveys and maintains a constructive dialogue with unions, employee representative bodies and works councils.

The Company continues to be committed to the development of all people in the organisation and actively promotes 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. Full consideration and every effort is given to the retention of people who become disabled during employment. The Company is a member of the Employers' Forum on Disability.

## **Policy and practice on payment of creditors**

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 (2008 30 days), provided that the relevant invoice is presented in a timely fashion and is complete.

The Company had 49 calendar days' purchases outstanding as at 31 December 2009 (2008 44 days), based on the average daily amount invoiced by suppliers during the year.

## **Political and charitable contributions**

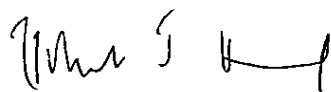
The Company made no political contributions during the year ended 31 December 2009 (2008 nil). Donations to charities during the year ended 31 December 2009 amounted to £749,727 (2008 £937,000), all of which went to charities in the United Kingdom.

## **Auditors**

Pursuant to a shareholders' resolution passed on 12 December 1997 the Company is not obliged to re-appoint its auditors annually.

So far as each Director is aware, there is no relevant audit information of which the Company's auditors are 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 auditors are aware of that information.

By Order of the Board



Robert Harwood  
for and on behalf of O2 Secretaries Limited  
Company Secretary  
24 September 2010

**Statement of Directors' responsibilities  
Year ended 31 December 2009**

The directors are responsible for preparing the Annual Report and the Company financial statements in accordance with applicable United Kingdom law and those International Financial Reporting Standards 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

- 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 the Company has complied with IFRSs, subject to any material departures disclosed and explained in the financial statements, and
- make judgements and estimates that are reasonable and prudent

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

**Statement of Directors' responsibilities  
Year ended 31 December 2009**

We have audited the financial statements of Telefónica O2 UK Limited for the year ended 31 December 2009 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 25. 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 Auditors**

As explained more fully in the Directors' Responsibilities Statement set out on page 8, 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 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.

**Opinion on the 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 2009 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  
Year ended 31 December 2009**

**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



Richard Addison (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
London

24 September 2010

**Telefónica O2 UK Limited**  
**Independent auditor's report**  
**Year ended 31 December 2009**

**Registered Number: 1743099**

	Note	2009 £m	2008 £m
<b>Revenue</b>		<b>5,784</b>	5,568
<b>Cost of sales</b>		<b>(3,454)</b>	(3,264)
<b>Gross profit</b>		<b>2,330</b>	2,304
Administrative expenses		(1,532)	(1,563)
<b>Operating profit</b>	2	<b>798</b>	741
Financial income	3	142	193
Financial expense	3	(116)	(55)
<b>Profit before taxation</b>		<b>824</b>	879
Taxation	4	(244)	(254)
<b>Profit for the year attributable to equity shareholders</b>		<b>580</b>	625
<b>Total comprehensive income for the year</b>		<b>580</b>	625

The accompanying notes are an integral part of these financial statements

There was no other recognised income or expense other than those shown above

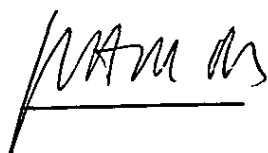
**Telefónica O2 UK Limited**  
**Statement of financial position**  
**As at 31 December 2009**

**Registered Number: 1743099**

		<b>2009</b>	<b>2008</b>
	<b>Note</b>	<b>£m</b>	<b>£m</b>
<b>Non-current assets</b>			
Property, plant and equipment	5	2,148	2,096
Intangible assets	7	1,541	1,676
Investments	8	4,205	4,205
		<b>7,894</b>	<b>7,977</b>
<b>Current assets</b>			
Inventories		60	60
Trade and other receivables	9	4,208	2,962
Other financial assets	10	193	286
Cash and cash equivalents	11	615	1,151
		<b>5,076</b>	<b>4,459</b>
<b>Current liabilities</b>			
Borrowings	12	(346)	(308)
Trade and other payables	13	(2,208)	(2,204)
Current tax liabilities		(139)	(152)
Provisions	14	-	(11)
		<b>(2,693)</b>	<b>(2,675)</b>
<b>Net current assets</b>		<b>2,383</b>	<b>1,784</b>
<b>Total assets less current liabilities</b>		<b>10,277</b>	<b>9,761</b>
<b>Non-current liabilities</b>			
Borrowings	12	(183)	(233)
Deferred tax liabilities	16	(16)	(49)
Provisions	14	(63)	(44)
		<b>(262)</b>	<b>(326)</b>
<b>Net assets</b>		<b>10,015</b>	<b>9,435</b>
<b>Equity</b>			
Ordinary share capital	17	10	10
Share premium		8,799	8,799
Retained earnings	18	1,206	626
<b>Total equity</b>		<b>10,015</b>	<b>9,435</b>

The accompanying notes are an integral part of these financial statements

These financial statements were approved by the Board of Directors on 24 September 2010 and were signed on its behalf by



Ramon Ros  
Director

**Statement of changes in equity**  
**Year ended 31 December 2009**

	Ordinary share capital Note 17 £m	Share premium £m	Retained earnings Note 18 £m	Total equity £m
<b>At 1 January 2008</b>	<b>10</b>	<b>8,799</b>	<b>-</b>	<b>8,809</b>
Total comprehensive income for the year	-	-	625	625
Share based payments	-	-	1	1
<b>At 31 December 2008</b>	<b>10</b>	<b>8,799</b>	<b>626</b>	<b>9,435</b>
Total comprehensive income for the year	-	-	580	580
<b>At 31 December 2009</b>	<b>10</b>	<b>8,799</b>	<b>1,206</b>	<b>10,015</b>

**Telefónica O2 UK Limited**  
**Statement of cash flows**  
**Year ended 31 December 2009**

**Registered Number: 1743099**

	Note	2009 £m	2008 £m
<b>Operating profit</b>		<b>798</b>	<b>741</b>
Depreciation and amortisation charges		598	614
Increase in inventories		-	(1)
Decrease/(Increase) in trade and other receivables		33	(72)
(Decrease)/Increase in trade and other payables		(123)	18
Increase/(Decrease) in provisions		8	(15)
Corporation tax paid		(219)	(142)
Other non cash transactions		-	2
<b>Net cash flow from operating activities</b>		<b>1,095</b>	<b>1,145</b>
 Purchase of property, plant and equipment		 (393)	 (409)
Purchase of intangible assets		(76)	(48)
Sale of property, plant and equipment		(3)	-
<b>Net cashflow used in investing activities</b>		<b>(472)</b>	<b>(457)</b>
 Repayment of borrowings including finance leases		 (14)	 (7)
Increase in borrowings		5	10
Increase in loans receivable		(1,200)	(1,038)
Interest received		119	41
Dividends received		-	1,040
Interest paid		(113)	-
<b>Net cashflow used in financing activities</b>		<b>(1,203)</b>	<b>46</b>
 <b>Net (decrease)/increase in cash and cash equivalents</b>		 <b>(580)</b>	 <b>734</b>
<b>Cash and cash equivalents at start of period</b>		<b>1,133</b>	<b>399</b>
<b>Cash and cash equivalents at end of period</b>	11	<b>553</b>	<b>1,133</b>

The accompanying notes are an integral part of these 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, its intermediate parent, for the year ended 31 December 2009.

**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.

**1. Accounting policies (continued)**

**Intangible assets**

***Licences***

Licence fees paid to Governments, 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 12 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, are recognised based upon usage.

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

**1. Accounting policies (continued)**

**Revenue (continued)**

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.

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.

**Roll-over minutes**

Subscription fee revenue is deferred to the extent it relates to unused minutes received by customers in a monthly bundle ("roll-over" minutes) 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, intangible assets are capitalised and amortised over their useful economic lives.

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

**Employee benefits*****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 O2 Pension Plan ("O2 PP"), a scheme sponsored by Telefónica Europe plc that provides benefits for the majority of UK employees in the Telefónica Europe plc Group. The O2 PP has both defined benefit and defined contribution sections. The defined benefit sections are closed to new entrants. The assets of the schemes are held independently of the Company's finances.

In its capacity as a participating employer of the defined contribution section of the O2 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 O2 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 O2 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 O2 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 2009.

**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.

**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 conditions is included in the fair value at the date of grant and is recognised as an expense irrespective of whether the market 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 remeasures the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

**Cash and cash equivalents**

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.

**Inventories**

Inventories comprise mainly handsets and are stated at the lower of cost and net realisable value (which reflects the value to the business of the handset in the hands of the subscriber) 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.

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

**Borrowing costs**

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.

**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 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.

**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.

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

**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

**1. Accounting policies (continued)**

**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.

**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.

<b>Standards and amendments</b>		<b>Mandatory application annual periods beginning on or after</b>
IFRS 9	<i>Financial instruments</i>	1 January 2013
IFRS 3 revised	<i>Business Combinations</i>	1 July 2009
Amendment to IAS 27	<i>Consolidated and Separate Financial Statements</i>	1 July 2009
<i>Improvements to IFRS (April 2009)</i>		1 January 2010 (*)
IAS 24 revised	<i>Related parties</i>	1 January 2011
Amendment to IAS 39	<i>Eligible hedge items</i>	1 July 2009
Amendment to IFRS 2	<i>Share based payments</i>	1 January 2010
Amendment to IFRS 1	<i>Additional exemptions in the initial adoption of IFRS</i>	1 January 2010
Amendment to IAS 32	<i>Classification of issues of rights to equity instruments</i>	1 February 2010
(*)The amendments to IFRS 2, IAS 38 (relating to intangible assets acquired in business combinations) IFRIC 9 and IFRIC 16 are effective for all fiscal years beginning 1 July 2009. There is no mandatory application date for the additional guidance to the appendix of IAS 18 on the determination of agent / principal because this appendix is not part of the standard.		
<b>Interpretations</b>		<b>Mandatory application annual periods beginning on or after</b>
IFRIC 17	<i>Distributions of Non-cash Assets to Owners</i>	1 July 2009
IFRIC 19	<i>Extinguishing financial liabilities with equity instruments</i>	1 July 2010
Amendment to IFRIC 14	<i>The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction</i>	1 January 2011

The Company does not expect that the first-time adoption of these interpretations will have a significant impact on its financial statements.



**1. Accounting policies (continued)**

**Fair value estimation**

The fair value of trade and other receivables, 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 other financial assets for disclosure purposes has been calculated using market values provided by third parties where available, or where not available, based on discounted cash flows. The fair value of other financial assets is £193 million at 31 December 2009 (31 December 2008 £286 million). 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 2009 and 31 December 2008.

**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. 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 2009 by approximately £113 million (2008 £113 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 are 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 an impairment and may have a material adverse impact on the operating results and financial condition of the Company.

**1. Accounting policies (continued)**

***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 series 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.

***Provisions***

Provisions are recognised when an event in the past gives rise to a current obligation for the Company, the settlement of which requires an outflow of resources that is considered probable and can be estimated reliably. 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

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
Depreciation of property, plant and equipment (note 5)	<b>377</b>	381
Amortisation of intangible assets (note 7)	<b>221</b>	234
Staff costs (note 23)	<b>448</b>	429
Auditors' remuneration		
Audit	<b>0.7</b>	0.7
Non-audit	<b>0.7</b>	0.5
Inventories		
Cost of inventories recognised as an expense (included in cost of sales)	<b>970</b>	971
Write downs of inventories recognised in the year	<b>2</b>	6
Operating lease rentals payable	<b>141</b>	141
Restructuring costs	<b>25</b>	-
Provision for doubtful debts	<b>141</b>	112

**3. Net financial income**

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
<b>Financial income</b>		
Interest income on cash, cash equivalents and other financial assets	<b>67</b>	51
Dividend received from subsidiaries	<b>-</b>	39
Interest income from other group companies	<b>75</b>	103
<b>Total financial income</b>	<b>142</b>	193
<b>Financial expense</b>		
Interest payable to other group companies	<b>(7)</b>	(13)
Other financial costs	<b>(109)</b>	(42)
<b>Total financial expense</b>	<b>(116)</b>	(55)
<b>Net financial income</b>	<b>26</b>	138

**4. Taxation**

**Analysis of charge in period**

	2009 £m	2008 £m
Current tax - current year movement	290	271
Current tax - adjustment in respect of prior periods	(14)	2
Deferred tax - current year movement (note 16)	(32)	(25)
Deferred tax - adjustment in respect of prior periods	-	6
<b>Taxation</b>	<b>244</b>	<b>254</b>

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

	2009 £m	2008 £m
<b>Profit before taxation</b>	<b>824</b>	<b>879</b>
<b>Profit before taxation multiplied by rate of corporation tax in the UK of 28% (2008: 28.5%)</b>	<b>231</b>	<b>250</b>
Effects of:		
Expenses not deductible for tax purposes	23	9
Income not taxable	-	(11)
UK – UK transfer pricing adjustment	(1)	(2)
Adjustments in respect of prior periods	(14)	8
Other	5	-
<b>Total taxation</b>	<b>244</b>	<b>254</b>

With effect from 1 April 2008 the standard rate of UK Corporation tax reduced from 30% to 28%. As a result the tax charge for the year ended 31 December 2008 has been calculated at the weighted average rate of 28.5%.

The following changes were announced in the UK Budget on 22 June 2010: (i) the full rate of corporation tax will reduce to 27% with effect from 1 April 2011, and will decrease by a further 1% each 1 April thereafter until reaching 24% with effect from 1 April 2014; (ii) the rate of annual writing down allowances on qualifying plant and machinery will reduce by 2%, to 18% for the general capital allowance pool and to 8% for the integral features pool, with effect from 1 April 2012. As this legislation was not substantively enacted by the balance sheet date, the figures within these accounts are calculated in accordance with the existing rates, 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
<b>Cost</b>				
At 1 January 2008	403	3,980	279	4,662
Additions	-	(5)	492	487
Reclassifications <sup>1</sup>	41	382	(434)	(11)
Disposals	(4)	(73)	-	(77)
At 31 December 2008	440	4,284	337	5,061
Additions	-	-	426	426
Reclassifications <sup>1</sup>	59	321	(377)	3
Disposals	(12)	(150)	-	(162)
<b>At 31 December 2009</b>	<b>487</b>	<b>4,455</b>	<b>386</b>	<b>5,328</b>
<b>Depreciation</b>				
At 1 January 2008	218	2,413	-	2,631
Charge for the year	54	327	-	381
Reclassifications <sup>1</sup>	-	30	-	30
Disposals	(4)	(73)	-	(77)
At 31 December 2008	268	2,697	-	2,965
Charge for the year	43	334	-	377
Disposals	(12)	(150)	-	(162)
<b>At 31 December 2009</b>	<b>299</b>	<b>2,881</b>	<b>-</b>	<b>3,180</b>
<b>Net book value</b>				
<b>At 31 December 2009</b>	<b>188</b>	<b>1,574</b>	<b>386</b>	<b>2,148</b>
At 31 December 2008	172	1,587	337	2,096

<sup>1</sup>Reclassifications include adjustment to the allocation between tangible asset and intangible asset classifications

Included within plant and equipment are finance leased assets with a net book value of £185 million (2008 £177 million)

**6. Goodwill**

	Goodwill £m
<b>Cost</b>	
At 1 January 2008, 31 December 2008 and 31 December 2009	196
<b>Amortisation and impairment</b>	
At 1 January 2008, 31 December 2008 and 31 December 2009	196
<b>Net book value</b>	
At 31 December 2009	-
At 31 December 2008	-

**7. Intangible assets**

	<b>UMTS licence £m</b>	<b>Software £m</b>	<b>Assets in the course of construction £m</b>	<b>Total £m</b>
<b>Cost</b>				
At 1 January 2008	4,030	989	19	5,038
Additions	-	-	48	48
Reclassifications <sup>1</sup>	-	74	(46)	28
Disposals	-	(26)	-	(26)
At 31 December 2008	4,030	1,037	21	5,088
Additions	-	-	76	76
Reclassifications <sup>1</sup>	-	77	(73)	4
Disposals	-	(131)	-	(131)
<b>At 31 December 2009</b>	<b>4,030</b>	<b>983</b>	<b>24</b>	<b>5,037</b>
<b>Amortisation</b>				
At 1 January 2008	2,438	788	-	3,226
Charge for the period	114	120	-	234
Reclassifications <sup>1</sup>	-	(22)	-	(22)
Disposals	-	(26)	-	(26)
At 31 December 2008	2,552	860	-	3,412
Charge for the year	114	107	-	221
Reclassifications <sup>1</sup>	-	(6)	-	(6)
Disposals	-	(131)	-	(131)
<b>At 31 December 2009</b>	<b>2,666</b>	<b>830</b>	<b>-</b>	<b>3,496</b>
<b>Net book value</b>				
<b>At 31 December 2009</b>	<b>1,364</b>	<b>153</b>	<b>24</b>	<b>1,541</b>
At 31 December 2008	1,478	177	21	1,676

<sup>1</sup>Reclassifications include adjustment to the allocation between tangible asset and intangible asset classifications

Included within software are finance leased assets with a net book value of £31 million (2008 £35 million)

The UMTS licence is an individual asset permitting the Company to operate its "3G" network. The remaining life of this asset is 12 years.

**8. Investments**

	<b>Shares in subsidiary undertakings £m</b>
<b>Cost</b>	
At 1 January 2008	5,206
Return on capital	(1,001)
<b>At 31 December 2008 and 31 December 2009</b>	<b>4,205</b>
<b>Net book value</b>	
<b>At 31 December 2008 and 31 December 2009</b>	<b>4,205</b>

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

On date February 2008 the Company received an amount of £1,040 million from O2 Willow Limited. This is to be regarded as a recovery of the investment and therefore reduced the cost of the investment to nil. The £39 million surplus over the cost of the investment is recognised as financial income (note 3).

A list of principal subsidiary undertakings is given below

<b>Name</b>	<b>Country of incorporation and operation</b>	<b>Activity</b>	<b>Portion of ordinary shares held %</b>
Be Un Limited	England & Wales	Trading	100% ordinary
giffgaff Limited	England & Wales	Trading	100% ordinary
O2 Third Generation <sup>(1)</sup>	England & Wales	Non trading	76.5% ordinary

(1) Held through an intermediate holding company

**9. Trade and other receivables**

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
Trade receivables	<b>534</b>	<b>603</b>
Prepayments	<b>172</b>	<b>82</b>
Accrued income	<b>147</b>	<b>167</b>
Amounts owed by other group companies	<b>3,355</b>	<b>2,110</b>
	<b>4,208</b>	<b>2,962</b>

Amounts owed by other group companies are unsecured, interest free and repayable on demand with the exception of two amounts. The first is an amount of £759 million (2008 £746 million) that bears interest at LIBOR plus 42 basis points. The second is an amount of £1,139 million (2008 £1,038) that bears interest at LIBOR plus 85 basis points.

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

		<b>Neither impaired or overdue on the reporting date</b>	<b>Not impaired but overdue on the reporting date</b>			
	<b>Carrying Amount £m</b>	<b>£m</b>	<b>Less than 90 days £m</b>	<b>Between 90 to 180 days £m</b>	<b>Between 180 to 360 days £m</b>	<b>Over 360 days £m</b>
Trade receivables as at 31 December 2008	<b>603</b>	<b>545</b>	<b>45</b>	<b>6</b>	<b>4</b>	<b>3</b>
Trade receivables as at 31 December 2009	<b>534</b>	<b>481</b>	<b>19</b>	<b>8</b>	<b>7</b>	<b>19</b>

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. Of the balance due in greater than 90 days most is expected to be recoverable in full from HMRC.

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:

	<b>£m</b>
Bad debt provision at 1 January 2008	<b>184</b>
Additions	<b>112</b>
Bad debt written off	<b>(78)</b>
Bad debt provision at 31 December 2008	<b>218</b>
Additions	<b>141</b>
Bad debt written off	<b>(116)</b>
<b>Bad debt provision at 31 December 2009</b>	<b>243</b>



**10. Other financial assets**

	2009 £m	2008 £m
Hire purchase contract deposits	189	286
Other financial assets	4	-

Hire purchase contract deposits of £189 million (2008 £286 million) are held in trust to meet the Company's obligations under finance leases disclosed in note 12. As a result of credit downgrades during the year on the deposits held in trust, an impairment charge £41m (USD 66m) was recognised against part of these assets. The impairment charge represents the best estimate of the risk to future cashflows, and is included in other financial costs in note 3.

Other financial assets include held to maturity investments relating to hire purchase contract deposits that are no longer required to support the leasing structure (2008 nil).

**11. Cash and cash equivalents**

	2009 £m	2008 £m
Short term deposits	615	1,151
<b>Cash and cash equivalents</b>	<b>615</b>	<b>1,151</b>
Bank overdraft included in borrowings (note 12)	(62)	(18)
<b>Cash and cash equivalents included in cash flow statement</b>	<b>553</b>	<b>1,133</b>

**12. Borrowings**

	2009 £m	2008 £m
<b><i>Current unsecured borrowings</i></b>		
Bank overdrafts	62	18
Amounts owed to joint ventures	10	10
Amounts owed to other group companies	228	219
	300	247
Obligations under finance leases	46	61
	346	308
<b><i>Non-current unsecured borrowings</i></b>		
Obligations under finance leases	183	233

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

**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
	2009	2009	2009	2008	2008	2008
	£m	£m	£m	£m	£m	£m
Within one year	45	10	35	76	15	61
Between one and five years	220	26	194	174	28	146
After five years	-	-	-	94	7	87
	<b>265</b>	<b>36</b>	<b>229</b>	<b>344</b>	<b>50</b>	<b>294</b>

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 has deposited sufficient funds with a trust company to meet the future hire purchase obligations. The deposit account is included in current asset investments. 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 which has provided a counter indemnity to BT Group Plc for this guarantee.

The Company has also entered into an agreement with IBM in respect of certain computer equipment, which is included in the figures above.

**13. Trade and other payables**

	2009 £m	2008 £m
Trade payables	216	185
Amounts owed to other group companies	484	462
Other taxation and social security	158	117
Other payables	65	65
Accrued expenses	1,060	1,157
Deferred income	225	218
	<b>2,208</b>	<b>2,204</b>

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

**14. Provisions**

	<b>Restructuring £m</b>	<b>Other provisions £m</b>	<b>2009 Total £m</b>	<b>Restructuring £m</b>	<b>Other provisions £m</b>	<b>2008 Total £m</b>
Current	-	-	-	10	1	11
Non-current	4	59	63	-	44	44
	<b>4</b>	<b>59</b>	<b>63</b>	<b>10</b>	<b>45</b>	<b>55</b>

	<b>Restructuring £m</b>	<b>Other provisions £m</b>	<b>Total £m</b>
At 31 December 2008	10	45	55
Charge for the period	29	18	47
Utilised in the period	(35)	(6)	(41)
Unwinding of discounts	-	2	2
<b>At 31 December 2009</b>	<b>4</b>	<b>59</b>	<b>63</b>

**Restructuring provision**

Provision has been made in full for the costs in regards to planned business restructuring programmes. The provision has been recognised based on estimated total costs of the restructure. The payment dates of these restructuring costs are uncertain but are currently anticipated to be within one year.

**Other provisions**

Other provisions include onerous lease contracts and future estimated site restoration costs. The payment dates are uncertain but are currently anticipated to be over the next 30 years.

**15 Pension costs**

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

	<b>2009 £m</b>	<b>2008 £m</b>
Pension costs	<b>36</b>	<b>29</b>

The actuarial valuation of the O2 PP as at 30 September 2008 has been updated to 31 December 2008 and 31 December 2009 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.

**15 Pension costs (continued)**

The main assumptions adopted for the O2 PP under IAS 19 are as follows

	Year ended 31 December 2009	Year ended 31 December 2008
	%	%
Nominal rate of increase in salaries	4.6	4.0
Nominal rate of increase of pensions in payment		
– Pension increases with inflation	3.5 – 3.6	3.0
– Pension increases with inflation limited to 5 per cent p.a.	3.5	2.9
Discount rate	5.8 – 6.0	6.6
Inflation assumption	3.6	3.0
Expected long-term return for		
– Equities	8.0	7.4
– UK Government bonds	4.2 – 4.4	3.6
– Other bonds	5.3	6.6
– Hedge funds	7.4	6.6
– Active currency	8.4	7.6
– Real estate	6.2	5.7
– Other	4.4	3.6

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. These tables are considered to be the most prudent available.

Movements in the present value of the O2 PP's defined benefit obligations in the current and preceding period were as follows

	31 December 2009	31 December 2008
	£m	£m
At start of year	517	637
Total current service cost	19	29
Interest cost	35	37
Actuarial (gains)	203	(180)
Settlement/(curtailment gain)	5	4
Benefits paid	(14)	(10)
<b>At end of year</b>	<b>765</b>	<b>517</b>

Movements in fair value of the O2 PP's scheme assets in the current and preceding period were as follows

	31 December 2009	31 December 2008
	£m	£m
At start of year	523	680
Expected return on scheme assets	37	51
Actuarial gains/(losses)	49	(253)
Employer contributions	29	54
Contributions from scheme members	-	1
Benefits paid	(13)	(10)
<b>At end of year</b>	<b>625</b>	<b>523</b>

**15. Pension costs (continued)**

The amount included in the consolidated statement of financial position of Telefónica Europe plc arising from its obligations in respect of the defined benefit sections of the O2 PP, as well as the analysis of the scheme's assets, is as follows

	31 December 2009 £m	31 December 2008 £m
Fair value of assets comprises		
– Equities	250	305
– UK Government bonds	27	25
– Other bonds	125	24
– Hedge funds	124	111
– Real estate	39	36
– Other	60	22
Fair value of assets	625	523
Present value of defined benefit obligations	(765)	(517)
<b>Net (deficit)/asset recognised in consolidated statement of financial position of Telefónica Europe plc</b>	<b>(140)</b>	<b>6</b>

**16 Deferred taxation**

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 28% (2008 28%)

The movement on the deferred tax account is as shown below

	£m
At 1 January 2008	(69)
Prior year charge to statement of comprehensive income	(6)
Current year credit to statement of comprehensive income	25
Credit to equity	1
At 31 December 2008	(49)
Prior year charge to statement of comprehensive income	-
Current year credit to statement of comprehensive income	32
Credit to equity	1
<b>At 31 December 2009</b>	<b>(16)</b>

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

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

**16. Deferred taxation (continued)**

<b>Deferred tax liabilities</b>	<b>Unremitted earnings £m</b>	<b>Accelerated tax depreciation £m</b>	<b>Total £m</b>
At 1 January 2008	(120)	-	(120)
Credit to the statement of comprehensive income	51	-	51
At 31 December 2008	(69)	-	(69)
Credit to the statement of comprehensive income	69	-	69
Transfer from assets	-	(23)	(23)
<b>At 31 December 2009</b>	<b>-</b>	<b>(23)</b>	<b>(23)</b>

<b>Deferred tax assets</b>	<b>Accelerated tax depreciation £m</b>	<b>Employee share base payments £m</b>	<b>Other £m</b>	<b>Total £m</b>
At 1 January 2008	51	-	-	51
Charge to statement of comprehensive income	(36)	3	1	(32)
Credit to equity	-	1	-	1
At 31 December 2008	15	4	1	20
Charge to statement of comprehensive income	(38)	-	1	(37)
Credit to equity	-	1	-	1
Transfer to liabilities	23	-	-	23
<b>At 31 December 2009</b>	<b>-</b>	<b>5</b>	<b>2</b>	<b>7</b>

<b>Net deferred tax liability</b>	<b>£m</b>
<b>At 31 December 2009</b>	<b>(16)</b>
At 31 December 2008	(49)

**17. Ordinary share capital**

	<b>31 December 2009</b>		<b>31 December 2008</b>	
	<b>Number of shares</b>	<b>£</b>	<b>Number of shares</b>	<b>£</b>
<b>Authorised</b>				
Ordinary A shares of 20 pence each	10,010,200	2,002,040	10,010,200	2,002,040
Ordinary B shares of 20 pence each	40,010,800	8,002,160	40,010,800	8,002,160
<b>Total shares</b>	<b>50,021,000</b>	<b>10,004,200</b>	<b>50,021,000</b>	<b>10,004,200</b>
<b>Called up, allotted and fully paid</b>				
Ordinary A shares of 20 pence each				
<b>At end of year</b>	<b>10,001,000</b>	<b>2,000,200</b>	<b>10,001,000</b>	<b>2,000,200</b>
Ordinary B shares of 20 pence each				
<b>At end of year</b>	<b>40,004,000</b>	<b>8,000,800</b>	<b>40,004,000</b>	<b>8,000,800</b>
<b>Total shares</b>	<b>50,005,000</b>	<b>10,001,000</b>	<b>50,005,000</b>	<b>10,001,000</b>

**17. Share capital (continued)**

The Company has two classes of issued and authorised 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 and the distributable reserves of the Company are £2,645 million (2008: 2,185 million) as analysed below.

	2009 £m	2008 £m
Retained Earnings	1,206	626
Provision against intangible fixed asset	2,068	2,068
Realisation of provision against intangible fixed assets	(629)	(509)
Distributable reserves	2,645	2,185

**19. Financial commitments and contingent liabilities**

**Operating lease commitments**

At 31 December 2009 the Company was committed to making the following payments in respect of operating leases:

	2009 £m	2008 £m
<b>Lease payments</b>		
Within one year	122	118
Between one and five years	286	297
After five years	158	179
	566	594

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 2009 are £40 million (2008: £47 million).

**19 Financial commitments and contingent liabilities (continued)**

**Other commitments**

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
Contracts placed for capital expenditure not provided in the accounts – Property, plant and equipment	<b>178</b>	<b>183</b>
<b>Total other commitments</b>	<b>178</b>	<b>183</b>

**20. Related party disclosures**

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

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
<b>Revenue</b>		
Other group undertakings	<b>72</b>	<b>57</b>
<b>Purchases</b>		
Other group undertakings	<b>(136)</b>	<b>(107)</b>
<b>Total net transactions</b>	<b>(64)</b>	<b>(50)</b>

All related party transactions relate to regular trading activities of the Company on an arms length basis

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

Related party transactions with Directors and key management are detailed in note 22

**21. Auditors' remuneration**

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

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
<b>Audit services</b>		
UK statutory audit fees	<b>0.7</b>	<b>0.7</b>
Other assurance services	<b>0.7</b>	<b>0.5</b>
<b>Total audit and audit-related fees</b>	<b>1.4</b>	<b>1.2</b>

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

**22. Key management and Directors' compensation**

The compensation of key management for the year ended 31 December 2009 was as follows

	<b>2009</b>	<b>2008</b>
	<b>£000</b>	<b>£000</b>
Salaries and short-term employee benefits	<b>1,837</b>	<b>1,541</b>
Post-employment benefits	<b>33</b>	<b>31</b>
Share based payments	<b>559</b>	<b>171</b>
<b>Total key management compensation</b>	<b>2,429</b>	<b>1,743</b>

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



**22. Key management and Directors' compensation (continued)**

The emoluments of the Directors for the year ended 31 December 2009 was as follows

	<b>2009</b>	<b>2008</b>
	<b>£000</b>	<b>£000</b>
Aggregate emoluments in respect of qualifying services	<b>1,837</b>	1,541
Aggregate amount of company contributions paid to a pension scheme	<b>33</b>	31
	<b>1,870</b>	1,572

During the year, two Directors (year ended 31 December 2008 nil) accrued retirement benefits under a defined benefit pension plan. No Directors exercised share options in the year (year ended 31 December 2008 nil) and four Directors received Telefonica S A shares in respect of qualifying service under long-term incentive plans (year ended 31 December 2008 nil).

In respect of the highest paid Director

	<b>2009</b>	<b>2008</b>
	<b>£000</b>	<b>£000</b>
Total amount of emoluments and amounts (excluding shares) receivable under long-term incentive schemes	<b>915</b>	1,196

The highest paid Director included received shares under the Telefónica Performance Share Plan but did not exercise share options during the reported period. The highest paid Director is a member of the O2 defined contribution pension plan.

**23. Employees**

	<b>2009</b>	<b>2008</b>
	<b>No</b>	<b>No</b>
Average number of full time employee equivalents (including executive Directors)		
Technology	<b>1,623</b>	1,689
Customer operations	<b>7,104</b>	7,684
Administration	<b>2,093</b>	2,012
<b>Total employees</b>	<b>10,820</b>	11,385

The benefits expense incurred in respect of these employees were

	<b>2009</b>	<b>2008</b>
	<b>£m</b>	<b>£m</b>
Wages and salaries	<b>366</b>	358
Social security costs	<b>38</b>	37
Pension costs (note 15)	<b>36</b>	29
Share based payments (note 24)	<b>8</b>	5
<b>Total employee benefits expense</b>	<b>448</b>	429

The Company's employees and Directors participated in a number of employee incentive share schemes operated by Telefónica Europe plc (see note 24 for further details).

## **24. Share based payments**

Two employee incentive schemes based on the shares of Telefónica, S A are currently in operation

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 vesting 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 2009 was as follows

	2009 £m	2008 £m
Equity settled share based payments	2	1
Cash settled share based payments	6	5
<b>Total share based payments</b>	<b>8</b>	<b>6</b>

The amounts recognised in the Company's statement of comprehensive income for Employers' National Insurance on share based payments for the year ended 31 December 2009 was £1m ( 2008 £1m)

The liability recognised in the statement of financial position for share based payments at 31 December 2009 totalled nil (2008 £nil) The total intrinsic value of share based payment liabilities that had vested at 31 December 2009 was nil (2008 £nil)

### **Share plans**

The share plans operated by the Company during the year ended 31 December 2009 are

#### ***Telefónica Performance Share Plan***

The Telefónica Performance Share Plan was approved at the Telefonica, 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 has 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

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

<b>TSR ranking</b>	<b>% shares vest</b>
Below median	0%
Median	30%
Upper quartile	100%

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

**24. Share based payments (continued)**

The number of shares Telefonica, S A granted to employees of the company in the year ended 31 December 2009 is 455,197 (2008 378,171)

As this plan will be settled by the physical delivery of Telefónica, S A shares to employees, the statement of comprehensive income charge for the year ended 31 December 2009 has been recognised against equity

The fair value of the rights granted to the participants at the 2009 grant date was €8.41 per share (2008 grant €8.39). 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 2009 the first tranche of share awards granted in 2006 vested. At the date of vesting the weighted average share price was €17.48. The total number of shares which vested were 614,769.

**O2 Performance Cash Plan**

This plan mirrors the conditions of the Telefónica Performance 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 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:

<b>TSR ranking</b>	<b>% Shares vest</b>
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 183,156 (2008 219,579).

The fair value of the rights granted to the participants in the 2008 scheme was €19.55 per share at 31 December 2009 (2008 €15.85). 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 2009 the first tranche of notional share awards granted in 2006 vested. At the date of vesting the weighted average share price at vesting was €17.48. The total number of notional shares vesting in the tranche was 545,747.

In 2009 the total charge to equity for the unvested share based payments amounted to £2 million, there was also a reversal of £2 million arising from the 2006 share grant which vested in the year. The

**Notes to the financial statements**

overall impact on equity in 2009 arising from share based payments was £nil (2008 £1 million)

**25. Parent company and controlling party**

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

At the end of the period 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