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## Board of Directors' Report on Business Activity



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### Telefónica O2 Czech Republic Group

#### Overview of the Group and the main changes in 2010

The group of Telefónica O2 Czech Republic (hereinafter Telefónica O2 Group) comprises Telefónica O2 Czech Republic, a.s. (hereinafter Telefónica O2 or Company) and several other subsidiaries. In 2010, the Group's services were provided mostly on the territory of the Czech Republic and in Slovakia. Through a wholly-owned subsidiary Telefónica O2 Slovakia, the Group has been operating in Slovakia since 2007. In 2007, Telefónica O2 acquired 100% of DELTAX Systems a.s. (hereinafter DELTAX Systems). During 2009, DELTAX Systems liquidated as a legal entity and merged in the successor company Telefónica O2 Business Solutions, spol. s r.o. (formerly Telefónica O2 Services, spol. s r.o.). In line with its strategy to add new services to the traditional voice and data, Telefónica O2 partnered with other companies and started MOPET CZ a.s., a venture to launch mobile payment services. Telefónica O2 holds a 14% share of the new company.

Telefónica O2 is the largest integrated telecommunications operator and offers a comprehensive range of both fixed and mobile voice, data and internet services in the Czech Republic. In September 2006 it also started offering a digital television service (O2 TV), and in 2007 it significantly expanded its IT and ICT operations (comprehensive business communications solutions). It also offers its network infrastructure for lease by other operators of public and private networks and services.

The retail business in the Czech Republic focused on two main customer segments – business and consumers. The business segment included medium business and corporate customers, and public and government institutions. Telefónica O2 also provides services on wholesale basis to other public telecommunications network providers and to providers of public telecommunications services both in the Czech Republic and abroad.

As at 31 December 2010, Telefónica O2 Group comprised the following subsidiary companies and affiliates:

<b>Companies incorporated in the Czech Republic</b>					
<b>Company</b>	<b>Registered address</b>	<b>Area of business</b>	<b>Company identification number</b>	<b>Registered capital</b>	<b>Company's share in the registered capital of the subsidiary expressed in %</b>
Telefónica O2 Business Solutions, spol. s r.o.	Praha 4–Michle, Za Brumlovkou 266/2, postal code 140 00	Data services and consultancy in the field of telecommunications, IT/ICT services	45797111	CZK 10,000,000	100 %
CZECH TELECOM Austria GmbH	c/o Vienna CityTax Steuerberater GmbH, Wagramer St, Sien, postal code 1220 Austria	Public service of lease of lines in the fixed telecommunication network	FN 229578s	EUR 35,000	100 %
CZECH TELECOM Germany GmbH	Kennedyallee 97a, Frankfurt am Main, postal code 60596 Germany	Lease of telecommunication lines	HRB 51503	EUR 25,000	100 %
Telefónica O2 Slovakia, s.r.o.	Einsteinova 24 Bratislava postal code 851 01 Slovakia	Operation of a public telecommunication network; public service of lease of lines	35848863	EUR 240,000,000	100 %
<b>Affiliate companies</b>					
AUGUSTUS spol. s r.o.	Praha 10–Vinohrady, Na Zájezdu 1935/5, postal code 101 00	Consultancy and agency in the field of non-telecommunications	49356160	CZK 166,000	39.76%
První certifikační autorita, a.s.	Praha 9–Libeň, Podvinný mlýn 2178/6, postal code 190 00	Certification services in the area of digital signature	26439395	CZK 20,000,000	23.25%
MOPET CZ a.s.	Praha 4–Nusle, Hvězdova 1716/2b, postal code 140 78	Real-time mobile payment services	24759023	CZK 91,000,000	14.29%

In June 2009, the Board of Directors of Telefónica O2 approved an increase of the registered capital of Telefónica O2 Slovakia by way of a pecuniary contribution of EUR 150,209,121.69. The company's registered capital of EUR 49,790,878.31 thus increased to EUR 200,000,000.00. The increase became effective on 19 August 2009.

In May 2010, the Board of Directors of Telefónica O2 approved an increase of the registered capital of Telefónica O2 Slovakia by way of a pecuniary contribution of EUR 40,000,000.00. The company's registered capital of EUR 200,000,000.00 thus increased to EUR 240,000,000.00 EUR. The increase became effective 6 May 2010.

### Restructuring programme

In line with its long-term strategy focused on improving its operating efficiency, in 2010 Telefónica O2 implemented an ambitious restructuring programme; its aim was to implement a more effective organisational structure with fewer levels of organisation. The Company also focused on improving the efficiency of the processes through the continuing integration of fixed and mobile platforms and systems, with a particular attention on network operation; the outsourcing option was considered for some activities. The programme led to optimisation of the network operation, where some activities associated with certain technologies and locations were outsourced to a strategic partner, together with maintenance and repair of supporting technology. More than 1,000 employees were let go in connection with the restructuring, of which approximately 50% as a direct result of outsourcing in the area of network operation.

Number of employees of the Telefónica O2 Group by region:

	As at 31 December 2009	As at 31 December 2010
Telefónica O2 Czech Republic, a.s.	8,011	6,936
Telefónica O2 Business Solutions, spol. s r.o.	272	178
<b>Employees in the Czech Republic</b>	<b>8,283</b>	<b>7,114</b>
Telefónica O2 Slovakia, s.r.o.	404	408
<b>Employees in Slovakia</b>	<b>404</b>	<b>408</b>
<b>Group employees – total</b>	<b>8,687</b>	<b>7,522</b>

### Projects to improve operating efficiency and customer experience

In addition to the above-mentioned restructuring programme, the Company continued to implement other projects, which sought to improve operating efficiency at the same time as raising the quality of service and, by extension, enhancing customer experience. Telefónica O2, as technology innovator, embarked on a project to develop tools and processes that would allow bringing all key instruments and customer relationships online. As part of the project of internal efficiency improvement and in connection with the headcount reduction, the area of leased properties was reduced. Reconfiguration of power supply schemes in offices, call centres and at selected base stations has led to significant savings on electricity consumption. The Company's fleet was downsized by 25%, which has led to fuel savings. Likewise, the process of customer documentation flow was improved through the implementation of a central point of entry.

Projects aimed at the building of customer trust and satisfaction started to deliver their first tangible results already in 2010. Quality improvements in service delivery, sales in brand stores and the Company's drive for active, credible and transparent communication with customers have led to a reduction in the number of complaints and claims by 25–30%, depending on the segment. Improvements could be seen also in call centres – the rate of their utilisation increased, with the number of calls answered within twenty seconds hovering steadily around 85% at the end of the year. The average number of calls per customer was down approximately 15% and the average duration of call shortened by approximately 8%. An ongoing independent customer satisfaction survey of call centres revealed that, during 2010, the level of customer satisfaction improved across all segments; approximately 64% of all requests registered by call centres were resolved during the first call.

Telefónica O2, pursuing the strategy to retain its leadership in the mobile internet market, significantly expanded the coverage of its high-speed mobile networks (EDGE and 3G), without compromising on the quality of service, and boosted the transmission speeds. The Company covered 72 towns and their greater areas with signal, and improved the coverage of ten other towns. At the end of 2010, 84 towns, which represent 42.5% of the population, were covered with the service. The average downlink speed reached 1.8 MB/s; in locations where new network had been built, the average speed could be as high as 4 MB/s. The technology coverage was up 81 percentage points and reached 98% of the population, which brought it to the level of the other two operators. The expansion of the mobile broadband network went hand in hand with a new portfolio of mobile internet tariffs for both pre-paid and contract customers. This in turn reflected in higher level of customer satisfaction across all customer segments.

All the above has led to a 1.3 percentage point increase on the scale of the Customer Satisfaction Index, which helped the Company with closing the gap to its competitors.

## Telefónica O2 Slovakia

As at 31 December 2010, Telefónica O2 Slovakia registered 880 thousand customers, of which 334 thousand were contract customers. The number of customers increased 59% year on year. The revenues reached EUR 112 million, which is 51% more than in 2009. In the third and fourth quarter of 2010, Telefónica O2 Slovakia showed a positive operating income before depreciation and amortisation (OIBDA).

The company continued marketing its O2 Féť product with the same slogan – 'simplicity, transparency and flexibility'. In September 2010, a new product, O2 Moje Firma, was introduced in the SME segment. In 2010, Telefónica O2 Slovakia focused mainly on customer acquisition and on improving the quality of its customer base through Mobile Number Portability. To make the porting option more attractive, the company offered bonuses for every number ported to the O2 network. As a result of this campaign, in 2010 almost 142 thousand customers ported their already existing number to the O2 network.

At the end of September, the company announced its plan to roll out a proprietary 3G network in Slovakia. The launch of commercial service in the expanded 3G network is scheduled for June 2011. By July 2011, the O2 3G network should cover already 33% of the Slovak population in 24 towns.

At the end of December 2010, the network of Telefónica O2 Slovakia was available already to 94.9% of the population in Slovakia. The span of the network allowed carrying of almost 89% of calls 'on net'. The remaining 11% of calls were connected using national roaming. The share of on-net calls went up by almost 4 percentage points compared to the end of 2009.

A survey carried out by the independent market research agency Ipsos Tambor jointly with Telefónica O2 Slovakia revealed that O2 ranked at the top of all mobile operators in Slovakia in terms of customer satisfaction. The Customer Satisfaction Index (CSI) of O2 reached a record level, as did the company's gap on its competitors.

Telefónica O2 Slovakia also fared the best in the fifth year of the only independent awards of mobile operators in Slovakia. More than two thirds of votes secured the title 'Mobile Operator of the Year' for O2 – already in the second consecutive year.

## Risk management

Risk management is one of the primary management tools for effective governance of companies in the Group. Its purpose is to render support in accomplishing the Company's vision and strategy. All companies in the Telefónica Group apply the same risk management model which fully conforms to the best international practice in the field of corporate governance and the COSO II framework (Committee of Sponsoring Organizations of the Treadway Commission). Close cooperation with other members of the Telefónica Group contributes to further development of the risk management system, which is an integral part of the Group's internal control system.

Risks are identified based on an assessment of the relevant management levels and suggestions made by the division Risk Management and Internal Audit and other units of the Group, and are evaluated in terms of their potential financial impact and likelihood of materialisation. Where the value of a risk exceeds a set limit, the risk is included in the risk catalogue of the Company.

Also in 2010, the Risk Management unit was responsible for the methodology and risk management system on the Group level. The governing bodies – the Board of Directors and the Supervisory Board, or, where appropriate, the Audit Committee – were informed on a monthly basis of all major risks to which the Group was exposed, and of the ways the risks were mitigated.

The Risk Management unit also handles the risks of Telefónica O2 Slovakia; the risks are managed according to the common methodology of the Telefónica Group.

The Company may encounter the following risks associated with the conduct of its business:

### **Commercial (market) risks**

Possible losses caused by market uncertainty, developments in the market, austerity measures adopted by the government and the public sector, competitive pressures, changes due to regulatory actions (including those taken by the European Commission) and changes in the legislation, in particular in connection with the adoption of the new regulatory framework.

### **Financial risks**

Possible losses stemming from the fluctuations in the value of financial instruments, in particular the exchange rates of currencies or interest rates.

### **Credit risks**

Risks of exposure to defaulting business partners or customers, e.g. receivables from customers or distributors. The number of defaulting partners may increase in conjunction with the continuing economic recession.

### **Operating risks**

Risks of possible losses caused by incidents relating to processes, human resources, network elements and information systems, or by external factors.

## The telecommunications market in the Czech Republic

In 2010, the Czech telecommunications market saw the first signs of the gradual economic recovery, which brought an approximately 2% growth of the economy measured by the Gross Domestic Product (GDP). Despite the positive developments, especially in early 2010 customers continued to drive prices down as they optimised their spending for all products and services, including telecommunication services, and the competitive pressure further intensified. During the year, the customer spend on mobile services gradually increased, slowing down the rate of ARPU dilution. The mobile market was also influenced by regulation in the area of mobile termination rates and international roaming; the number of customer additions slowed down followed by revenues decline. According to Telefónica O2's estimates, revenues from the Czech telecommunications market were down approximately 7% in 2010.

Revenues from the fixed line segment declined approximately 8% year on year, while mobile revenues saw a drop of 6% approximately, basically matching the rate of decline from 2009. The fixed line penetration reached 30% at the end of 2010, continuing the downward trend of previous years. Mobile penetration (measured by the number of registered SIM cards with a 13 month activity criterion), on the other hand, exceeded 134% (an accurate figure cannot be determined due to differences in the Czech operators' methodologies of accounting for mobile customers), which is among the highest penetration rates in Europe.

Among European Union member states, the Czech Republic has for a long time been in the upper echelon of countries with the highest volumes of voice traffic in mobile networks. This, however, did not stop the fixed-to-mobile substitution and the proportion of mobile voice traffic continued to grow also in 2010. According to Company's estimates, 86% of all voice traffic generated in 2010 was in the mobile networks, which translates into a 2 p.p. year-on-year growth.

The year 2010 saw a massive growth in the demand for data services – and the operators moved quickly to respond by expanding the coverage of their 3G networks and coming out with new products in this area.

### Trends in the fixed line market

In 2010, the revenues from fixed lines reached approximately CZK 45 billion, which represents a year-on-year decline of approximately 8%. The fall of the voice revenues was partly offset by the growing revenues from broadband internet, IT services and business solutions.

Below we bring a round-up of the most important events in the fixed line market in 2010.

The acquisition of the retail business of České Radiokomunikace a.s. at the end of 2009 allowed T-Mobile Czech Republic a.s. (hereinafter T-Mobile) to offer its own fixed telecommunication service. At the beginning of 2010 T-Mobile introduced its '2in1' bundle combining an ADSL Internet data tariff and a choice of mobile voice tariffs; the products in the bundle were more economically priced than when purchased separately.

During 2010, České Radiokomunikace a.s. continued to deploy the WiMAX technology in other towns in the Czech Republic. České Radiokomunikace a.s. announced a change of ownership at the end of the year; Macquarie, a fund management company from Australia, became the new owner.

In September, Dial Telecom a.s. took over the corporate and wholesale businesses of Volný and strengthened its position in the Czech telecommunications market. Together with the business and wholesale customer base, Dial Telecom a.s. took over also a part of the sales and technical department. Dial Telecom a.s. also announced plans to continue investing in the expansion of its proprietary optical infrastructure, as per its strategy.

At the beginning of April, UPC Česká republika, a.s. (hereinafter UPC) added UPC Fiber Power 25 to its broadband internet portfolio and at the same time permanently slashed the prices of its two fastest internet services (UPC Fiber Power 50 and UPC Fiber Power 100) by 40%.

In the pay TV market, Telefónica O2 came out with an innovated O2 TV concept branded O2 TV Flexi in the autumn, in which it heeded the wishes of customers who wanted to make up their own programme menu and did not want to pay for channels they do not watch. Now they can combine their own menu of programmes in the basic package and select two optional programme packages of different varieties.

T-Mobile entered the pay TV market in November with its T-Mobile TV. Under this brand, T-Mobile began to market an already existing satellite platform by Skylink, one of the big four satellite TV providers in the Czech Republic.

The number of satellite television and IPTV users continued to grow in 2010. UPC began to broadcast in 3D on its HD+ channel.

Providers of WiFi internet connectivity (including various mutations of FTTx technology) retained, with approximately 835 thousand users, their strong position in the fixed broadband market. Despite the relatively high number of these providers, the quality of service varied greatly between them. During the course of 2010, WiFi providers intensified investments in FTTx infrastructure.

## Trends on the mobile market

The mobile market in the Czech Republic in 2010 yielded revenues in the range of CZK 76 billion, which translates into a year-on-year drop of approximately 7%.

In the conditions of the gradually recovering economy and high penetration, all mobile operators saw their customer base increase in 2010. The net additions of active customers of Telefónica O2 and the registered customers of T-Mobile and Vodafone Czech Republic a.s. (hereinafter Vodafone) reached 108 thousand in 2010, compared to 249 thousand in 2009. The net additions recorded a 70% slump year on year.

In 2010, Telefónica O2 recorded a 2.1% year-on-year drop in the number of active customers down to 4,839 thousand, which is attributed mainly to the one-off disconnection of 111 thousand inactive customers. Without the effect of the one-off disconnection, the total number of customers would rise 0.1% year on year, which, given the highly competitive and penetrated mobile market in the Czech Republic, is a good result. The exact share of active customers of the Company in the total market cannot be determined due to differences in the methodologies used by T-Mobile and Vodafone; the two companies publish only figures of registered customers. The ongoing migration of customers from the pre-paid to post-paid service produced a year-on-year increase of 5.7% in the number of contract customers of Telefónica O2 (disregarding the effect of the one-off reduction due to disconnection of inactive customers), up to 2,975 thousand, in 2010.

Mobile operators responded to the needs voiced by their customers and innovated their voice and data tariff portfolios, shifting their focus to mobile internet and internet in mobile devices. As to voice tariffs, the offer of the so-called 'flat-rate' tariffs with unlimited calls included in the monthly fee was substantially expanded. Vodafone introduced a wholly new 'Tailor Made' tariff concept.

In the spring, Telefónica O2 expanded its offer of flat-rate mobile tariffs; SME customers could choose from O2 Business, tariffs with unlimited calling within business hours. Another innovation came in the form of the innovated tariffs for SMEs O2 Business with the new O2 Business Unlimited with unlimited calls, SMS and data. In January, T-Mobile launched Grand and Grand Plus, the first flat-rate tariffs in its portfolio, with unlimited calls for non-business customers. Shortly after, T-Mobile introduced Profi tariffs, offering the same service to business customers. The SME proposition was later expanded by community-based tariffs under the Team brand. Also in 2010, T-Mobile launched pre-paid Twist tariffs, which came with free on-net calls and SMS for the rest of the day after the first five calls or SMS paid for.

In the second quarter of 2010, Telefónica O2 added a pre-paid service to its mobile internet offer, and in early June it introduced a new portfolio of post-paid mobile data tariffs. Also in the second quarter, T-Mobile came out with a pre-paid mobile internet tariff.

In March, Vodafone announced an innovative concept of 'Tailor Made' tariffs, which let customers combine voice and data services of their choice, from zero monthly fee to unlimited calls, SMS and data.

Throughout the year, all operators introduced the improved offers of internet in a mobile device, together with a choice of smartphones.

At the end of the first half of the year, a regulatory intervention by the European Commission cut the prices of voice calls and SMS sent from abroad. The European Commission required that all operators implement a so-called 'data roaming limit', to protect customers from unexpectedly high bills for internet usage during their travels abroad. The data roaming limit of CZK 1,500 including VAT was implemented with effect from 1 June; it concerned all users who use mobile internet when visiting European Union and European Economic Area countries.

During the course of 2010, all mobile operators continued with their efforts to modernize and expand their 3G networks. As at the end of the year, Telefónica O2's 'smart network' had the widest coverage of 43%; its mobile 3G network was, at the end of December, available in 84 towns and cities. At the beginning of 2010, T-Mobile started the commercial operation of its 3G network in selected districts of Prague, and at the end of the first half year it completed the project of GSM network modernisation. By the end of the year, T-Mobile's 3G network covered already 37% of the Czech population. Vodafone signed an agreement with MobilKom a.s., the operator of the U:fon network, for CDMA mobile data network sharing. Vodafone also continued with the expansion of its own 3G network, which covered 38% of the population by the end of 2010.

At the end of 2009, MobilKom a.s. announced a turnaround in its business strategy and market positioning and declared its intention to become the first low cost operator in the Czech Republic. It plans to offer voice and data services on a retail and wholesale basis. At the end of June 2010, MobilKom a.s. announced that it would open its network to other operators wishing to offer broadband mobile internet or voice under their respective brands; MobilKom thus opened the door to virtual operators. WIA, OpenCall or MujOperator were some of the virtual operators using the U:fon network at the end of the year.

## Regulation

Several changes occurred in 2010 in the regulatory environment which governs the field of electronic communications in the Czech Republic. The most material changes included the following:

- 1) changes in the legislation;
- 2) changes in the areas of markets analysis and product regulation;
- 3) changes in the Universal Service provision and in the government's policy and support of broadband internet access.

Below we bring an overview of the most important changes in the legislation which governs the area of electronic communications:

- Enactment of the Act No. 132/2010 Coll., on audio-visual media services on demand and on the amendment to some other laws (Act on Audio-visual Media Services On-demand);
- Enactment of the Act No. 153/2010 Coll., amending the Act No. 127/2005 Coll., on electronic communications and on the amendment to some related laws (Electronic Communications Act), as amended, and some other laws;
- Promulgation of the Regulation No. 318/2010 Coll., laying down the form of traffic and location data records and the method of its provision to the Czech Telecommunication Office;
- promulgation of the Regulation No. 360/2010 Coll., laying down the format for electronic form of "the proposal for the decision of the dispute on obligation to payments" and technical requirements for its usage;
- Commencement of the implementation of the revised regulatory framework for electronic communications networks in the Czech law:
  - I. Directive 2009/136/EC of the European Parliament and of the Council amending Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services;
  - II. Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector and Regulation (EC) No 2006/2004 on cooperation between national authorities responsible for the enforcement of consumer protection laws;
  - III. Directive 2009/140/EC of the European Parliament and of the Council amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services;
  - IV. Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities, and 2002/20/EC on the authorisation of electronic communications networks and services;
  - V. Directive 2002/20/EC on the authorisation of electronic communications networks and services;
- Regulation (EC) No 1211/2009 of the European Parliament and of the Council establishing the Body of European Regulators for Electronic Communications (BEREC) and the Office.

Telefónica O2 was involved in the preparation of the above legislation by providing consultation either directly or on the platform of industry associations of telecommunications operators or through its parent company Telefónica.

The passing of the new Payment Services Act also directly concerned the Company. The provision of these services – previously known as “third party services”, of Telefónica O2, which allowed the customers to order and buy goods and services of third parties, was concerned primarily by the following laws:

- Act No. 284/2009 Coll., on the Payment System, which incorporates in particular the European Parliament and Council Directive 2007/64/EC on payment services in the internal market, European Parliament and Council Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, to be amended by the European Parliament and Council Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions,
- Act No. 285/2008 Coll., on selected measures against the legalisation of the proceeds from crime and terrorist financing.

The Company also contributed to the preparation of the above legislative amendments through its involvement in the process of expert or public consultations, either directly – through industry associations of telecommunications operators, or through the parent company.

#### **Relevant markets analysis and product regulation**

Telefónica O2 continued to meet its duties with which it was tasked based on the relevant markets analysis undertaken by the Czech Telecommunication Office (hereinafter CTO) in previous periods.

In April 2010, the CTO published new regulated wholesale mobile termination rates. The price per one minute of call went down to CZK 1.96 with effect from 1 January 2010, and further down to CZK 1.66 with effect from 1 July 2010. Based on the same CTO decision, the maximum regulated wholesale mobile termination rates will continue to go down also in 2011: from 1 January 2011 to CZK 1.37 and from 1 July 2011 to CZK 1.08.

In February 2010, the CTO published the analysis of market no. 1 – access to the public telephone network in a fixed point, and subsequently decided on the determination of an undertaking with a significant market power and on the imposition of remedies.

In May 2010, the CTO published the analysis of the wholesale physical access to infrastructure in a fixed point, and subsequently decided on the determination of an undertaking with a significant market power on the imposition of remedies and price regulation.

In December 2010, the CTO published the relevant market analysis for market no. 6 – wholesale terminating segments of leased lines irrespective of the technology used for the provision of leased or reserved capacity.

The CTO promulgated decisions for relevant markets no. 2, 3 and 7, identifying an undertaking with a significant market power and imposing remedies and price regulation.

The CTO proceeded with the consultation on the regulation strategy in the area of Next Generation Access (NGA), and on 27 September 2010 it published a document 'Proposals for Regulation of Next Generation Optical Access Networks according to Individual Network Construction Scenarios'. This paper is based on a document published by the European Commission 'Recommendation on regulated access to Next Generation Access Networks [C(2010)6223]' on 20 September 2010.

### **Regulation of international roaming**

Retail prices of incoming calls went down to EUR 0.5 per minute with effect from 1 July 2010; the prices of outgoing calls were down to EUR 0.39 per minute. The prices in Czech crowns were set based on the applicable exchange rate.

In March 2010, Telefónica O2 introduced a safeguard mechanism for data services provided to end customers. Customers are automatically protected against too high bills for data roaming services over EUR 50 per month.

### **Imposition of duties related to the provision of the Universal Service**

Telefónica O2 provided the following services during 2010 as part of meeting its duties imposed by the CTO in relation to the Universal Service provision:

- (a) the public payphone service;
- (b) access to the public telephone service, of the same quality as for other end users, for people with disabilities, namely by means of special terminal equipment;
- (c) special price plans for persons with disabilities, which are different from the regular price plans provided under the standard commercial terms and conditions.

As to the services under (a), a CTO decision from 2009 led to a significant reduction in the number of public payphones operated as part of the Universal Service in 2010.

### **Universal Service**

The CTO published its final decision determining the amount of loss incurred as a result of Universal Service provision in 2007 and 2008.

Telefónica O2 submitted a request for reimbursement of loss incurred as a result of Universal Service provision in 2009. The CTO commenced a process of verification of the claim against the document supplied.

The CTO published a final decision determining the amount of loss from the provision special price plans for people with physical or health-related disabilities in 2009.

### **State policy and support in the area of broadband internet**

The Ministry of Industry and Trade of the Czech Republic completed a policy paper titled 'Digitální Česko' (Czech Republic Goes Digital), which was put for public consultation in December 2010. The policy paper deals with the development of ICT, with an emphasis on levelling out the disparities in broadband internet availability between urban and rural areas. The policy paper also includes a plan for the development of optical and wireless access networks in the Czech Republic.

EU structural funding continued to be available for projects to implement ICT in public and private sector organisations.

Telefónica O2, as a member of industry associations (Association for Information Technologies and Telecommunications, Association of Mobile Network Operators and the Czech Telecommunications Association), sent its comments on the draft of Digitální Česko policy paper. The Company is constantly monitoring options offered to customers by structural funds, and modifies its products and services so that they are eligible for subsidies. A special attention was paid to Call 8 under the Integrated Operational Programme for the development of eGovernment services in the regions.

## Networks and technology

In 2010, Telefónica O2 continued to expand and modernize its network infrastructure, which consists of the largest fixed line and mobile telecommunication network in the Czech Republic.

As far as mobile networks are concerned, investments were directed mainly at an extensive expansion of the Company's 3G network based on the UMTS/HSPA technologies, increasing data transmission speeds, upgrading the GSM network technology and at providing for sufficient capacities now when the traffic is growing.

Compared to the situation in early 2010, when the 3G network covered only main regional cities, the network has been significantly expanded to other locations throughout the year. The number of UMTS/HSPA base stations at the end of 2010 stood at 1,835, compared to 1,364 at the end of 2009. The coverage of the population with the 3G signal increased from 26.6% at the end of 2009 to 42.5% at the end of 2010. The year 2010 also saw the completion of a massive upgrade of the 2nd generation mobile network which had been commenced in the previous year; this effectively increased the coverage of the EDGE technology, which allows for faster data transmission in network, to 97% of the territory and 98% of the population of the Czech Republic. Thanks to this, combined with the CDMA network, which covers 90.4% of the population, Telefónica O2 had, at the end of 2010, the best mobile data infrastructure in the Czech Republic.

Data traffic in mobile networks increased dynamically in 2010. In peak hours, it reached on average more than double that of 2009. Investments in network transmission capacities followed suit. Further increases in the volume of voice traffic and additional demand from new developments (residential, commercial and industrial) have led to 65 new base stations and 147 smaller transmitters, namely to improve coverage in buildings, being installed in the GSM network in 2010. At the end of 2010, the total number of GSM transmitters reached 4,995, and the coverage of the population stood at 99.6%.

In the fixed line area, a significant share of investments went into broadband and IPTV projects. To satisfy the demand from customers, Telefónica O2 expanded the capacity of access points and strengthened the capacities of transmission lines in the IP/MPLS backbone network. The number of ADSL access points reached 2,415 at the end of 2010, compared to 2,402 in 2009. In 2010, 162 IP DSLAMs were put into operation, and O2 TV was available in 2,265 locations. The total installed capacity of ports went up to 1,050,700, which is a year-on-year increase of 7.6%. The share of O2 TV-enabled access ports installed in IP DSLAM equipment stood at 62% at the end of 2010, compared to 56% at the end of 2009. A total of 840,400 were occupied at the end of 2010 (up 11% on the previous year).

Telefónica O2 continued to roll out its access network, namely to satisfy the demand from customers in new residential, commercial and industrial developments. The access network consisted of metallic cables spanning the whole territory of the Czech Republic, supplemented with optical cables and radio relay systems. At the end of 2010, the total length of metallic cable was 305.1 thousand km (up 1.7 thousand km year on year). The optical network capacity continued to increase with the growing volume of traffic generated by broadband customers, connectivity orders from corporate customers and, in selected cases, the need to connect new residential developments. The total length of optical cable, including those laid in conduit systems, reached 31,529 km at the end of 2010, compared to 31,204 km in 2009. The total length of optical cable reached 998,691 km (a year-on-year increase by 22,889 km).

The Company also added to the capacity of two existing international telephone exchanges by building a new soft switch telephone exchange. The capacity of subscriber interfaces of HOST exchanges and Remote Subscriber Units (RSU) was optimised accordingly. At the end of 2010, the fixed line network comprised, in addition to the international exchanges, also six transit exchanges and 138 HOST exchanges. The network of RSUs was optimised by reducing their number by 10, down to 2,374.

Voice over IP services enjoyed a dynamic growth in 2010. During the year, the number of end users of the Company's IP Centrex service doubled and reached almost 40 thousand.

The GSM network operated by Telefónica O2 Slovakia consisted of 964 base stations at the end of 2010. Network-related investments in Slovakia focused mainly on the building of own transmission capacities.

As mentioned earlier in the Annual Report, in the course of 2010 Telefónica O2 increased the share of network operation and maintenance activities contracted out to external parties, which achieved a significant saving of operating costs and their greater variability.

## Voice services

In the area of mobile voice services, in 2010 Telefónica O2 continued to build a strong awareness of the simplicity of its O2 NEON tariffs. At the same time, as part of the project to simplify its product portfolio, the Company actively supported the migration of customers from older tariffs to O2 NEON. Customers would benefit from more freedom that O2 NEON tariffs offer and could take full advantage of fixed broadband internet access in the form of discounts on other services, calls to a selected number and many others.

In March 2010, Telefónica O2 came out with a special proposition to new users of O2 NEON tariffs: customers (registered small business owners or entrepreneurs) who activated a new number with O2 NEON L, L+, XL or XXL during the period from 1 to 14 March 2010 were eligible for a 30% discount for the whole duration of the contract (2 or 3 years, depending).

From 1 June, Telefónica O2 started offering an add-on service O2 Navzájem, which came with unlimited calls within a group of up to seven friends, any time of day, for a flat fee. The service was offered to contract customers and the users of the O2 pre-paid card. Each person in the group paid the same monthly fee and the service offered more value for money as the number of 'friends' increased. The unlimited communication with selected contacts makes the service an ideal complement to O2 NEON tariffs.

New customers of the mobile pre-paid service from Telefónica O2 could enjoy a unique offer between 1 April and 30 June 2010. Users of O2 NA!PIŠTE and O2 NA!HLAS could sign up for a special promotion offering one minute of call for only CZK 1. Additional benefits that come with the pre-paid service also included a choice of four top-up packages: calling on weekend or in the evening for CZK 0.50 per minute, weekend SMS for CZK 0.50 or internet in a mobile device for CZK 20 per week. For every top up, pre-paid customers could claim one of the guaranteed rewards via [www.odmenazadobiti.cz](http://www.odmenazadobiti.cz) ('reward for top-up'). At the end of 2010, Telefónica O2 went live with its innovated Reward for Top-up loyalty programme for the customers of pre-paid services. The goal of the innovation was to bring the programme even closer to the target group of customers by offering them a range of rewards, which depended on the number of months the customer actively used the number for.

O2 DA was Telefónica O2's proposition to Russian- and Vietnamese-speaking customers. The tariff came with cheaper calls to sixteen countries: calls and SMS to Russia or Vietnam were, for instance, only CZK 5.50 per minute and CZK 2.60, respectively.

Having performed a detailed analysis of small business and entrepreneur customers' needs for mobile voice communication, from April 2010 Telefónica O2 expanded its offer of mobile tariffs designed for this important customer segment with the addition of the new O2 Podnikání tariffs which were the first in the Czech market to offer unlimited calls within business hours included in the monthly fee. This benefit did not come with any time limitation and could be enjoyed as long as the tariff was subscribed. The new O2 Podnikání tariffs came in four options: O2 Podnikání M, O2 Podnikání L, O2 Podnikání XL and O2 Podnikání XXL. The highest tariff offered, within the monthly subscription fee, unlimited calls between 9 am and 5 pm anywhere, without network restrictions. In the case of the other tariffs, the unlimited calls were tied to the same hours as above, and to more than 7 million numbers in the O2 network, including all fixed lines in the Czech Republic. Thanks to O2 Podnikání, customers no longer have to monitor their usage and costs and dedicate their time in full to their business.

From May, Telefónica O2 began to market O2 Business, innovated tariffs for SMEs. The new O2 Business Unlimited was offered as a truly unlimited option, giving its users unlimited calls, data and SMS to all networks in the Czech Republic for the new price of CZK 2,900 (exclusive of VAT). The other O2 Business also offered a lot of value – more free minutes, lower per-minute rates and lower monthly fees. To complement O2 Business, customers could choose one of the O2 Podnikatel add-on tariffs offering value on-net calls.

In the fixed line area, traffic continued to be gradually carried over from traditional fixed lines to Voice-over-IP (VoIP). Naturally, in 2010 Telefónica O2 focused on further development of this technology and introduced O2 Unlimited Line and O2 Virtual Exchange, two services offering a reasonably priced virtual PABX exchange included in the monthly fee. Telefónica O2 marketed its VoIP services as an additional option with its data services of guaranteed quality. The number of VoIP customers more than doubled during the course of 2010.

Customers in the lower segments, which do not require a virtual exchange functionality and use asymmetric internet access via ADSL, were the target group for Telefónica O2's new IP service (IP telefonní připojka). For a monthly fee of CZK 230 exclusive of VAT, the customer had a guaranteed telephone service over ADSL, with unlimited calls to all fixed line networks in the Czech Republic and a rental of a high-quality VoIP telephone set. The service was open only to business customers.

On its quest to continuously develop and improve its VoIP service, Telefónica O2 introduced a guaranteed fax service (Faxová připojka) for the customers of O2 Unlimited Line, O2 Virtual Exchange and the IP telephony service.

In December 2010, Telefónica O2 expanded its offer of calling from home options. All fixed access customers were offered calls to all mobile networks with prices starting already at CZK 2 per minute if they subscribed to O2 Calling Mobile 60 or O2 Calling Mobile 120. Telefónica O2 at the same time expanded its offer of international calling packages; customers could call 47 international destinations for prices starting at only CZK 2 per minute.

From February, deaf or hearing-impaired customers could use the free assistance service O2 Deaf Call. Telefónica O2 operated a 24/7 line where specially trained operators helped people with a complete or partial loss of hearing communicate with hearing persons. The service could previously be used via a text telephone or fax, and now communication via e-mail and SMS were introduced. The service works on a simple principle: the operator receives instructions from the non-hearing customer via e-mail, fax or SMS and conveys the message to the hearing recipient. Likewise, the operator can interpret information to the deaf or hearing impaired recipient, in which case the message is transcribed and despatched using the preferred means.

From 1 November 2010, Telefónica O2 has been offering O2 Emergency Care, a service which is a valuable addition to the portfolio of Telecare and eHealth services. Telefónica O2 was the first – and is as yet the only mobile operator in the Czech Republic – to offer a mobile emergency care service. The aim of O2 Emergency Care is to reduce the health and social risks for senior citizens or people with disabilities, allowing them to lead a quality life in their own social environment. The mobility of the solution is a particular benefit over the fixed-line based services on the market. Users of the service can call for help in emergencies not only from their home but from anywhere.

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## Internet, data and value added services

During the course of the year, Telefónica O2 continued to market its broadband proposition branded as O2 Internet. Customers activating the home variant O2 Internet Home got the service for CZK 600 per month for a period of one year – without a commitment and fixed access charges. New and existing customers also qualified for additional discounts if they combined their internet service with other services. From the middle of 2010, the Company focused on promoting its higher tariff with the speed of up to 16 MB/s for CZK 400 per month. A good balance of speed, price and reliability continued to be the primary attraction for getting ADSL from Telefónica O2.

During the course of 2010, Telefónica O2 strengthened its leadership in the mobile data market. Together with the expansion of its mobile broadband network, the Company launched the Smart Network campaign which spearheaded the offer of new services in the area of mobile internet and internet in a mobile device.

From 8 June, Telefónica O2 had a new post-paid mobile internet tariffs. Customers could choose from O2 Mobile Internet Standard for CZK 500 inclusive of VAT with FUP data limit of 2 GB, O2 Mobile Internet Pro for CZK 750 inclusive of VAT with FUP data limit of 10 GB, O2 Mobile Internet Unlimited for CZK 1,000 inclusive of VAT and no data limit. O2 Mobile Internet Start for CZK 300 inclusive of VAT with a monthly data limit (FUP) of 500 MB, which gave a good balance between the price and downloadable data, found its customers mainly among occasional users of mobile internet. The Company also introduced mirror range of mobile internet services in the form of add-ons to the fixed O2 Internet, and improved the proposition even further by offering a satisfaction guarantee – the service could be 'returned' without a sanction within two months of purchase.

Telefónica O2 was the only operator in the market to introduce, from 1 June, a concept of pre-paid mobile internet branded as O2 Pre-paid Mobile Internet, accompanied by a range of daily packages. The service gave customers unlimited access to the internet, without the need to commit to a contract and regular payments; it came in four options, tiered by price. The daily packages consisted of 24 hour blocks which

could be used up anytime within two months from the activation. The user could go online and offline as often as they liked within one block, which was capped at 500 MB of data (FUP). The pricing structure was as follows: 1 day – CZK 50; 5 x 1 day – CZK 200; 10 x 1 day – CZK 350; 30 x 1 day – CZK 900. Customers could subscribe to pre-paid mobile internet in two ways - with the O2 Mobile Internet set or the O2 Mobile Internet card. The set consisted of a pre-paid SIM card with five weeks of free internet access and a Huawei E1750 USB modem, and it was priced at CZK 995. The O2 Mobile Internet card could be purchased separately for CZK 95; it came pre-loaded with a credit of CZK 50, which gave the customer one day of free access. Customers appreciated that they paid only for those days when they actually went online. The product was designed namely for customers who need mobile internet access only occasionally.

In June, Telefónica O2 expanded its portfolio of internet access via a mobile device for pre-paid customers. Smartphone owners wanting blithely access to the internet via their mobile device could subscribe to the new O2 Internet on Your Mobile Plus, which was priced at CZK 75 per week inclusive of VAT. The monthly data limit (FUP) was set at 500 MB.

SME customers could get, if they subscribed to selected mobile data tariffs, a Samsung N 150 netbook for the subsidised price of CZK 1,495, or the professional notebook HP 4520s for CZK 6,495, both with an integrated 3G modem, hence giving the customer access to the fastest mobile data network without the need to have any additional equipment.

Starting from June, the Company's customers were given the opportunity to use the BlackBerry Express service without the initial acquisition cost of BlackBerry Enterprise server. A new tariff BlackBerry Modem also let customers use their BlackBerry devices as a modem for wireless internet access from a personal computer.

On 30 November 2010 Telefónica O2 started offering data tariffs for the iPad with WiFi and 3G capability. All the data tariffs came without a contract and commitment – they could be simply activated and deactivated as needed. The WiFi hotspots of Telefónica O2 in the Czech Republic were opened to customers free of charge.

As to internet connectivity and data services for the corporate segment, in 2010 Telefónica O2 focused namely on increasing its head start on the other providers, and on adding more value to these services for the customer to benefit from. In January 2010, the Company introduced a new concept of internet connectivity for corporate customers. The support of the PAM32 SDL protocol made it possible to offer symmetric access of up to 20 MB/s over the wide-reaching metallic cable network. The service O2 Internet Business also came with an unprecedented scope of value added services – from connection reliability guarantee, VoIP, anti-virus shield and user defined filters of internet communication to a mobile back-up. O2 Internet Business represented a solid foundation upon which the customer could build a reliable communication solution addressing the needs of their businesses and offering voice and data – safely. The introduction of the service helped the Company increase its share of the corporate internet access market.

In the area of fixed data services, at the beginning of the year the Company performed a thorough analysis of this segment, which included, among other things, individual interviews with customers. This exercise resulted in a proposal of modifications with the view to make the service a tight fit with the profiles of individual customers and their needs. The interviews focused namely on the technology, access capacities (speeds), optimal configuration of the service availability guarantee and the offer of add-on services. The retail giant Kaufland with almost one hundred outlets was one of the major new acquisitions in the second half of the year.

In April, Telefónica O2 started offering a new service branded as O2 Clean Internet, which gave a professional level of protection against malicious code to any computer network which was connected to the internet through the infrastructure of Telefónica O2. The service O2 Clean Internet could be installed on most types of internet connection offered by the Company (symmetric/asymmetric xDSL lines, IOL Ethernet, VPN Express, etc.). The professional solution considerably reduced the occurrence of malicious code (malware, spyware) and viruses in local networks and at the same time gave the users all the necessary tools to monitor and manage the security of the online interface and filter out unwanted internet traffic. The solution did not require any modifications on the part of the customer's infrastructure as the whole service was operated from the O2 data centre and did not pose any capacity demands on the customer's network. The price was CZK 500 per internet connection.

Customers of O2 TV could enjoy two innovations from Telefónica O2 introduced on 1 October 2010. All users of the virtual Video on Demand home movie rental function could watch all films in the New Releases section at a discount of CZK 25, and films for children at a discount of 25%. Ten new channels were added to the programme offer of O2 TV, making the total of 81 digital channels. The channels were activated automatically and free of charge, depending on the customers' choice of package.

On 15 October, Telefónica O2 presented its innovated O2 TV concept. From that date onwards, all customers could pick and mix channels as per their preference and needs to make the basic package which is now called O2 TV Flexi. This package containing automatically 20 channels of choice could be supplemented with two add-on theme packages with up to 19 additional channels for the price starting from CZK 400 (if fixed internet access is subscribed simultaneously), or from 550 (concurrently with fixed voice) or CZK 650 (standalone price). Naturally, any number of add-on theme packages from the 'menu' could be on top of the basic O2 TV Flexi. The more packages were subscribed, the bigger the savings. Every second package cost CZK 50 less; the maximum discount was CZK 150. If the channel selection no longer suited the customer, they could re-configure it every 30 days free of charge.

Machine-to-Machine (M2M) communication was among the most dynamically growing business areas in 2010. During the second quarter of the year, Telefónica O2 started offering IP Connect M2M, a service supporting the communication between metering equipment and other technology with customer networks. It is a service relying on a low-capacity fixed data connection with a high degree of availability, especially when combined with mobile back-up. The transmission capacity requirement of this service is on the same par with ATM machines, metering and surveillance equipment. The Company developed its M2M proposition further by offering remote access to fixed networks. Telefónica O2 also came out with a special mobile tariff O2 Machine to meet the demand from customers for a capped cost of data transmission within mobile M2M solutions. It was the first service offering a comprehensive M2M solution and other standardised add-on services, including remote equipment control, self-activation of services or a complete range of Software as a Service applications. O2 Car Control was the first M2M service which spanned the whole value chain and naturally it was met with an enthusiastic market reception.

The portfolio of O2 Car Control services was expanded in the first quarter of the year. The new service, Personal Control, makes it possible to monitor employees working in the field for their greater safety and also to optimise the effectiveness and quality of their work. Leaflet distribution, working in hazardous or difficult conditions or community work were the typical areas in which the service was put to good use.

## Convergent services

In 2010, Telefónica O2 innovated its successful concept of consumer services which had been launched in May 2009. It is based on fixed broadband ADSL access (O2 Internet, Internet Home). These tariffs let the customer choose freely and flexibly from a diverse portfolio of fixed and mobile services, and benefit for example from a combination of fixed broadband with O2 Mobile Internet, O2 TV digital television, O2 Calling or the mobile tariffs O2 NEON. Greater efficiency and the focus on the customers' needs were the mark of Telefónica O2's convergent market offer. During the course of the year, the combined services were gradually gaining popularity among the customers of Telefónica O2. The convergent concept also allowed for effective routing and managing data traffic from customers, which delivered additional efficiencies in the utilisation of fixed and mobile data networks.

From September 2010, corporate customers of Telefónica O2 were invited to take full advantage of what a truly convergent operator could offer. O2 Team Combi, a solution for company mobile communication, gave customers the ultimate availability through the redirection of fixed line calls to a mobile number or the other way round, and made it possible to implement corporate communication rules (call bans and restrictions, company numbering plans, tagging of private calls, etc.). O2 Team Combi could be installed with every voice service; prices started from CZK 1 per month.

Starting from the third quarter of the year, Telefónica O2 offered a mobile back-up solution to its fixed service, internet access and data VIP service customers; the new service ran on all mobile networks (UMTS, EDGE, CDMA, GPRS), and together with the widest fixed data network coverage, a number of technologies to choose from and the added benefit of the mobile network, Telefónica O2 offered to its corporate customers an unprecedented guarantee of quality of data communication, with higher availability and guaranteed access even when the network was experiencing problems. The offer of convergent services included also a fully mobile access to the corporate fixed data network, which has the benefit of integrating highly mobile, temporary sites or locations that are outside the reach of the fixed line network into the customer's ICT systems.

## Payment services

Telefónica O2 has been providing payment services to its customers in keeping with the Act No. 284/2009 Coll., on the payment system, already from 1 November 2009. The services allow customers raise a payment order and use their mobile device or fixed line to pay for goods or services provided by third parties. The customer has a choice of several methods of payments; the most widely used method is via Premium SMS, which, in 2010, was opted for on average by 521 thousand customers per month. The so-called Audiotex (Premium-rate Telephone Number) service was the second most popular payment method, with an average monthly payment per customer of CZK 754, up 19.9% year on year. The total of funds used to pay for goods and services, via the two aforementioned methods of payment, reached CZK 722 million in the Czech market in 2010. Customers could also opt for Datarif (a dial-up data transfer).

In autumn 2010, Telefónica O2, in collaboration with other mobile operators, members of the Association of Mobile Network Operators, launched a new campaign in the Czech market – 'Plat mobilem' ([www.platmobilem.cz](http://www.platmobilem.cz), 'Pay with Your Mobile'). Its role is to promote mobile transactions in the amount between CZK 20 and CZK 1,500 that can be made using a mobile data capable mobile telephone. The service, O2 Payment, has been in Telefónica O2's portfolio since October 2010.

In October 2010, Telefónica O2, together with several Czech banks (Česká spořitelna, a.s., GE Money Bank, a.s., Raiffeisenbank, a.s., UniCredit Bank Czech Republic, a.s.), mobile operator Vodafone Czech Republic, a.s., and A-communications (Malta) Limited, started MOPET CZ, a.s., a company incorporated in the Commercial Register on 3 November 2010. The company's business is to launch a new mobile payment method in the Czech market, to provide an alternative to cash payments for goods and services.

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## ICT services, solutions for business and for the government

As in the other segments of its business, also in ICT and business and government solutions, Telefónica O2 began to see the first signs of recovery in the economy. Furthermore, after the parliamentary elections in the Czech Republic, the new cabinet commissioned a review of cost-effectiveness in the public sector, with the aim to close the state budget deficit by way of reducing government spending. This resulted in a lower number of ICT projects in which the Company participated. Despite challenges of the economic situation, Telefónica O2 confirmed its position as a reliable and efficient partner to the government's needs for telecommunications and comprehensive ICT solutions.

The Company successfully forged ahead with its systems integration project at the Ministry of Agriculture, participated in projects for supporting ICT operations at the State Agricultural and Intervention Fund, Ministry of Transport and the Office of the Government Representation in Property Affairs.

In 2009, Telefónica O2 engaged in partnership with the Czech Post to provide technology for the Data Box Information System (ISDS), the flagship project in the field of eGovernment. The data boxes are used as a data repository and to deliver official digital correspondence from the authorities and for making certain acts with regard to them. The volume of transactions carried by the system in the form of data messages in 2010 exceeded 27 million.

In line with its eHealth strategy, Telefónica O2 started a pilot operation of a new service O2 Emergency Care, which was implemented in partnership with the town district of Prague 10. The service is to benefit namely senior citizens who live with a constant risk to their life or health. After pressing a button on the handset, the user is automatically connected to a helpdesk staffed with operators who are qualified according to the relevant legislation in the area of social services.

The year 2010 also saw the live launch of Pilsen Card in a Handset, which is an equivalent to the plastic multifunctional smart card of the Pilsen Municipal Transport Company. The project relies on NFC (Near-Field-Communication), which allows for the integration of the Pilsen Card in selected mobile handsets. Telefónica O2 implemented this project in partnership with other external suppliers.

## Interconnection

The year 2010 saw, in the area of network interconnection, a further wave of consolidation of the Czech telecommunications market. This trend was propelled also by the transfer of a significant portion of the activities of České Radiokomunikace to T-Mobile, which spurred the ADSL broadband internet market. T-Mobile used the metallic cables unbundled by Telefónica O2 to provide the service. On the other hand, another major service provider, VOLNÝ, a.s., commenced a retreat from the residential fixed broadband market.

In the area of fixed public electronic communication networks, particularly GTS Czech, T-Mobile, Dial Telecom and RIO Media pursued acquisitions which resulted in the strengthening of their respective market positions.

Mergers and acquisitions in the electronic communication markets raised the need for changes in the fixed network interconnection between Telefónica O2 and other licensed operators. No changes were implemented in the mobile network interconnection between Telefónica O2 and other mobile service providers.

At the end of 2010, the fixed network of Telefónica O2 was interconnected with sixteen networks operated by other licensed entities. Telefónica O2's mobile network in the Czech Republic was interconnected with the networks of three other mobile operators and with twelve fixed public electronic communication networks.

The share of customers using the services of other operators relying on the Wholesale Line Rental (WRL) service from Telefónica O2 saw an increase in 2010. Carrier Selection/Carrier Pre-selection (CS/CPS), on the other hand, gradually lost importance as the number of subscribers stabilised and no major fluctuations in the numbers of activations occurred.

### National wholesale services

The trend, which in the area of national wholesale was evident already in the previous year, eventually culminated in 2010. The unfavourable macroeconomic climate accelerated the already ongoing consolidation of the telecommunications market.

Despite the fact that the economic reality called for more stringent cost control and a number of economizing measures, mobile operators followed the strategy of Telefónica O2 and innovated their service portfolios and continued to roll out their 3G networks in an effort to satisfy the growing demand for mobile internet and internet in handset.

These market developments spurred the demand for Telefónica O2's wholesale services, especially its backbone network capacity. In collaboration with T-Mobile, Telefónica O2 commenced the preparation for 3G network sharing, a project to save costs to both companies and accelerate the deployment of the network.

With a strong campaign of T-Mobile in the consumer fixed broadband market, Telefónica O2 recorded an increase of wholesale ADSL connections, whose number went up by 22,000 to the total 70,000.

The demand for Ethernet-based data services also continued to grow. The Company responded by increasing the coverage and innovating its product portfolio in favour of higher speeds. The interest in services with higher transmission capacities of 1Gbit/s and greater also increased.

### **International wholesale services**

In the area of international data and internet services, Telefónica O2 responded to the growing demand for international transmission capacity by acquiring a sufficient capacity reserve. As in the previous year, also in 2010 the Company saw a rising demand for high capacity international leased lines (Lambda 2.5 and 10 Gbps), and the volume of sales increased accordingly. Likewise, international IP connectivity was up, as was the demand for Ethernet-based services.

In the area of international voice services, Telefónica O2 continued to strengthen its market position in Central and Eastern Europe. The Company forged ahead with interconnecting its networks directly with those of other European fixed and mobile operators in Europe and beyond, with a focus on Russia, Near and Middle East. The transit voice traffic recorded a 12% increase on 2009, and reached a record-breaking mark of close to 1.7 billion minutes.

Also in 2010, Telefónica O2 maintained a high quality of voice services. Vodafone Germany recognized the Company as the international operator with the best quality of service.

In the area of international services, the Company closely cooperated with the international operator TIWS (Telefónica International Wholesale Services), which is a part of the Telefónica Group.

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## Comments on the financial results

In this section we present and comment on the consolidated financial results of the Telefónica O2 Group prepared in accordance with International Financial Reporting Standards (IFRS).

### Consolidated financial results

#### **Revenues, Operating Costs and OIBDA**

The consolidated revenues reached CZK 55.7 billion in 2010, down 7.0% year on year. Gains from the sale of non-current assets reached CZK 92 million in 2010, compared to CZK 422 million in 2009. As described in 2009 Annual Report, in 2009 the Company sold its former headquarters with a one-off gain of CZK 342 million. The total consolidated operating costs declined 1.8% year on year, reaching CZK 33.4 billion in 2010, as a result of strict financial discipline and the booking of several non-recurring items.

As a reaction to uncertain and potentially negative developments in the telecommunication market and the regulatory environment, in 2003 ČESKÝ TELECOM (predecessor of Telefónica O2 Czech Republic) booked an impairment loss of CZK 9,909 million from fixed line assets which constitute a cash generating unit (CGU). Since then the impairment tests were performed annually. The most recent impairment test performed as at 30 June 2010 took into account the Company's fixed broadband and data focused strategy, enhanced fixed network performance as well as the continuous synergies from integration with the mobile segment, and resulted into an impairment loss reversal of CZK 4,344 million, which amount was positively reflected in OIBDA.

Consequently, with the help of the above item, the consolidated operating income before depreciation and amortization (OIBDA) increased by 1.1% reaching CZK 27.4 billion in 2010. Without the impact of the impairment reversal, OIBDA would have declined 14.9% year on year in 2010 to CZK 23.0 billion; the decline was driven by the lower revenues and non-recurring items booked in 2009 and 2010. Comparable OIBDA<sup>1</sup> decreased 6.7% year on year to CZK 24.5 billion in 2010, while comparable OIBDA margin<sup>2</sup> reached 44.1% in 2010, which was basically a flat year on year trend (2009: 44.2%). OIBDA adjusted for guidance<sup>3</sup> decreased 8.4% year on year and reached CZK 24.1 billion in 2010, which was within the guidance range of -5% to -9%.

### Depreciation and Amortization

The consolidated depreciation and amortization amounted to CZK 11.9 billion in 2010, resulting in a 1.2% decline year on year. The impairment reversal led to an increase in the depreciation and amortization by CZK 316 million in 2010.

### Operating Income, Income before Tax and Net Income

The consolidated operating income and consolidated income before tax went up 3.0% year on year and reached CZK 15.5 billion and CZK 15.3 billion, respectively, in 2010, largely due to the above-mentioned impairment reversal. Without the item factored in, operating income and income before tax would have declined 23.7% and 24.1% year on year, respectively, driven by the declining OIBDA and slightly higher net finance expenses, which were not fully compensated by the lower depreciation and amortisation charge. The consolidated net income amounted to CZK 12.3 billion in 2010, up 5.3% year on year, due to the combination of the above-mentioned factors. Excluding the impairment reversal, the net income would have declined 22.7% to reach CZK 9.0 billion.

### Cash and Debt levels

On 31 December 2010, the Group's consolidated financial debts (long-term and short-term) amounted to CZK 3.0 billion, down 3.4% compared to the 2009 year-end. The amount of cash and cash equivalents reached CZK 4.8 billion as at the end of 2010, compared to CZK 1.3 billion the year before. The combination of cash and debt balances resulted in a net leverage<sup>4</sup> of -2.4% and a gross leverage<sup>5</sup> of 4.1% as at the end of 2010, compared to 2.5% and 4.2%, respectively, as at 31 December 2009.

### Capital Expenditure

The total consolidated capital expenditure amounted to CZK 5.7 billion in 2010, down 12.7% year on year. As in the previous years, 2010 investments were selectively targeted at the growth areas of the business. The expansion of mobile broadband networks (EDGE and UMTS), enhancement of the fixed broadband network and upgrades to the information systems ranked among the key investment priorities in 2010.

<sup>1</sup> OIBDA excluding royalty fees and management fees (2009: CZK 754 million, 2010: CZK 1,057 million) and non-recurring items (2009: universal service, gain from real estate and settlement agreement with T-Mobile totalling CZK 1,548 million; 2010: universal service, restructuring costs and impairment reversal totalling CZK 3,915 million).

<sup>2</sup> Comparable OIBDA over Comparable business revenues (business revenues excluding universal service: 2009: CZK 367 million; 2010: CZK 47 million).

<sup>3</sup> In terms of 2010 guidance calculation, OIBDA royalty fees and management fees (2009: CZK 754 million, 2010: CZK 1,057 million). In addition, 2009 OIBDA base excludes non-recurring items (settlement with T-Mobile, universal service and gain from real estate sale) totalling CZK 1,548 million and 2010 OIBDA excludes non-recurring items (universal service and impairment reversal) totalling CZK 4,373 million; 2010 guidance assumes no changes in consolidation and constant FX rates of 2009.

<sup>4</sup> Long and short term financial debts less cash and cash equivalents over equity.

<sup>5</sup> Long and short term financial debts over equity.

## Cash Flow

The total consolidated free cash flows<sup>6</sup> increased 21.2% year on year and reached CZK 16.4 billion in 2010, largely due to the lower amount of paid taxes (down 40.1% year on year) and the lower payments on investments in property, plant and equipment and intangible assets (down 34.9% year on year to CZK 5.5 billion).

## Overview of consolidated revenues

The total consolidated revenues in 2010 reached CZK 55.7 billion, down 7.0% year on year, mainly due to further cuts in mobile termination rates, the slow economic recovery impacting on customers' spend patterns and the lower-than-expected revenues from IT and business solutions due to the lower number of projects in the public sector segment.

The total consolidated voice revenues (voice-outgoing, interconnection and other wholesale services, monthly and one-off charges from voice services and connection charges) amounted to CZK 34.4 billion in 2010, down 11.1% year on year.

In the highly penetrated mobile market in the Czech Republic, the total active mobile customer base decreased 2.1% year on year down to 4,839 thousand at the end of 2010. This performance has been impacted to a large extent by one-off disconnection of 111 thousand inactive contract customers in the second quarter of 2010. Excluding the effect of the one-off disconnection, the customer base would have increased 0.1% year on year. The number of contract customers went up 1.7% year on year, reaching 2,864 thousand at the end of 2010 (+5.7% year on year, discounting the impact of the disconnection of inactive accounts). Consequently, contract customer net additions reached 160 thousand in the year (excluding the disconnections). The solid performance was driven by the continuous growth of O2 NEON tariffs, customer migration from the prepaid to the contract segment and a solid uptake of mobile broadband customers. At the end of 2010, contract customers represented 59.2% of the base (+2.3 percentage points year on year). The number of prepaid active customers reached 1,975 thousand at the end of 2010, down 7.3% year on year.

The blended monthly average churn rate reached 2.4% in 2010, posting a 0.3 percentage point year on year increase mainly due to the disconnection of inactive accounts the contract customer base. In the fourth quarter of 2010, however, the churn rate declined 0.2 percentage points down to 2.2%, which was facilitated by the improved churn of prepaid customers.

In terms of usage, mobile traffic<sup>7</sup> carried in the Czech Republic grew 6.8% year on year to 8,790 million minutes in 2010.

In 2010, blended ARPU<sup>8</sup> reached CZK 468.5, down 8.1% year on year, impacted largely by MTR cuts. However, the year-on-year decline of ARPU decelerated during 2010: from 11.2% year on year in the first quarter to 6.0% year on year in the fourth quarter 2010, which is attributed to the ongoing stabilization in the customer spend. Not including the impact of the MTR cuts, ARPU would go down 6.6% in the first quarter, 3.7% in the second quarter, 3.5% in the third quarter and 1.9% in the fourth quarter. Contract ARPU reached CZK 659.7 in 2010, down 11.4% year on year, while the rate of decline in the fourth quarter slowed down to 8.5% year on year and closed at CZK 643.5. Customer migration from prepaid to the contract tariffs and MTR cuts continued to drive contract ARPU dilution. The prepaid ARPU decreased 7.8% year on year down to CZK 206.0 in 2010 with just a 5.4% drop to CZK 212.3 in the fourth quarter. The data ARPU was down 4.1% year on year to CZK 120.1 in 2010, and in the fourth quarter saw a year-on-year improvement of 2.7% to CZK 123.1.

<sup>6</sup> Net cash from operating activities and net cash used in investing activities.

<sup>7</sup> Inbound and outbound, excluding inbound roaming and roaming abroad.

<sup>8</sup> Including inter segment revenues.

The total number of fixed accesses operated in the Czech Republic declined 5.7% year on year to 1,669 thousand as at the end of December 2010. Compared to 2009, the number of net losses decelerated 17.4% to 101 thousand in 2010 (2009: 123 thousand), a trend propelled by a healthy demand for naked access and the increasing number of VoIP lines installed for corporate customers.

Voice traffic generated in the fixed network went down 13.1% year on year in 2010 to 1,741 million minutes as a result of continued fixed telephony lines losses and fixed to mobile substitution.

The total number of active mobile customers in Slovakia reached 880 thousand at the end of December 2010, up 59.2% year on year, with 99 thousand net additions in the fourth quarter (+10.6% year on year). Additionally, in absolute terms, Telefónica O2 Slovakia considerably grew its customer base by the figure of 328 thousand in 2010, posting a 44.0% year-on-year growth. The number of contract customers was up 71.0% year on year, reaching 334 thousand at the end of 2010, while the number of prepaid active customers increased 52.8% year on year, closing the year at 546 thousand. Consequently, contract customers represented 38.0% of the total customer base at the end of 2010, up 2.6 p.p. year on year. Contract ARPU reached EUR 19.0 in 2010, while prepaid ARPU stood at EUR 8.5.

Consolidated revenues from monthly and one-off charges from voice services went down 11.8% year on year to reach CZK 13.6 billion in 2010. The decline was driven mainly by the lower number of fixed telephony accesses and the impact of the new concept of services for the consumer segment, which is based on a broadband proposition, including naked ADSL. The revenues from the mobile segment declined only slightly; the decline reflected the preference of contract customers for lower-priced voice tariffs.

Revenues from outgoing voice reached CZK 11.9 billion in 2010, down 9.8% year on year due to the lower volume of voice traffic generated in the fixed network, the higher proportion of mobile customers on semi- and flat-rate based tariffs and lower roaming revenues.

Revenues from interconnection and other wholesale services declined 10.4% year on year to CZK 8.9 billion in 2010 as a result of namely the 28.1% reduction in MTR and lower revenues from roaming visitors, which have not been fully offset by the marginal growth in international transit services in the fixed line segment.

Revenues from SMS & MMS & value added services were down 2.7% year on year to CZK 4.8 billion as a result of a higher proportion of SMS revenues being included in the monthly charges for O2 NEON tariffs and the higher number of customers subscribing to these tariffs. In 2010, O2 customers in the Czech Republic sent 2,477 million SMS in total, which represents a 2.5% year on year increase.

Revenues from leased lines and fixed data services went down 10.7% year on year to CZK 3.1 billion, mainly due to lower revenues from leased lines, which were not fully compensated by a growth in IP based data services.

Revenues from internet (including monthly and one-off charges), mobile data and IPTV grew 12.6% year on year in total and reached CZK 8.3 billion in 2010, largely as a result of the positive reception of the new broadband-centric (naked ADSL) proposition by the market and the growth of the O2 Internet customer base. The total number of ADSL accesses reached 806 thousand at the end of 2010, up 11.1% year on year, with 81 thousand net additions recorded in 2010. In the fourth quarter, the company reported 29 thousand ADSL net additions, helped also by the upswing in wholesale accesses. The total number of O2 TV customers reached 129 thousand at the end of 2010. Additionally, from the second half of 2010, this revenue stream has been positively impacted by a growing contribution of mobile internet revenues driven by the growing demand for mobile broadband. This was a result of our successful marketing campaign promoting the advantage of mobile broadband networks for customers.

Consolidated revenues from IT and business solutions went down 7.4% year on year to CZK 2.6 billion, largely due to a year-on-year decline in the number of public sector projects in the second half of the year. Revenues from equipment and activation fees declined 4.7% to CZK 1.5 billion due to lower sales of handsets and other equipment. Other telecommunication revenues went down 6.7% year on year to CZK 915 million, to which the lower revenues from Universal Service (2009: CZK 367; 2010: CZK 47 million) contributed.

## Overview of consolidated operating expenses

The consolidated operating expenses of the Telefónica O2 Group declined 1.8% year on year and reached CZK 33.4 billion in 2010 as a result of our strict financial discipline implemented by the Company to offset, to the maximum degree possible, the declining revenues and the impact of several non-recurring items. While in 2009 the consolidated operating expenses have been positively impacted by the settlement agreement with T-Mobile (CZK 1,027 million), in 2010 the redundancy payments related to the Company's restructuring programme (CZK 458 million) became more prominent in the context of the operating expenses. Excluding these two items, the consolidated operating expenses would decline 6.0% to CZK 32.9 billion in 2010.

The interconnection and roaming expenses declined 10.3% year on year to CZK 10.2 billion in 2010, in line with the interconnection revenues; this was mainly due to the MTR cuts and lower roaming prices. The cost of goods sold fell 16.8% year on year to CZK 1.9 billion in 2010, as a result of the lower handset sales and the lower average cost of equipment. Other costs of sales, which comprise the costs of contents, sub-deliveries, the customer loyalty program, telecom services and other cost of sales, decreased 27.5% in total and reached CZK 1.8 billion in 2010. The costs associated with the Universal Service in 2010, together with the lower revenues and lower sub-deliveries for ICT projects, were the key drivers of this trend.

The total personnel costs including redundancy payments amounted to CZK 7.1 billion in 2010, which is 0.7% higher year on year compared to 2009. Not accounting for redundancy payments booked in relation to the restructuring programme (CZK 458 million), personnel costs would go down 7.1% year on year. The total number of Group employees reached 7,522 as at 31 December 2010, down 13.4% year on year. The headcount of Telefónica O2 was reduced 13.4% year on year, down to 6,936 as at the same date, of which some 50% related to the outsourcing in network area.

The marketing and sales expenses (marketing and commissions) declined 6.1% year on year in total, down to CZK 2.6 billion in 2010, as a result of the Company's continuous effort at efficient marketing expenditure. The network & IT repairs and maintenance expenses increased 3.9% year on year to CZK 2.5 billion, largely as a result of the outsourcing of network-related activities. Rental, buildings and vehicle costs reached CZK 2.2 billion, up 1.7% year on year, while the costs of utilities were down slightly (1.4% year on year) and reached CZK 1.1 billion in 2010. Other external expenses (billing and collection, call centres, consultancy and professional fees and other external expenses, including royalty and management fees), and other operating expenses, reached CZK 2.8 billion in 2010, 1.3 times higher year on year, largely due to the settlement agreement with T-Mobile reached in 2009. Excluding this item, this expenditure category would increase 25.5% year on year, driven by the higher cost of call centre operation, as a result of the Company's campaign to improve the quality of customer experience.

Taxes (other than income tax) and provisions for bad and doubtful debts and inventories increased 16.1% year on year in total and reached CZK 1.1 billion in 2010, and were impacted by a review and adjustment of the bad debts provision policy in 2009 based on the success rate of collection on accounts receivables.

## The outlook for 2011

In 2011, Telefónica O2 Group will continue to focus closely on its customers - by further improving and strengthening its relationship with the customers through better quality of service and offering new products to meet the customers' needs. The primary goal of these initiatives is to offer a best-in-class customer experience and level of satisfaction. In particular, the Company will continue with its innovations to the fixed broadband value proposition; by introducing VDSL-based services it plans to stabilize fixed access losses and maintain competitiveness. In line with its 3G coverage expansion strategy, and thanks to its recently signed 3G network sharing agreement with T-Mobile, the Company intends to introduce an innovated proposition of mobile broadband and data services to the market. In 2010, Telefónica O2 built up a competitive advantage of having the widest quality 3G network coverage. In 2011, the Company will aim to retain this advantage and increase the number of mobile broadband and data customers, hence improving the respective share of this segment in the total mobile revenues.

Telefónica O2 Slovakia will continue in the active marketing of its 'transparency, value and simplicity' customer proposition. By doing this, it plans to further improve its financial performance and profitability while maintaining a solid rate of growth of its customer base.

The group does not have a full visibility of its revenues performance in 2011. It expects that ICT revenues could continue to be under pressure of the lower-than-expected number of projects in the public sector. In addition, mobile revenues will be hit by additional MTR cuts (-35% in 2011). The Company will persevere with its effort to tap into efficiency reserves in the area of operating and investment expenditure, while investing prudently in areas where investment generates value for the customer and maximizes cash flow generation, which remains one of the primary goals for 2011.

In 2011<sup>9</sup>, the Group expects OIBDA<sup>10</sup> to decline within the range of 1% and 5% and CAPEX to be around CZK 5.7 billion.

<sup>9</sup> 2011 guidance excludes changes in consolidation, includes potential capital gains from non core asset sales, assuming constant FX rates of 2010.

<sup>10</sup> In terms of 2011 guidance calculation, OIBDA excludes royalty and management fees (2010: CZK 1,057 million). In addition, 2010 OIBDA base excludes reversal of the impairment loss of CZK 4,344 million.