Board of Directors' Report on Business Activity

Telefónica O2 Czech Republic Group

Overview of the Group and the main changes in 2009

As at 31 December 2009, the group of Telefónica O2 Czech Republic (Telefónica O2 Group) comprised Telefónica O2 Czech Republic, a.s. (Telefónica O2, Company) and several other subsidiaries. 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 expanded its business to Slovakia, and on 2 February 2007 launched commercial operation. In 2007, Telefónica O2 acquired 100% of DELTAX Systems a.s. (DELTAX Systems). During 2009, DELTAX Systems was 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.).

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 an IPTV service (O_2 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 corporate, business and government sub-segments. 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 2009, Telefónica O2 Group comprised the following subsidiary companies and affiliates:

Companies incorporated in the Czech Republic					
Object of the company	Identification number	Area of business	Registration number	Registered/share capital	Share of the issuer in the registered/ share capital in%
Telefónica O2 Business Solutions, spol. s r.o.	Prague 10, Vršovice, Kodaňská 1392, postal code 100 00	Data services and consulting in the field of telecommunications	45797111	CZK 10,000,000	100%
CZECH TELECOM Austria GmbH	/o Vienna CityTax Steuerberater GmbH, Wagramer St, Sien, 1220 Austria	Data transmission services	FN 229578s	EUR 35,000	100%
CZECH TELECOM Germany GmbH	Kennedyallee 97a, Frankfurt am Main, 60596 Germany	Data transmission services	HRB 51503	EUR 25,000	100%
Telefónica O2 Slovakia, s.r.o.	Einsteinova 24 Bratislava Postal code 851 01, Slovakia	Operation of a public telecommunications network; provision of a public telecommunications service and the service of leased lines	35848863	EUR 200,000,000	100%
Affiliated companies					
AUGUSTUS, spol. s r.o.	Prague 10-Vinohrady, Na zájezdu 1935/5, postal code 101 00	Consulting and brokerage activity in non-telecommunica- tion disciplines	49356160	CZK 166,000	39.76%
První certifikační autorita, a.s.	Prague 9-Libeň, Podvinný mlýn 2178/6, postal code 190 00	Certification services in the area of electronic signature	26439395	CZK 20,000,000	23.25%

On 30 November 2007, the process of liquidation of Centrade, a.s. v likvidaci, was completed. The company was deleted from the Commercial Register on 22 August 2008. During the fourth quarter of 2007, SPT TELECOM (Czech Republic) Finance B.V. initiated preparatory steps for its voluntary liquidation. The main legal steps leading to the liquidation of the company were made by the end of 2008, and the company was deleted from the Commercial Register on 9 February 2009.

In December 2008, the Board of Directors of Telefónica O2 approved the schedule of actions leading to the merger through consolidation of the wound-up undertaking DELTAX Systems a.s. with the successor undertaking Telefónica O2 Services, spol. s r.o. The merger resulted in the cessation of DELTAX Systems. The assets of DELTAX Systems, its rights and obligations, including rights and obligations under the labour law, passed to the successor company. The merger became

legally conclusive on the day of the registration of the company in the Commercial Register which was 1 August 2009. The planned integration of both companies is a fit the Group's strategy to vest all activities in the field of ICT services and integrated business solutions in one business services business unit, which will be a part of the parent company. The goal was to claim the highest position among the leading providers of ICT in the Czech Republic. Telefónica O2 Business Solutions is now the only provider in the Czech market offering a full scope of ICT solutions – fixed and mobile telecommunications (voice and data), terminal equipment, network infrastructure, development and implementation of proprietary software based on the customer's requirement, security, system integration, full operation and maintenance of all technologies, outsourcing of selected services, assistance with the specification of new requirements and training of employees. The integration of ICT services in one organisation has simplified the management and process model and improved resource utilisation and operational effectiveness.

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.

As at 31 December 2009, the total of fixed lines operated by Telefónica O2 in the Czech Republic reached 1.771 million, and the number of mobile customers reached 4.945 million. As at the same date, the Company registered also 677 thousand retail ADSL connections and 138 thousand O_2 TV customers. The number of mobile customers of Telefónica O2 Slovakia increased to 553 thousand as at the end of 2009.

On 19 January 2009, Telefónica O2 entered into a framework agreement with Pražská správa nemovitostí and Central Group regarding the sale of its former headquarters in Olšanská ulice in Prague. The sale concerned the land lot No. 4 with an area of 12.5 thousand of square metres, which is zoned for building, and two administrative buildings of the former headquarters in Olšanská ulice – numbers 3 and 5. The transaction showed in the Company's bottom line for the first quarter of 2009 a one-off gain from the sale of the real property, amounting to CZK 348 million and was booked as incremental cash.

At the beginning of the month of May, Telefónica O2 entered into an agreement with T-Mobile to settle disputes related to prices for interconnection of the two operators' networks in the period between 1 January 2001 and 31 December 2001. Based on the agreement, T-Mobile refunded to Telefónica O2 a fixed amount of approximately CZK 1 billion. At the same time, all litigation by both parties in relation to this matter was stopped. The transaction showed in the Company's bottom line for the second quarter of 2009 in the form of lower operating costs and incremental cash.

During 2009, Telefónica O2 also negotiated conciliation with Tele2 EUROPE S.A. and ended the mutual dispute in the Czech Republic. Tele2 retracted its lawsuit. Telefónica O2 is no longer exposed to any risk in connection with the amount of CZK 2,141,603,909 originally claimed by Tele2 EUROPE in the dispute from 2005.

Telefónica O2 Slovakia

As at 31 December 2009, Telefónica O2 Slovakia registered a total of 553 thousand customers, of which 196 thousand were contract customers. This represents a year on year increase of 69.9%. During 2009, Telefónica O2 Slovakia had more than 90 thousand applications for porting of a number from another operator's network into its network, which was more than three times

the number from 2008. Thanks to the company's efforts, the time needed for porting of a number was, effective from 1 September 2009, shortened from 25 days originally to 5 days at present. The shortened number portability process has proven itself as an effective market competition tool and became a significant growth impulse for the third operator. By decision of the regulator, mobile interconnection rates fell 30% in 2009, which represent a significant decline compared to the previous period and is seen as a sign of the improving regulatory environment in Slovakia.

Also in 2009, Telefónica O2 Slovakia marketed its O_2 Fér tariff with all its original parameters – simplicity, clarity and economy – preserved. In the case of O_2 Fér, which was launched in September 2008, the same terms and conditions apply both for contract and pre-paid customers. O_2 Fér is simultaneously offered without a commitment and the need to pay monthly subscription fees. O_2 Fér comes with a single rate on calls and SMS to all numbers in all networks in Slovakia. From September 2009, the single call and SMS rate was expanded also to calls from Slovakia to all fixed and mobile networks in the Czech Republic. O_2 Fér has become the best-seller of the Slovak mobile market.

In March 2009, Telefónica O2 Slovakia successfully launched it new tariff O_2 Data Neomezeně, which, for a flat monthly fee, offers unlimited mobile internet in the network of Telefónica O2 Slovakia – without the user having to watch the volume of transmitted data. The company also expanded its portfolio by adding two special top-up packages with discount rate minutes. In September 2009, Telefónica O2 Slovakia introduced the most extensive portfolio of mobile telephones in the Slovak market. Customers can opt having the price of the handset split into instalments or pay the whole amount in a single payment.

A number of joint-venture projects were launched in 2009. The most important among those, a joint-venture TESCO mobile with TESCO Stores was inspired by positive experience of partnership between Telefónica O2 and TESCO in the United Kingdom and Ireland. The two other partners – Nay and Swan – are established companies in the Slovak market. They had their own extensive distribution network and a broad client base, thanks to which Telefónica O2 quickly and effectively penetrated new segments of the market.

At the end of 2009, Telefónica O2 Slovakia recorded the highest customer satisfaction levels in its history; the Customer Satisfaction Index (CSI) reached to the record score of 84. Also owing to this fact, the company increased its longstanding lead in the area of customer satisfaction before its competitors: to 5.1 points (Orange) and 7.4 points (T-Mobile). An independent poll of users ranked Telefónica O2 Slovakia the Mobile Operator of the Year.

The company invested in the development of its online distribution channels for services, handsets and credit top-ups. Other major investments went into the project for improving the efficiency of the company's Customer Relationship Management (CRM). Telefónica O2 Slovakia continued in the expansion of its distribution network, which, in addition to own brand stores and franchises, now includes a special sales channel: the distributor network.

The company also continued in the roll-out of its proprietary network. At the end of 2009, the number of BTS reached 917, of which 70 BTS were added during 2009. As a result, Telefónica O2 Slovakia covered 93% of the Slovak population with the signal of its network. At the same time, 85% of all traffic was carried over the proprietary network, with 15% of traffic carried based on the national roaming arrangement.

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 Risk Management, 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 2009, 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, its 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 or competitive environment, changes in the legislation, which includes also regulatory intervention. Regulatory actions taken by the European Commission may have a significant bearing on the Company's bottom line.

Financial risks
Risks 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.