
Introduction



Innovative
approach

Independent auditor's report

To the Shareholders of Telefónica O2 Czech Republic, a.s.:

I. We have audited the consolidated financial statements of Telefónica O2 Czech Republic, a.s. and its subsidiaries ("the Group") as at 31 December 2010 presented in the annual report of Telefónica O2 Czech Republic, a.s. ("the Company") on pages 85 – 140 on which we have issued an auditors' report dated 18 February 2011, presented in the annual report on pages 87–88. We have also audited the separate financial statements of the Company as at 31 December 2010, which are presented in the annual report of the Company on pages 141–195 on which we have issued an auditors' report dated 18 February 2011, presented in the annual report of the Company on pages 143–144 (both referred further as "financial statements").

II. We have also audited the consistency of the annual report with the financial statements described above. The management of Telefónica O2 Czech Republic, a.s. is responsible for the accuracy of the annual report. Our responsibility is to express, based on our audit, an opinion on the consistency of the annual report with the financial statements.

We conducted our audit in accordance with International Standards on Auditing and the related implementation guidance issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the information presented in the annual report that describes the facts reflected in the financial statements is consistent, in all material respects, with the financial statements. We have checked that the accounting information presented in the annual report on pages 6–84 and 196–201 is consistent with that contained in the audited financial statements as at 31 December 2010. Our work as auditors was confined to checking the annual report with the aforementioned scope and did not include a review of any information other than that drawn from the audited accounting records of the Company. We believe that our audit provides a reasonable basis for our opinion.

Based on our audit, the accounting information presented in the annual report is consistent, in all material respects, with the financial statements described above.

III. In addition, we have reviewed the accuracy of the information contained in the report on related parties of Telefónica O2 Czech Republic, a.s. for the year ended 31 December 2010 presented in the annual report of the Company on pages 202–210. The management of Telefónica O2 Czech Republic, a.s. is responsible for the preparation and accuracy of the report on related parties. Our responsibility is to issue a report based on our review.

We conducted our review in accordance with the applicable International Standard on Review Engagements and the related Czech standard No. 56 issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the review to obtain moderate assurance as to whether the report on related parties is free from material misstatement. The review is limited primarily to enquiries of company personnel, to analytical procedures applied to financial data and to examining, on a test basis, the accuracy of information, and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the report on related parties of Telefónica O2 Czech Republic, a.s. for the year ended 31 December 2010 is materially misstated.



Ernst & Young Audit, s.r.o.
License No. 401
Represented by



Brian Welsh
Partner



Petr Vácha
Auditor, License No. 1948

25 March 2011
Prague, Czech Republic

Financial and operational highlights

Financial data is based on audited consolidated financial statements prepared in accordance with International Financial Reporting Standards. All figures, unless otherwise stated, are in CZK millions as at 31 December of each year.

Financials	2010	2009
Revenues	55 712	59 889
OIBDA – Operating income before finance costs, tax, depreciation and amortization ¹	27 380	27 076
Operating income	15 524	15 075
Income before taxes	15 318	14 877
Net income	12 280	11 666
Total assets	92 792	92 768
Property, plant and equipment	56 651	57 545
Total equity	73 176	73 879
Financial debts	3 024	3 131
Capital expenditure	5 663	6 489
Operations (end of period)		
Fixed accesses (x 1,000)	1 669	1 771
ADSL connections (x 1,000)	806	725
Pay TV – O2 TV (x 1,000)	129	138
Mobile registered customers in Czech Republic (x 1,000)	4 839	4 945
- of which contract pre-paid	2 864	2 814
	1 975	2 130
Active mobile customers in Slovakia (x 1,000)	880	553
Group headcount (end of period)	7 522	8 687
Ratios (in %)		
OIBDA margin (OIBDA/Revenues)	49,1	45,2
Net income/Revenues	22,0	19,5
Capital expenditure/Revenues	10,2	10,8
ROA (Net income/Total assets)	13,2	12,6
ROE (Net income/Equity)	16,8	15,8
Gross gearing (Financial debts/Total equity)	4,1	4,2

Macroeconomic indicators ²	2010	2009
Population (in millions)	10,5	10,5
GDP growth (in %) ³	2,2	-4,1
Inflation (in %)	1,5	1,0
Unemployment (end of period, in %)	9,6	9,2
CZK/USD exchange rate – average over the period	19,1	19,1
CZK/USD exchange rate – end of period	18,8	18,4
CZK/EUR exchange rate – average over the period	25,3	26,4
CZK/EUR exchange rate – end of period	25,1	26,5

¹ Including impairment reversal/loss and gains from sale of non-current assets. In 2009, the Group posted an impairment loss of CZK 23 million, while in 2010 it recorded impairment reversal of CZK 4,344 million attributable to the fixed line segment assets and impairment loss of CZK 18 mil.; gain from the sale of non-current assets reached CZK 422 million in 2009 compared to CZK 92 million in 2010.

² Sources: Czech Statistical Office, Czech National Bank, Ministry of Labour and Social Affairs.

³ At constant 1995 prices.

Letter from the Chairman of the Board of Directors



To Our Shareholders

Let me use this opportunity to review the activities, development and the results of the Telefónica O2 Czech Republic Group in 2010. Our results of the past year were marked by the gradual economic recovery, continuing strict regulation and the highly competitive climate in all areas we do business in. Despite the challenges of the external environment, I can frankly say that I regard our results of the past year as satisfactory and our activities make a good springboard for further improvement in the year 2011.

Let me first make a brief summary of our goals we entered the year 2010 with. In line with our long-term strategy to maintain the leadership in the Czech telecommunications market, our goal was to keep up the customer adds in our key business areas, which are mobile contract customers and ADSL broadband internet. By actively promoting our ADSL-centric proposition in the fixed access segment, we aimed to slow down the rate of decline in the number of fixed lines. Growing demand from our customers for mobile broadband internet propelled our plans to improve our offer in this area, alongside the expansion of our mobile data network coverage. In Telefónica O2 Slovakia, our aim was to grow the customer base and improve financial performance. Last but not least, we wanted to deliver on all of the above while maintaining our high operating efficiency.

And now let me review, in more detail, the achievement of our goals for 2010.

I am proud to say that we succeeded, without accounting for the one-off reduction of inactive customers, in increasing the number of our mobile contract customers by 160 thousand, especially in the fiercely competitive atmosphere that prevailed in the market in 2010. This achievement was largely aided by our active strategy focused on the migration of customers from pre-paid services to contracts, the steady popularity of our O2 NEON tariffs, and, in the second half of the year, also the positive effect of the increased mobile broadband customer base. Despite the considerable competitive pressure felt throughout the whole year 2010 from the cable provider UPC, we accomplished a solid growth in our ADSL customer base. In 2010, their number grew more than 11% to 806 thousand. The steady growth in the number of customers using our internet connectivity service without a voice tariff, and the growth in business customers using the Voice-over-IP service, contributed to the fact that the number of fixed accesses' losses in 2010 declined 17% on the previous year, down to 101 thousand.

As I already mentioned above, our long-term aspiration is to keep our leadership in the mobile internet market in the Czech Republic. We gave this segment our focused attention in 2010, with some positive results to report. By the end of 2010, we have covered almost 43% of the population with our 3G network, and EDGE was within the reach of almost all Czech population. At the same time we considerably increased the transmission speed – without compromising on the quality of the voice and data traffic. Together with our high-speed networks expansion we also launched a portfolio of innovated mobile internet tariffs

for our pre-paid and contract customers. The offer was successfully promoted by means of our Smart Network campaign, which delivered a promising growth in the number of mobile broadband customers and customers of internet in the mobile telephone in the second half of the year, followed by a positive effect on our mobile revenues.

Our offer of simple, transparent and clear O2 Fér tariffs in Slovakia, which, in the past two years, completely turned around the development in the Slovak mobile market, continued to attract customers and improve financial performance. In the past year alone, the number of customers went up by 328 thousand, closing the year 2010 with 880 thousand customers in total, which represents a 15% share of the market. This, in turn, delivered a solid revenue growth and positive OIBDA in the third and fourth quarter.

In line with our long-term strategy to constantly drive for better operating efficiency, in order to keep us in a competitive position in today's challenging market environment and to continue to create value for our shareholders, we embarked on an ambitious programme of restructuring in 2010. Its aim was to implement a more efficient organisation structure by way of reducing the number of organisation levels in the Company. We also focused on improving the efficiency of processes and systems. Special significance was attached to the transformation of our network operation, which resulted in outsourcing of some network related activities and delivered a headcount reduction by more than a thousand employees, with a positive effect on the staff costs in the second half of the year.

In addition to the above-mentioned restructuring programme, we continued with other projects aimed at improving our operating efficiency while raising the quality of customer care and customer experience. Improvements in the quality of service delivery, sales in our brand stores and communication with our customers have produced a reduction in the number of complaints and claims in both main customer divisions. We also saw an improvement in our call centres; their level of production increased while the average number of calls per customer and the average duration of call went down. Overall level of customer satisfaction with the service of our call centres also improved across all segments. All the above-mentioned activities aimed at enhancing the customer experience delivered an improvement in our Customer Satisfaction Index and helped us with closing on our competition.

As I already mentioned at the beginning, our financial performance in 2010 was aided by the gradual economic recovery, which has led to the stabilisation of consumption during the year in question, especially as far as mobile customers were concerned. Our revenues were at the same time under the pressure of falling termination rates and lower-than-expected ICT revenues due to fewer projects commissioned by the public sector. The total consolidated revenues reached CZK 55.7 billion in 2010, which is a 7% decline on the previous year. Projects and measures aimed at operating cost efficiency succeeded with reducing the operating costs (not accounting for the impact of the settlement agreement with T-Mobile from 2009) by 4.7% year on year, down to CZK 33.4 billion. The consolidated operating income before depreciation and amortisation (OIBDA) improved 1.1% year on year and reached CZK 27.4 billion, mainly due to the reversal of the impairment charge. Not accounting for this accounting operation, OIBDA would decline 14.9%, namely as a result of the lower revenues and one-off items posted in 2009 and 2010; the OIBDA margin would be 41.3%. This helped us maintain an above-average operating profitability compared to other operators in Central and Eastern Europe. I already mentioned that the year 2010 saw our investments going mainly into the roll-out of our mobile broadband networks and into projects to improve the quality of these networks. We also continued our selective investments in pro-growth areas, including namely various ADSL developments. We pursued focused investments in our information systems and technologies, to make their processes more efficient in the interest of greater operating efficiency and a better customer experience. The total investment costs were down 12.7% year on year to CZK 5.7 billion in 2010. Finally, in my review of our financial performance in 2010, I would like to highlight the 21.2% increase in free cash flows, which reached the total of CZK 16.4 billion and translates into CZK 51 per share.

The year 2011 will see us persevering with our dedication to improvement and enhancement of our relationship with customers by means of raising the quality of service and offering new products to meet the customers' needs. The priority for these initiatives and other projects is to achieve the ultimate customer experience and satisfaction. We will also continue with introducing further improvements to our portfolio of broadband services, where we plan to launch a host of VDSL-based services, in order to stabilise the number of fixed accesses and remain competitive. In line with our plans for further roll-out of the 3G network, and with the help of the recently signed agreement on 3G network sharing with T-Mobile, we will focus on offering innovated mobile broadband and data services. To this end, we plan to take advantage of our competitive position of having the largest and the best 3G network to attract more mobile broadband and mobile data customers, which will drive the share of these services in the total mobile revenues.

In Slovakia, we plan to continue with the active marketing of our transparent, simple and value-based services. We are confident that this strategy will impart a positive reflection on our financial performance and profitability, and help us maintain a solid growth in our customer base.

As there are several factors with an uncertain outcome at play, which will nonetheless have a bearing on our revenues, we present only a general outline of the expected developments in 2011. We anticipate that the revenues from ICT services may continue to be under the influence of the restrictions in the public sector, which will result in a lower number of projects. Additionally, mobile revenues will continue to be under pressure due to further cuts in mobile termination rates (by 35% in 2011). At any case, we will stay loyal to our drive for efficient operating and investment expenditure while continuing with investments that generate value for our customers and enhance their experience. And finally, cash flow generation and its maximisation remains one of our key strategic priorities for the future.



Luis Antonio Malvido
Chairman of the Board of Directors

Calendar of key events in 2010

January

Telefónica O2 launched a new network documentation portal which distributes digital maps detailing the situation of telecommunication networks on land to investors.

February

Telefónica O2 published its audited consolidated financial results prepared under International Financial Reporting Standards for the fiscal year 2009. Consolidated revenues reached CZK 59.9 billion and the net profit grew to CZK 11.7 billion.

The Board of Directors elected Louis Antonio Malvido its Chairman and appointed him Chief Executive Officer of Telefónica O2.

Jiří Dvorjančanský was appointed Executive Director for Residential Marketing at Telefónica O2.

Telefónica O2 became general partner to the Open Air Festival, a new multicultural project for the whole family.

March

Telefónica O2 introduced new tariffs O2 Business – the first tariffs in the Czech market that offered unlimited calling within business hours for a flat monthly fee.

The number of people participating in Reward for Top-up programme for the customers of pre-paid services exceeded a one million mark.

April

Telefónica O2 started marketing O2 Clean Internet, a service giving a professional standard of protection against malware and viruses in local networks, to business customers.

By purchasing goods at the traditional Easter markets, employees raised almost CZK 240,000 to benefit sheltered workshops.

The number of messages delivered via Data Box, a system for the official communication between the authorities on the one hand, and legal and natural persons on the other, exceeded a ten million mark.

May

An Ordinary General Meeting of shareholders of Telefónica O2 Czech Republic was held. The shareholders approved, among other things, a proposal of the Board of Directors for the payment of a dividend of CZK 40 per share. María Eva Castillo Sanz, an independent member of the Board of Directors of Telefónica, S.A., became a new member of the Supervisory Board and the Audit Committee.

The Board of Directors of Telefónica O2 approved an increase of the registered capital of Telefónica O2 Slovakia by means of a pecuniary contribution in the amount of EUR 40 million, to reach the total of EUR 240 million.

Telefónica O2 implemented changes in the organisation structure of the Company. A Marketing division and Strategy and Business Development division were created.

Telefónica O2 expanded the portfolio of its mobile data services with a new service O2 Pre-paid Mobile Internet, intended mainly for customers who are occasional users or are only just taking their first steps online; the pre-paid credit allows for being online anywhere, simply and anytime, without commitment.

June

Telefónica O2 took part in the global mobile campaign 1GOAL in support of children's education.

Telefónica O2 designed a special training in communication with people with a partial or total loss of hearing. The participants have become local ambassadors for the deaf or partially deaf in their regions.

July

Employees raised CZK 420,000 for the project called 'Let's Help Change the Story of One Life'.

Telefónica O2 matched the proceeds from each duck sold in the O2 Foundation's campaign Reward for Top-up between 27 July and 2 October; the proceeds from the fundraising campaign benefit a helpline for children (Linka Bezpečí) and for senior citizens (Linka seniorů).

August

Telefónica O2 acquires the domain www.o2.cz.

David Šita, Director, Strategic Account Division, left his post at Telefónica O2.

Telefónica O2 promulgated the date 2 August as the Day to Celebrate Coverage and, together with its customers, celebrated the six year anniversary of mobile internet in the Czech Republic by launching a special edition O2 Mobile Internet set.

Telefónica O2 matched the whole amount raised by employees to benefit the victims of floods, and prepared special programmes and services for those in need. All funds raised were donated to People in Need, a relief organisation which used them to alleviate the impact of floods in the stricken areas.

September

An Extraordinary General Meeting of shareholders of Telefónica O2 was held. The shareholders approved, among other things, a change in the form of all Company common shares in the nominal value of CZK 100 from bearer share to registered share. The reason for this change was the adoption of an amendment to the Public Procurement Act.

Jose Perdomo, Director, Consumer Division at Telefónica O2, left his post to join the newly established division Global New Services in the Telefónica Group, to helm its eHealth activities.

Telefónica O2 merged two divisions Strategic Accounts and Corporate and Business into a new Business division under the leadership of František Schneider.

Telefónica O2 introduced a new pre-paid card O2 Da, an economically priced option for Russian speaking and Vietnamese speaking customers in the Czech Republic call and send SMS to sixteen countries at local rates.

O2 Foundation donated CZK 10 million to help disadvantaged children and youth already for the ninth time.

October

A total of 270 employees helped out in fifteen charitable organisations in all corners of the Czech Republic as part of the Telefónica O2 Volunteer Day.

Telefónica O2 launched an innovated concept of its O2 TV service.

Two Telefónica O2's websites of O2 TV and the campaign Reward for Top-up, topped the WebTop100 of the most accomplished web presentation.

Telefónica O2 launched a new service, O2 Emergency Care, which expands the portfolio of telemedicine and telecare services supported by modern eHealth technologies.

November

The Supervisory Board of Telefónica O2 elected Alfonso Alonso Durána its Chairman and María Eva Castillo Sanz as the 1st Vice-Chairman. Anselmo Enriques Linares was co-opted a member of the Supervisory Board (the position had been vacant after Enrique Used Aznar's death in September 2010). The Supervisory Board elected František Schneider to succeed Jose Perdomo as member of the Board of Directors; František Schneider was formally made member of the Board of Directors after the resignation of Jose Severino Perdomo Lorenzo in September 2010.

Michal Urválek left Telefónica O2 and Steven Tree was made acting Director of the Human Resources division.

Telefónica O2 covered more than 40% of the Czech population with its 3G mobile data network; EDGE was available to 98% of the population.

Telefónica O2, in collaboration with the Czech Police, prepared a campaign to protect senior citizens against fraudsters and thieves.

Telefónica O2 received the prestigious 2010 Top Corporate Philanthropist award for the Most Responsible Partnership for its environmentally-friendly project of the Open Air Festival.

December

Tony Hanway is named the new Director of the Consumer Division at Telefónica O2.

As has become the tradition, employees raised CZK 317,000 to benefit disadvantaged fellow citizens through their purchases of Christmas gifts handmade in sheltered workshops.