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Board of Directors' Report on Business Activity



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The Czech telecommunications market in the first half of 2011

In the first six months of 2011, the telecommunications market in the Czech Republic continued to decline as a result of a slow recovery in consumer spend, additional mobile termination rates (MTR) cuts and the competitive pressures in selected customer segments.

The mobile market was dominated largely by introduction of new data services.

At the beginning of the year, Telefónica CR introduced a cost-optimised new way of charging for mobile services. Customers paid CZK 15 for the first hour of connection and the maximum amount of CZK 30 for a full day (FUP data limit was 30 MB/day). Especially customers who surf the internet on their mobile only occasionally benefited from the new mobile data pricing.

T-Mobile Czech Republic, a.s. (T-Mobile) came out with three new data bundles for contract and prepaid customers (Twist Internet in Mobile for A Week, Twist Internet for Travelling for A Month and Internet for Travelling for A Day). T-Mobile also introduced new data roaming tariffs, in both a "One Day" and "One Week" option.

Vodafone Czech Republic a.s. (Vodafone) launched mobile data roaming tariffs for the occasional data user in February: Passport Data for A Day and Passport Data for Good. The tariffs allow for the local monthly tariff being used also for going online in selected countries.

In March, Vodafone expanded its internet access portfolio when it added Connect for Two Days tariff, which is designed mainly for the occasional user of mobile internet.

Since March 2011, Telefónica CR cut the prices of its baseline offer of data roaming services for all zones; the largest price cut was for the EU zone, from CZK 240/MB down to CZK 24/MB, which is approximately 90%. The prices for roaming data bundles were also reduced by a significant margin.

Just before the holidays, all operators cut their prices of data roaming and voice services.

An independent survey by Ipsos Tambor showed that Telefónica CR had the best mobile data services and the best mobile internet coverage. The respondents confirmed that Telefónica CR is the leader in mobile internet among all operators.

In March, T-Mobile launched Magic Tuesdays, a new concept of customer benefits which replaced the company's previous Bonus programme. Bonus remained in effect only for medium business and large corporate customers.

From April, Telefónica CR introduced a number of improvements in the way it serves its entrepreneur and small business clientele. Telefónica CR among other things abolished the interactive voice response system in the call centres. The customer is now put directly through to the live operator. Selected brand stores have been fitted with special priority desks staffed with qualified assistants for business customers.

During the first half of the year, all mobile operators continued to modernize 3G networks and expand their coverage in the Czech Republic.

In February, Telefónica CR and T-Mobile signed an agreement to share their 3G networks in areas which are not yet covered. The shared infrastructure will in the future include approximately 1,000 BTS, with each operator committing to building a half of them. Telefónica CR will cover the eastern part of the Czech Republic, while T-Mobile will do the western part of the country.

As part of the 3G network sharing arrangement with T-Mobile, Telefónica CR standardised its methodology for the calculation of population coverage. At the end of June, the Company covered 55% of the population with its 3G network, thus confirming its leadership among mobile operators.

Two new virtual operators went live in the Czech Republic at the beginning of the year. OpenCall, which uses the CDMA network of U:fon operated by MobilKom a.s. (MobilKom), offers wireless fixed access and mobile voice in the form of a prepaid card. The second one, Mujoperator, also uses U:fon's network infrastructure to carry its services.

Several changes in the ownership relationships of companies occurred in the Czech fixed market during the first half of 2011.

The Office for the Protection of Economic Competition consented in January to the sale of České Radiokomunikace, a.s., to funds managed by Macquarie of Australia. The seller, Falcon Group, also owns almost 40% of T-Mobile.

In February, MobilKom, which operates the U:fon mobile network, announced a change in its ownership. Divenno Holdings, the parent company of Dial Telecom, a.s., acquired 100% of the shares in the company.

Also in February, UPC Česká republika, a.s. (UPC) took over Sloane Park Property Trust, a.s., which allowed UPC to interconnect the backbone optical networks of both companies. UPC established UPC Business, a unit dedicated solely to serving the business customer. In March, UPC also opened its first data centre in Prague.

In the fixed access segment, VOLNÝ, a.s., decided to terminate the provision of ADSL internet to the residential segment as part of its new strategic direction. Approximately 11 thousand of household accounts were taken over by Telefónica CR. The migration commenced in mid-March 2011 and the service parameters and the prices remained the same.

In February, MobilKom came out with a new proposition of fixed internet access using the ADSL technology, which complemented MobilKom's existing portfolio of prepaid and postpaid mobile internet. MobilKom buys fixed line connectivity wholesale from Telefónica CR.

In early May, Telefónica CR launched its new VDSL technology, which offers up to three times faster broadband internet for the home. Existing customers were given a faster internet connection at no extra charge. The technology was available to approximately 45% of households which are within a 1.3 kilometre radius from the switch..

Regulation

Several changes occurred during the first half of 2011 in the regulatory environment which governs the field of electronic communications in the Czech Republic. The most material changes included the following:

- Enactment of the Government Resolution No. 156/2011 Coll., amending the Government Resolution No. 154/2005 Coll., on the determination of the amount and method of calculation of fees for using radio frequencies and numbers, as amended;
- Enactment of the Government Decree No. 53/2011 Coll., amending the Decree No. 117/2007 Coll., on network numbering plans and electronic communications services, as amended;
- Enactment of the Decree No. 22/2011 Coll., on the method of determination of coverage of terrestrial radio broadcasting over selected frequencies;
- Continuation of the implementation of the revised regulatory framework for electronic communications networks in the Czech law:
 - Directive 2009/136/EC of the European Parliament and of the Council of 25 November 2009 amending Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services; 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;
 - Directive 2009/140/EC of the European Parliament and of the Council of 25 November 2009 amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, 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;
 - Regulation (EC) No. 1211/2009 of the European Parliament and of the Council of 25 November 2009 establishing the Body of European Regulators for Electronic Communications (BEREC) and the Office.

Telefónica CR 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, S.A.

Relevant markets analysis and product regulation

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

On 1 January 2011, the regulated wholesale price of mobile termination went down from CZK 1.66/minute to CZK 1.37/minute.

Further in January, the CTO issued a decision by which it gave a mandate to Ernst & Young, s.r.o., to develop a LRIC methodology and a model for the service of call termination in fixed public networks. The outputs from this project will be used by the CTO for the determination of maximum call termination prices for fixed public networks in late 2012 and early 2013.

Also in January 2011, the CTO decided to appoint the Asset Valuation Institute of the University of Economics in Prague to deliver a calculation of a WACC value for the purposes of regulation in the sector of electronic communications. Telefónica CR expects that the updated WACC will be used for the determination of regulated prices from 2012 onwards.

In February 2011, the CTO embarked on the third round of analysis of the relevant market No. 5 – wholesale broadband access in electronic communications networks. Telefónica CR expects that the analysis will be published in the form of a general measure by the end of 2011.

In April 2011, the CTO issued a decision, reflecting on the results of its analysis of the relevant market No. 6 – wholesale terminating segments of leased lines irrespective of the technology used for the provision of leased or reserved capacity, which changed the regulatory measures applicable to Telefónica CR in this market. Based on the decisions, pricing regulation no longer applies to the wholesale service. The imposed regulatory measures newly apply also to Ethernet leased lines.

Imposition of duties in connection with the Universal Service provision

Telefónica CR provided the following services 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.

For services under a), a CTO decision from 2009 reduced the number of payphones included in the Universal Service in 2011. The duty to operate payphones as part of the Universal Service concerned municipalities under 4,999 residents.

For services under c), a CTO decision imposed on Telefónica CR the requirement to provide the Universal Service component for special prices for a period of three years starting from 2 July 2011.

Government policy in the area of broadband internet

In January 2011, the Czech government approved a State Policy in the Area of Electronic Communications – Digital Czech Republic. The strategy deals with the development of ICT, with a special emphasis on bridging the digital divide between urban and rural areas. The document set the following objectives:

1. to ensure that broadband internet with the minimum (downlink) speed of 2 Mb/s, and 10 Mb/s in towns, is available in all populated locations in the Czech Republic by 2013;
2. to ensure that, by 2015, broadband internet is available in all rural settlements, with a speed which will equal at least 50% of the average broadband speed in towns. 30% of homes and businesses in towns should have internet with a speed of at least 30 Mb/s available to them.

As part of the process to implement the policy Digital Czech Republic, the Ministry of Industry and Trade published the first draft of the development criteria for the planned auction of frequencies in the so-called "digital dividend" band.

Continued support from the EU Structural Funds allowed ICT projects to continue in public institutions. The funding was directed mainly into the building of regional networks interconnecting public institutions, and also in the business sector. Telefónica CR was successful in tendering for public contracts financed with structural funding.

In April, the European Commission started the process of public consultation in the Community concerning the state aid rules with regard to fast roll-out of broadband networks.

Telefónica Czech Republic Group in the first half of 2011

The corporate names of some companies in the Telefónica Czech Republic (the Group Telefónica CR or the Group) changed in the first half of 2011: with effect from 10 May 2011, the corporate name of Telefónica O2 Slovakia, s.r.o., changed to Telefónica Slovakia, s.r.o. (Telefónica SK); with effect from 16 May 2011, the corporate name of Telefónica O2 Czech Republic, a.s., changed to Telefónica Czech Republic, a.s (Telefónica CR or the Company). The corporate names of the other members of the Group remained without change. The changes related to the effort to harmonize the corporate names of all European companies belonging to the group of Telefónica, S.A. In addition to the Czech Republic and Slovakia, Telefónica will be the one corporate brand also in the United Kingdom, Germany and Ireland. O2 remains the commercial brand of Telefónica CR.

In the context of the fiercely competitive telecommunications market, in the first half of 2011 Telefónica CR continued to improve its services, build up the relationship with its customers, develop and market new products and services in growth areas. The Company's strategy was focused on maximum accommodation of customers' demands in fixed and mobile broadband internet and mobile voice services for contract customers. This effort resulted in a solid growth in the customer base and, depending on the segment, maintenance or growth of the market share.

The net additions of mobile contract customers of 93 thousands ensured a 57% share of total market net additions for Telefónica CR. The result was also aided by the continued demand for mobile data services and the related expansion of the mobile data portfolio. Telefónica CR also continued to expand the coverage of its 3G mobile network based on a network sharing arrangement with T-Mobile. In February, the Company entered into an agreement with T-Mobile to share 3G network infrastructure in not yet covered areas of the Czech Republic. At the end of June 2011, 3G services were available to approximately 55% of the population.

The expanding 3G network coverage propelled the market interest for small-screen internet and mobile internet. As the demand grew, so did the penetration of smartphones in Company's customer base, which was approximately 16% at the end of June and represented a 6 percentage point year-on-year increase. In the first half of the year, the share of smartphone sales in the total handset sales was approximately 50%. In order to stimulate demand for small-screen internet, Telefónica CR launched a new marketing campaign with Google and Samsung in June. The campaign "Now I Know Why Have Internet in A Mobile" demonstrates the advantages of having small-screen internet and how smart applications can make people's lives easier. The campaign yielded its first results already in June, when the monthly incremental increase in the number of small-screen internet users more than doubled compared to the previous two months.

In the area of fixed broadband internet, the Company is pursuing its strategy to offer the best internet service in the marketplace and to strengthen its competitive position, to which end it focused on improving its services. In early May, Telefónica CR started to offer a VDSL service. Compared to ADSL, the new VDSL technology offered customers up to three times faster internet, while the prices for existing customers remained the same. The purpose was to retain the existing higher-value customers and to reduce churn. During a period of less than two months (until the end of June), the VDSL service was opted for by more than 40,000 customers, and in July already 9% of residential customers were using it and enjoying the benefits it brings. Telefónica CR thus managed to maintain its more than ten percent year-on-year growth in the number of xDSL customers, despite the highly competitive environment in the marketplace.

In Slovakia, the Group continued to offer its tariffs O2 Fér and added a special tariff for entrepreneurs, small and medium business customers – O2 Moja Firma. In April, a new tariff, O2 Filip, was added to the portfolio, to capture higher-value customers with a view to increasing ARPU. Telefónica SK's attractive proposition to the market assured a strong growth and improvement of the quality of the customer base, which in turn led to a significant rise in revenues and financial performance. In the first half of 2011 the company posted a positive OIBDA.

All above-mentioned activities produced a solid operating result in terms of customer base growth. The number of xDSL customers reached 841 thousand at the end of the first half of 2011, which is an 11.1% year-on-year increase. The number of O2 TV customers reached 130 thousand at the end of the first half year. As at the same date, the number of fixed accesses operated by Telefónica CR was 1.6 million. During the first six months of 2011, their number went down by 58 thousand, which is 6.2% less than in the same period of 2010. The number of mobile customers increased 0.5% to 4.9 million despite the highly saturated market. The increase was driven mainly by the growth in the number of contract customers, of which there were almost 3 million at the end of June, which is an increase of 6.5%. In the second quarter their number went up 57 thousand – the best result since 2009. The decline in the number of prepaid customers slowed down to 63 thousand in the first half of the year, compared to 70 thousand in the same period of 2010; in the second quarter alone, the number was down by only 15 thousand, which is the mildest drop since 2009. The number of mobile customers in Slovakia was up 122 thousand in the first half of 2011 and at the end of June stood at 1,003 thousand.

As in the previous years, also in the first half of 2011 the Company continued its campaign to improve its operating efficiency. The implementation of a restructuring programme which followed on the 2010 restructuring continued, and produced a Group-level headcount reduction of 192, down to 7,329 in the first half of 2011. In relation to the programme, the Company posted restructuring costs of CZK 158 million in the first half of the year.

As at 30 June 2010 and 2011, the total headcount of the Telefónica CR Group was the following in the geographical breakdown:

	As at 30 June 2010	As at 30 June 2011
Telefónica Czech Republic, a.s.	7,647	6,767
Telefónica O2 Business Solutions, spol. s r.o.	243	162
Employees in the Czech Republic	7,890	6,929
Telefónica Slovakia, s.r.o.	408	400
Employees in Slovakia	408	400
Group headcount total	8,298	7,329

Telefónica Slovakia

In the first half of 2011, Telefónica SK continued to market its successful services O2 Fér and O2 Moja Firma, the latter of which is a tariff for entrepreneurs, small and medium business customers. In early April, Telefónica SK introduced O2 Filip, a postpaid tariff for residential customers with a choice of three price points. The main selling point of the service was calls within the O2 which were free right from the first second of call. Customers also welcomed a "wallet" which gave them freedom to pick and choose their services for any given month. A customer would prepay a certain volume of service – "load the wallet" – and use the credit for SMS, calls to other mobile networks or data services in a proportion that they could change every month as they wished.

In the first half of the year, Telefónica SK directed a lot of effort to covering the territory with its proprietary 3G network which started offering service on commercial basis on 18 July 2011. On that date, the network covered approximately 30% of the Slovak population and by the end of August the coverage expanded further to reach one third of all population. Together with the launch of the 3G network, the company came out with two new 3G data bundles in Slovakia – one for small-screen internet and the first ever internet for notebook PC (big screen).

At the end of June 2011, Telefónica SK's own network covered already 94.9% of the Slovak population, which gave the company the leverage to carry 90% of traffic in its proprietary network. The remaining 10% of calls were still connected through national roaming. The share of on-net calls grew one percentage point year on year.

An independent survey by Ipsos Tambor for Telefónica SK revealed that Telefónica SK still has the highest score in the Customer Satisfaction Index among all mobile operators in Slovakia. The Customer Satisfaction Index (CSI) reached a historically record level and the company increased its lead over the nearest competitor.

As at 30 June 2011, Telefónica SK had 1,003 thousand customers, of which 411 thousand were contract customers. This represents a year on year growth in the customer base of 41.5%, which gave Telefónica SK the leverage to strengthen its position in the Slovak mobile market, where it held a 16.6% share at the end of June – up 1.9 percentage point compared to the end of 2010. Since the implementation of number portability (in November 2007) until 30 June 2011, customers ported already 313 thousand numbers to Telefónica SK.

The revenues of Telefónica SK reached EUR 73.1 million in the first half of 2011, which is up 49.8% year on year. The company also posted a positive Operating Income before Depreciation and Amortisation (OIBDA) for the first half year..

New products and services

On 27 January 2011, Telefónica CR changed the way it bills for occasional use of mobile data services. Users now pay CZK 15 for the first hour of connection, and CZK 30 for a full day. The daily FUP data limit was set at 30 MB. The new method of billing is economical especially for occasional use of mobile internet. To those who want to go online wherever and whenever via their mobile phone, the Company offered the postpaid O2 Internet on Your Mobile Start for CZK 150 per month, O2 Internet on Your Mobile for CZK 300 per month for even a more demanding user. The new method of billing applied equally to new and existing customers. The billing unit of time became activated when a data link was established. Within the frame of the billing unit the customer can download data continuously – but they can also pause the transmission. The customer is informed via SMS right after going online that the service is being billed.

For its customers who use the fixed line, Telefónica CR introduced new tariffs and bundles with calls to all mobile networks in the Czech Republic priced from CZK 2 per minute. Customers who call international benefited from a new service which offered calls to international fixed lines in 47 countries of the world priced from CZK 2 per minute. New tariffs and bundles O2 Calling Mobile and O2 Calling International can be combined depending on the most frequently called destinations. They can be used in pairing with fixed voice tariffs with free calls to fixed networks in the Czech Republic. For attractive prices, customers could call in all directions. The offer could be subscribed by residential customers, entrepreneurs and small businesses. O2 Calling Mobile was activated by approximately 15 thousand customers in 6 months.

For new and existing mobile prepaid customers, Telefónica CR prepared a new cut-price call offer valid from the beginning of March. All users of the tariffs NA!HLAS or NA!PIŠTE could call three O2 numbers of their choice for only CZK 0.50 per minute for up to six months.

From 1 March, the Company cut its data roaming prices – both in the baseline offer and for the majority of roaming bundles. The largest price cuts were for the EU zone, with prices slashed from CZK 240/MB to CZK 24/MB. The new pricing for the EU zone was the most competitive offer on the market. The zone encompassing the rest of Europe saw the prices cut from CZK 420/MB to CZK 240/MB, and the rest of the world from CZK 660/MB to CZK 300/MB. For roaming bundles available to both contract and prepaid customers, the prices were reduced to CZK 60/2 MB, CZK 120/4MB, CZK 240/10 MB and CZK 1,200/50MB. Additionally, the price for the roaming bundle EURODATA 250 MB was cut from CZK 2,388 to CZK 480 from 1 April. The benefits of this bundle product were welcomed especially by frequent travellers in the EU who need to use data roaming regularly. With regard to the reduced data roaming prices, EU limit, a service which makes sure that customers travelling in EU countries do not exceed a specific limit, also changed: the limit of CZK 1,176 now allows 49 MB of data.

Those of Telefónica CR's customers who are self-employed or run a small business could get 30% extra free minutes of calls to all networks with their O2 Business or O2 NEON tariff. If they simultaneously activated a second SIM card, they got 50% of free minutes extra. In order to improve the customer satisfaction in this segment, Telefónica CR stopped using the interactive voice response (IVR) system in its call centre from April; the customer was put through directly to a live operator. Especially for business customers, special priority desks were set up in selected brand stores, staffed with trained specialists. The priority desks were available from mid-April in 60 stores in the Company's retail network and their number has been steadily rising. At the beginning of April, Telefónica CR launched a new communication campaign to promote its proposition to entrepreneurs and business customers. The stars of the campaign are two cartoon characters, Martin and Lucie. The campaign sought to promote the benefits that are delivered by the products and improvements in customer care.

From 9 May 2011, Telefónica CR has a new fixed broadband internet using the VDSL technology on the market. VDSL is capable of delivering up to three times faster internet to the home. Existing customer had their home internet speed increased without any extra charge. Telefónica CR also introduced new fixed internet prices for download speeds up to 25 Mb/s and upload speed of up to 2 Mb/s. Existing customers got a speed upgrade without any extra charge above what they had been paying for home internet. If a customer committed for 12 months, they could claim a modem for only CZK 1. Customers who were not within the reach of VDSL could enjoy a host of O2 Extra discounts with a number of retail partners. When committing for 12 months, these customers got a prepaid Mobile Internet set worth CZK 995 for only CZK 1. Customers of the tariff O2 Internet Pro with the speed of up to 16 Mb/s were migrated to Internet Aktiv for a lower price of CZK 850 per month. Customers could choose one of the two new VDSL tariffs – Internet Optimal with a download speed of up to 16 Mb/s or Internet Aktiv with a download speed of up to 25 Mb/s and an upload speed of up to 2 Mb/s. Telefónica CR at the same time introduced promotional

pricing for new customers willing to commit for 12 months. With the commitment, Internet Optimal cost CZK 500 compared to the listed price of CZK 700 per month; Internet Aktiv could be ordered for CZK 600 compared to the standard listed price of CZK 850.

Together with the marketing campaign "Now I Know Why" in June, Telefónica CR introduced other new products and services for the users of small-screen internet. The upgraded O2 Active portal and the O2 official facebook page newly feature the section Mobile Applications. Customers can use a detailed guide through the world of applications and small-screen internet – either in print or through a special application Now I Know Why. In partnership with Samsung, Telefónica CR prepared an offer of smartphones for "smart prices" and a special small-screen internet package for young people. In order to facilitate customers' first steps in the world of mobile applications, the Company introduced a number of innovations to customer care. A special team of operators now dispense advice and assistance in social networks – on the official facebook page and via the Company's twitter feed. The four-member team of specialists is available every day from 8am until 8pm including weekends to give assistance, advice and answer questions. Detailed video tutorials on the official YouTube feed in section O2 Guru and specialists in O2 brand stores were also available by way of assistance and advice.

Existing customers in the corporate segment benefited from Telefónica CR's offer of faster asymmetrical broadband internet connection using the VDSL technology and also a faster symmetrical internet connection, including a seamless migration from Internet Forte to Internet Business service.

From 1 May, Telefónica CR cut the prices of most mobile handsets for corporate customers. The new prices were much more competitive – in comparison with both the offers from other mobile operators and unaffiliated e-shops.

On 15 May, Telefónica CR introduced "Exclusive Customer", a new proposition to corporate customers. Any company subscribing to all basic services (fixed voice, fixed internet, mobile voice) could apply for the status of Exclusive Customer, which came with premium benefits such as better customer care, proactive optimisation, special handset prices, personal assistance over a telephone and many others, to reward the customer for their loyalty, improve satisfaction and create opportunity for up-selling of new services from Telefónica CR. The Company believes that the new proposition will help it strengthen its market position in this highly competitive segment.

At the same time as it launched its new website www.o2.cz on 1 February 2011, Telefónica CR started to offer e-bill functionality. An electronic bill in section My O2 gives an overview of fixed and mobile usage of customers. By implementing this feature, the Company responded to the market demand for this type of billing and improved its customer care.

Commented financial results

In this section we present and comment on the unaudited consolidated financial results of the Telefónica CR Group including the results of Telefónica Czech Republic, a.s. (Telefónica CR or the parent company), Telefónica Slovakia, s.r.o., Telefónica O2 Business Solutions, spol. s r.o. and other smaller operating companies. The results were prepared according to International Financial Reporting Standards (IFRS).

Consolidated Financial Statements

Consolidated business revenues went down 6.7% year on year to CZK 25,898 million in 1H 2011 (-7.2% year on year in 2Q to CZK 13,033 million). The financial performance of the Group was impacted by the prevailing competitive pressure largely in corporate and SMB mobile segments, MTR cuts, and lower ICT revenues. Fixed business revenues in the Czech Republic declined 7.9% year on year reaching CZK 11,300 million in 1H 2011 (-7.6% year on year in 2Q 2011, down to CZK 5,657 million). At the same time, the mobile revenues in the Czech Republic declined 9.7% down to CZK 12,925 million in 1H 2011 and 10.7% year on year down to CZK 6,504 million in 2Q. With the impact of MTR cuts excluded, the growth rates would be at -7.0% and -5.0% in 1H and 2Q 2011, respectively. On the other hand, revenues in Slovakia continued to grow steadily and recorded a 49.8% year-on-year increase, reaching EUR 73.1 million in 1H 2011 (+46.7% year on year, up to EUR 38.5 million in 2Q 2011 alone).

In 1H 2011, the Company continued in its effort to deliver cost efficiencies in both commercial and non-commercial areas, to compensate for pressure on the revenues. Despite the higher commercial activity, largely in fixed and mobile broadband areas, the total consolidated operating costs were down 4.1% year on year, reaching CZK 15,867 million (-5.0% excluding brand fees and management fees); the situation was also positively influenced by MTR cuts. The positive impact coming from 2010 and 1H 2011 restructuring programs led to a 9.7% year-on-year reduction of personnel expenses in 1H 2011. The total Group headcount reached 7,329 at the end of June 2011, down 11.7% year on year. In 1H 2011, the headcount has been reduced by additional 192 employees.

Group's Operating Income Before Depreciation and Amortisation (OIBDA) reached CZK 10,275 million in 1H 2011, -8.3% year on year (-11.2%, down to CZK 5,205 million in 2Q 2011 alone). In 1H 2011, Telefónica SK recorded a positive OIBDA again, reaching individual millions of EUR in the period. At the same time, the guided OIBDA¹ fell 6.8% year on year, reaching CZK 10,845 million in 1H 2011, while the OIBDA margin remained almost flat at 41.7%, on the back of the already mentioned focus on cost efficiency and profitability improvement in Slovakia.

Depreciation and amortization charges went up 1.0% year on year in 1H 2011, impacted by an impairment reversal booked in 3Q 2010 (higher gross value of fixed assets), as commented on in the previous quarters. Consolidated net income amounted to CZK 3,611 million and CZK 1,871 million in 1H and 2Q 2011, down 17.1% and 20.1% year on year, respectively, due to the decline in OIBDA and the higher depreciation and amortization, which were not fully compensated by the lower financial expenses and the lower income tax expense.

Consolidated CapEx reached CZK 2,554 million in 1H 2011, up 7.4% year on year. In line with the strategy to focus its investments into growth areas, the Company continued to target investments into capacity expansion and quality improvement of 3G network. In addition, CapEx was spent on a further expansion of the 3G network coverage, including the coverage of currently unserved areas on the basis of a network sharing contract with T-Mobile. The Company increased the 3G population coverage to ~ 55% as at the end of June 2011. Additionally, the Company focused its investments into the upgrade of the fixed broadband network in connection with the launch of a new VDSL-based customer proposition on 9 May 2011, which was aimed at strengthening of the Company's position on the highly competitive fixed broadband market in the Czech Republic. In Slovakia, CapEx was largely spent on additional network investment related to the planned launch of 3G services in mid July.

¹ In terms of 2011 guidance calculation, OIBDA excludes brand fees and management fees (CZK 423 million in 1H 2010 and CZK 551 million in 1H 2011), assuming constant FX rates of 2010.

Group free cash flows decreased 15.2% year on year, reaching CZK 6 billion in 1H 2011, as a combination of a 6.1% decline in cash from operating activities, better than recurring OIBDA decline and a 15.5% higher CapEx related cash payments due to the different CapEx phasing in 2011 compared 2010.

Consolidated financial debt amounted to CZK 3,111 million as at 30 June 2011, which produced a 2.9% growth compared to the end of 2010. Cash and cash equivalents reached CZK 10,820 million, up from CZK 4,798 million at the end of 2010, due to the accumulation of cash for the dividend payment in October 2011.

CZ Mobile Business Overview²

In 1H and largely in 2Q 2011, the mobile business continued to deliver a solid commercial performance in the mobile contract segment, which was supported by the market demand for mobile broadband services – in spite of the intense competitive pressure. The financial performance continued to be negatively impacted by the tough competition, MTR cuts (-30.1% year on year³) and the slow recovery of customer spend patterns.

The total mobile customer base reached 4,869 thousand at the end of June 2011, which is a 0.5% year-on-year increase. In 2Q 2011, the Company recorded 42.1 thousand net additions in its mobile customer base, the best figure in last seven quarters, on the back of the continuous strong contract base growth and a significant improvement in prepaid base. The number of contract customers went up 6.3% year on year, reaching 2,956 thousand at the end of 2Q 2011 with 56.9 thousand net adds in the quarter (+62.7% year on year, excluding the disconnection of 111 thousand inactive contract customers in 2Q 2010). This performance continued to be driven by customers migrating from the prepaid to the contract segment and the positive contribution of the growth in the number of mobile broadband customers. At the end of June 2011, contract customers accounted already for 60.7% of the base (+3.3 percentage points year on year). The number of prepaid active customers reached 1,912 thousand at the end of 1H 2011, down 7.2% year on year, with only 14.8 thousand net losses in the quarter, down from 47.9 thousand in 1Q 2011 and 62.6 thousand in 4Q 2010.

The blended monthly average churn rate reached 1.72% in 2Q 2011, posting a 1.1 percentage point year-on-year decrease (-0.3 percentage point excluding the impact of the disconnection of inactive customers in 2Q 2010) and a 0.3 percentage point decline compared to 1Q 2011. This is a result of the improvement in prepaid churn (-0.6 percentage point year on year and -0.5 percentage points quarter on quarter), which was driven by the increased focus on acquiring higher-value customers and the success of the customer loyalty scheme, which rewarded for regular top-ups. The contract churn declined 0.1 percentage points year on year compared to 2Q 2010 and 1Q 2011.

In terms of usage, the total mobile traffic⁴ from customers in the Czech Republic reached 4,433 million minutes in 1H 2011, up 1.0% year on year.

² Figures are shown net of inter-segment charges between fixed and mobile businesses

³ From CZK 2.37 to CZK 1.96 in January 2010, to CZK 1.66 in July 2010 and to CZK 1.37 in January 2011

⁴ Outbound and inbound, including roaming abroad, excluding inbound roaming

In 1H 2011, the mobile blended ARPU⁵ reached CZK 426.4, down 8.9% year on year (-10.2% year on year, down to CZK 428.7 in 2Q alone), in which the MTR cuts played a part. With the impact of MTR cuts excluded, the total ARPU in 2Q 2011 would have declined 6.3% year on year. Voice ARPU dilution, which itself was driven by the intense competition and the slow recovery of customer spend patterns, were, for the most part, the key drivers of the decline. Contract ARPU reached CZK 586.9 and CZK 585.1 in 1H and 2Q 2011, down 11.6% and 13.1% year on year, respectively (-9.6% year on year in 2Q 2011, excluding the impact of the MTR cuts). Prepaid ARPU fell 8.6% and 9.2% year on year in 1H and 2Q 2011, reaching CZK 185.8 and CZK 190.1 in these periods (-4.3% year on year in 2Q 2011, excluding the impact of the MTR cuts). Data ARPU declined 1.9% and 2.5% year on year in 1H and 2Q 2011, reaching CZK 114.8 and CZK 114.5. As was the case in 1Q 2011, the cuts in data roaming prices and the continuous SMS/MMS bundling were the key drivers behind the data ARPU dilution. With the effect of these two factors discounted, the data ARPU would improve 5.4% year on year, with the mobile broadband customer base uptake remaining the key driver of the improvement.

The total mobile business revenues in the Czech Republic declined 9.7% to CZK 12,925 million in 1H 2011 and 10.7% year on year, reaching CZK 6,504 million in 2Q alone, while the revenues from mobile services went down 10.4% and 11.5% year on year in these periods, as a result of the above-mentioned competitive pressure, MTR cuts, slow recovery in spend and the lower data roaming prices. Mobile termination rate cuts diluted the mobile service revenues by 3.8 percentage points in 1H as well as in 2Q 2011. Despite the 1.0% year-on-year growth in the outbound mobile voice traffic, the traffic revenues decreased 16.8% year on year, down to CZK 3,505 million in 1H 2011 (-18.5% year on year in 2Q), as a result of the frequent traffic bundling and the competitive pressure. Interconnection revenues went down 28.2% year on year to CZK 1,400 million in 1H 2011, largely due to the MTR cuts and the lower incoming traffic. Other revenues (including SMS & MMS, data and other business revues) declined 2.7% year on year in total, reaching CZK 3,517 million in 1H 2011 (-2.7% year on year in 2Q), largely due to the lower data roaming prices and more SMS/MMS bundling. With the effect of SMS/MMS bundling and data roaming price cuts excluded, data revenues would report a 5.6% year-on-year growth in 1H 2011, confirming the positive impact of the growing contribution of revenues from mobile broadband services.

CZ Fixed Business Overview⁶

In 1H 2011, the fixed business recorded again a solid commercial performance in terms of the broadband customer base and a further slowdown of the rate of decline in the number of fixed accesses. Similarly to the previous periods, revenues from traditional voice services recorded a further decline; however the decline rate slightly decelerated in 2Q, aided by the better performance in transit revenues. Broadband revenues sustained the growth seen in the previous quarter, which is very relevant in the highly competitive fixed broadband environment. Additionally, the financial performance in 2Q 2011 continued to be impacted by the lower ICT revenues.

The total number of fixed accesses declined 5.7% year on year, reaching 1,611 thousand at the end of June 2011, with 58.4 thousand net losses in 1H 2011 (-6.2% year on year). The trend was supported by the steadily solid uptake of naked accesses and VoIP lines for corporate customers.

⁵ Including inter-segment revenues

⁶ Figures are shown net of inter-segment charges between fixed and mobile businesses

The number of xDSL accesses reached 841 thousand at the end of 2Q 2011, up 11.1% year on year. In 1H 2011, their number went up by 34.7 thousand, posting an 11.3% year-on-year growth. As was communicated already with respect to 1Q, on 9 May 2011 Telefónica Czech Republic launched its VDSL-based proposition, which offers the customers considerably higher speeds and enhances their experience. Already 41 thousand customers subscribed to the new service by the end of June 2011. The total number of O2 TV customers reached 130 thousand at the end of 1H 2011.

Voice traffic generated in the fixed network went down 13.8% in 1H 2011 to 795 million minutes as a result of the continuing losses in the number of fixed accesses and the effects of fixed-to-mobile substitution.

In 1H 2011, the total fixed business revenues went down 7.9% year on year, to CZK 11,300 million. However, in 2Q alone, the decline rate decelerated to 7.6% year on year (-8.3% year on year in 1Q 2011 and -11.6% year on year in 4Q 2010). Revenues from traditional accesses fell 16.6% year on year in 1H as well as in 2Q 2011, reaching CZK 2,239 million in 1H 2011, due to continued losses of fixed accesses, while the revenues from traditional voice services went down 9.0% year on year, to CZK 3,398 million in 1H 2011. However, in 2Q alone, they declined by only 7.6% year on year; the positive effect came from the higher transit revenues posted in the quarter. Internet & broadband revenues increased 0.8% year on year in total in 2Q and 1H 2011, and reached CZK 3,012 million in 1H 2011, positively impacted by the growth in the number of xDSL customers, which is good news in the highly competitive fixed broadband market. Revenues from IT services and business solutions declined 6.8% year on year to CZK 959 million in 1H 2011 (-7.3% year on year in 2Q 2011), as a result of the lower number of projects in the government segment.

Slovakia

In 1H 2011, Telefónica SK continued to report a strong set of commercial and financial results, thus further strengthening its position in the Slovak mobile market. By the end of June 2011, the total number of active customers increased 41.5% year on year to a total of 1,003 thousand on 30 June 2011. The total subscribers net additions reached 122.2 thousand, driven by a growth in the contract customer base. The number of contract customers grew 59.1% year on year, reaching 411 thousand, which represents 76 thousand net additions over 1H 2011, while the number of prepaid active customers increased 31.4% year on year, ending up at 592 thousand at the end 1H 2011 (+46.2 thousand in 1H 2011). Consequently, the customer mix in Slovakia improved further and contract customers represented an already significant 40.9% share of total customer base, up 4.5 percentage point year on year. In terms of financial performance, the total revenues of Telefónica SK in the local currency increased 49.8% year on year to EUR 73.1 million in 1H 2011 (+46.7% year on year in the quarter to EUR 38.5 million, up from EUR 34.6 million in 1Q 2011), which had been fuelled by the strong base growth and also the year-on-year ARPU growth. In 1H 2011, Telefónica SK recorded a positive OIBDA again in the range of individual millions of EUR. In 2Q 2011, the contract ARPU reached EUR 18.2 (EUR 17.5 in 1Q), while the prepaid ARPU improved 2.4% year on year to EUR 8.7 (EUR 8.3 in 1Q).

Outlook for the second half of 2011

Based on the results delivered in the first half of 2011 and outlook for the second half, Telefónica CR Group confirms its full year guidance⁷ for OIBDA and CapEx.

⁷ OIBDA decline of -1% to -5%, CapEx around CZK 5.7 billion. In terms of 2011 guidance calculation, OIBDA excludes brand fees and management fees (CZK 1,057 million in 2010). In addition, 2010 OIBDA base excludes reversal of the impairment loss of CZK 4,343 million. 2011 guidance excludes changes in consolidation, includes potential capital gains from non core asset sales assuming constant FX rates of 2010.

Telefónica CR believes that the overall performance of mobile market in the Czech Republic will marginally improve and produce a slower rate of decline in revenues compared to the first half year. The solid commercial achievements in contract customer base during the first half of 2011, when the Company captured close to 60% of the total market net additions, it expects it will maintain its relevant share of the mobile subscriber market.

In line with the further expansion of its 3G network coverage, the Company expects the growth trend of internet-capable handsets and mobile broadband customer base to continue. This will reflect in the growth of non-SMS data ARPU in the second half of 2011.

The strong commercial and financial results of Telefónica SK in the first half year will positively impact the Group's financial performance in the next six months. The operation in Slovakia is very efficient due to its leverage on finance, network, operations, IT and other back office functions in the Czech Republic. As a result, the expected continued revenue growth in Slovakia will directly flow to OIBDA. Consequently, OIBDA in the second half year should almost double compared to the level in the first six months.

In addition to the facts mentioned above, Telefónica CR Group will persevere in its effort focused on delivering maximum efficiency of commercial and non-commercial expenditure in order to compensate for the revenue decline and to sustain its operating profitability. Initiated already in the first half of the year, the restructuring program will result in a full-year group-level headcount reduction of approximately 7% and an approximately similar saving of related personnel expenses.