Board of Directors' Report on Business Activity

02

We cover more than 1,500 cities and towns in the Czech Republic with 3G mobile networks.

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Telefónica Czech Republic Group

Overview of the Group and the main changes in 2011

The group of Telefónica Czech Republic (Telefónica Group) comprises Telefónica Czech Republic, a.s. (Telefónica or Company) and several other subsidiaries. In 2011, the Group's services were provided mostly on the territory of the Czech Republic and in Slovakia. Through a wholly-owned subsidiary Telefónica Slovakia, the Group has been operating in Slovakia since 2007.

In the first half of 2011, some companies in the Telefónica CR Group changed their company name. With effect from 10 May 2011, the company name of Telefónica O2 Slovakia, s.r.o., was changed to Telefónica Slovakia, s.r.o. Following that, with effect from 16 May 2011, the company name of Telefónica O2 Czech Republic, a.s., was changed to Telefónica Czech Republic, a.s. Other companies in the Group did not change. The changes were required to harmonise the company names in all European markets of the group Telefónica, S.A. In addition to the Czech Republic and Slovakia, Telefónica will be the single corporate brand in the United Kingdom, Germany and Ireland. O2 remains the commercial brand of Telefónica CR.

In June 2011, the Board of Directors of Telefónica CR approved a project to transform its subsidiary Telefónica O2 Business Solutions, spol. s r.o., through demerger by spin-off. The project sought to spin off a part of the assets of the demerged company into a newly incorporated subsidiary Internethome, s.r.o., whose business it is to provide electronic communications services. The change and the spin-off became legally effective as of 1 October 2011, when Internethome, s.r.o., was registered in the Commercial Register. The demerged company Telefónica O2 Business Solutions, spol. s r.o., whose core business continues to be the provision of information and communication technologies, was not dissolved in the process of the transformation.

On 1 January 2012, Telefónica CR incorporated a new subsidiary by the name of Informační linky, a.s.; the incorporation was registered in the Commercial Register as of the same date. The subsidiary was founded by contributing a part of the assets of the organisation unit Information and Assistance Services, which operates directory and assistance services on the numbers 1180, 1181 and 1188. The spin-off process transferred all units of the division (including employees) to the subsidiary.

Telefónica CR 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 CR 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 2011, Telefónica Group comprised the following subsidiary companies and affiliates:

Company	Registered address	Area of business	Company identification number	Registered capital	Company's share in the registered capital of the subsidiary expressed in %
Subsidiary companies					
Telefónica O2 Business Solutions, spol. s r.o.	Praha 4 – Michle Za Brumlovkou 266/2 postal code 140 00 Czech Republic	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 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%
Internethome, s.r.o.	Praha 4 – Michle Za Brumlovkou 266/2 postal code 140 00 Czech Republic	WiFi internet access services	24161357	CZK 200,000	100%
Affiliate companies					
AUGUSTUS spol. s r.o.	Praha 10 – Vinohrady Na Zájezdu 1935/5 postal code 101 00 Czech Republic	Consultancy and agency in the field of telecommunications	49356160	CZK 166,000	39.76%
První certifikační autorita, a.s.	Praha 9 – Libeň Podvinný mlýn 2178/6 postal code 190 00 Czech Republic	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 Czech Republic	Real-time mobile payment services	24759023	CZK 104,000,000	14.29%

Restructuring programme

As in the previous year, also in 2011 the Company strived to improve its operating efficiency. To this end, it embarked on the next phase of its restructuring programme. Restructuring projects focused, among other things, on the consolidation and optimisation of the call centre operations, resulting in a Group headcount reduction by 631 down to 6,890 in 2011. In connection with the Company posted restructuring costs of CZK 174 million in 2011.

Number of employees of the Telefónica Group by region:

Telefónica Europe	As at 31 December 2011	As at 31 December 2010
Telefónica Czech Republic, a.s.	6,340	6,936
Telefónica O2 Business Solutions, spol. s r.o.	154	178
Employees in the Czech Republic	**6,494**	**7,114**
Telefónica Slovakia, s.r.o.	396	408
Employees in Slovakia	**396**	**408**
Employees of the Group in total	**6,890**	**7,522**

Telefónica Slovakia

As at 31 December 2011, Telefónica Slovakia had a total of 1,164 thousand customers, of which approximately 498 thousand were contract customers. This represents a year-on-year growth of 32.2%. Since the free number portability was enabled in November 2007, customers of Telefónica Slovakia ported more than 387 thousand numbers to the network of Telefónica Slovakia.

Also in 2011 Telefónica Slovakia continued to market its successful tariffs O2 Fér and O2 Moja Firma designed for small and medium businesses. In early April the company launched O2 Filip, a new tariff for individual customers, which comes in three price point variants.

During the course of 2011, Telefónica Slovakia worked intensively on rolling out its own 3G network to new areas. The company put the commercial proposition of new data bundles on the market at the start of the second half of the year, when the network reached approximately 30% of the Slovak population. At the end of 2011, the coverage extended to one third of the population, and in December the company announced its plan to expand the network to cover 50% of the population in autumn 2012.

As part of its endeavour to improve customer care, in autumn 2011 Telefónica Slovakia introduced O2 Super, a new loyalty programme which included diverse benefits – culinary, travel, entertainment, home furnishings or body care. The company also brought to Slovakia a successful concept tried and tested in other Telefónica companies: O2 Guru. A specially trained O2 Guru team assists customers in particular with new technology. The project was started in Slovakia in mid-July 2011.

At the end of December 2011, Telefónica Slovakia reached already 94.9% of the Slovak population. The coverage already supported 90% of all calls carried within the company's own network. The remaining 10% of traffic was carried using national roaming.

An independent survey carried out by Ipsos Tambor jointly with Telefónica Slovakia showed that the company was again ahead of the field of Slovak mobile operators in terms of customer experience, and that it also leads the customer experience index among the Telefónica Group companies.

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 2011, 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.

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.

Operating risks

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

The above risks are regularly monitored and managed in a way that corresponds to the nature of the risk.

The telecommunications market in the Czech Republic

In the first half of 2011, the telecommunications market in the Czech Republic saw a decline. The reasons included the difficult economic environment in the marketplace including a fierce competition, and further cuts in the mobile termination rates. The situation improved slightly in the second half of the year, particularly as the consumption of mobile customers in the residential segment stabilised.

Despite the challenges of the environment, Telefónica CR managed to maintain a solid growth in the number of customers, especially in the area of mobile services and broadband internet.

In 2011, the number of mobile customers increased by 103 thousand to 4,942 thousand. As T-Mobile Czech Republic (T-Mobile) and Vodafone Czech Republic (Vodafone) use a different methodology of accounting for mobile customers, a true comparison is not possible; still, Telefónica CR significantly strengthened its market position as measured by the number of contract customers with an increase of 186 thousand, which represents a 49.5% share in the total additions of contract customers in the Czech mobile market in 2011. At the end of the year, the Company's market share stood at 39.4%, up 0.5 percentage point year on year.

All mobile operators directed their investments at improving their broadband data networks and increasing the network capacity, to prepare for future growth.

The modernisation and expansion of the 3G network in all parts of the Czech Republic continued in the first half of the year. In February, Telefónica CR and T-Mobile signed an agreement to share their 3G networks in the rural areas. The shared infrastructure should, in the future, include 1,000 BTS, with each of the two operators building a half of them. Telefónica CR committed to covering the eastern part of the Czech Republic with the network, while T-Mobile will roll out the network in the western part.

As part of the 3G network sharing arrangement, T-Mobile and Telefónica CR harmonised their methodologies for the calculation of the population coverage. At the end of December, the Company covered 73% of the population with signal.

Telefónica CR also continued to roll out its optical networks and pursued further investments in the WiFi segment, with a view to strengthening its market position.

Two new virtual operators started up in the Czech market in 2011. OpenCall uses the CDMA network of U:fon operated by MobilKom and offers wireless fixed access and a mobile service with a prepaid card. The other one, Mujoperator, also uses the network of U:fon to carry its service.

Trends on the fixed internet access market

Several changes occurred during 2011 in the ownership structure of market players.

In January, the Office for the Protection of Economic Competition gave permission to sell České Radiokomunikace to funds managed by the Macquarie Group of Australia. The seller was Falcon Group, which also owns close to 40% of T-Mobile.

In February, MobilKom, which operates the U:fon network, announced a change of ownership: Penta sold its 100% interest in the company to Divenno Holdings, the mother company of Dial Telecom.

Also in February, UPC Česká republika (UPC) took over Sloane Park Property Trust, which allowed UPC to integrate the optical backbone networks of the two companies. A new unit, UPC Business, was created, with a sole focus on the business segment. UPC opened its first data centre in Prague in December.

In early June, České Radiokomunikace (ČRa) merged with Morava Czech Communication Holdings, which had owned close to 100% of all ČRa's stock.

In the fixed access segment, VOLNÝ made a strategic decision top offering ADSL internet connectivity using other operators' infrastructure to residential customers. Telefónica CR took over close to 11 thousand non-business customers. The migration started in mid-March 2011; the price and service parameters remained the same.

Telefónica CR continued with improvements to its fixed internet access service by expanding the VDSL reach and increasing speeds to existing customers.

In early May, Telefónica CR premiered a new technology, VDSL (Very High Speed DSL), which allows up to two times faster home internet. Existing customers were given a speed increase without a price hike. The technology is available to approximately 45% of homes that are within a 1.3 km radius from the exchange. The new technology also ushered in changes to the fixed internet tariff structure – customers could benefit from a promotion offering new tariffs at reduced rates. The attractiveness of the technology is attested by the fact that more than 100 thousand customers, both existing and new, opted for VDSL by the end of 2011.

Trends in the mobile data market

A number of significant events happened in 2011, which affected the whole telecommunications market. The mobile market was dominated largely by the news of innovated or new data services. Below we list those events that we regard as most influential.

From March 2011, Telefónica CR cut the prices of its basic data roaming service for all zones; the biggest price cut was in the EU zone, with the price going down from CZK 240/MB to CZK 24/MB, i.e. by approximately 90%. Roaming data bundles also saw major price slashing.

Telefónica CR continued to strengthen its leadership in the 3G network coverage. The Company added 126 locations in June 2011. The advantages of fast mobile data were available to the residents of 1,699 towns and villages at the end of 2011, which represents 73% coverage of the Czech population.

The Company raised awareness of the advantages and extent of 3G network coverage through its 'Smart Network' campaign, which explained to the public the benefits of having internet in a mobile and of mobile internet.

A survey by Ipsos Tambor showed that Telefónica CR had the best mobile data and the most extensive coverage. The respondents confirmed that, compared to the competition, Telefónica CR offered the best mobile internet service.

Regulation

Several changes occurred in 2011 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 are the main changes to the legislation in the area of electronic communications:

— Promulgation of the Act No. 468/2011 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 Judgement of the Constitutional Court No. Pl.ÚS 24/11 dated 20 December 2011, cancelling the provision of Section 88a of the Act No. 141/1961 Coll., on criminal procedure (Code of Criminal Procedure), as amended, by expiration on 20 September 2012, which relates to the treatment of records of telecommunications traffic by law enforcement authorities;
— Promulgation of the Judgement of the Constitutional Court No. Pl. ÚS 24/10, cancelling the provision of Section 97(3) and Section 97(4) of the Act No. 127/2005 Coll., on electronic communications, and on the amendment to some related laws (Electronic Communications Act), as amended, and Decree No. 485/2005 Coll., on the extent of traffic and location data, the time of retention thereof, and the form and method of the transmission thereof to bodies authorised to use such data;
– Promulgation of the Government Regulation No. 156/2011 Coll., amending the Government Regulation No. 154/2005 Coll., on the determination of the amounts and the method of calculation of the charges for the use of radio frequencies and numbers, as amended;
— Promulgation of the Decree No. 53/2011 Coll., amending the Decree No. 117/2007 Coll., on the numbering plans of electronic communications networks and services, as amended;
— Promulgation 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 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 amending Directive 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 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 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.

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.

In January 2011, the CTO published its selection of Ernst & Young, s.r.o., to produce the LRIC methodology, including a model for call termination in fixed public networks. The outputs of this model are expected to be used by the CTO to set the maximum call termination rates in 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 expects that the updated WACC will be used for the determination of regulated prices from next year onwards.

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

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 in this market. Based on the decisions, pricing regulation no longer applies to the wholesale service; however the imposed regulatory measures now apply also to Ethernet leased lines.

Effective from 1 July 2011, the regulated wholesale price for mobile termination was reduced to CZK 1.08 per minute.

Regulation of international roaming

In keeping with the presently applicable regulatory framework, the regulated international roaming rates went down effective from 1 July 2011 as had been planned.

The retail rates for incoming calls went down on 1 July 2011 to EUR 0.11 per minute; the price for an outgoing call was brought down to EUR 0.35 per minute. The price for an SMS stayed at the level of EUR 0.11. The prices, expressed in Czech crowns, were adjusted based on the applicable exchange rate.

On 6 July 2011, the European Commission published a proposal encapsulating its vision for Phase III of mobile roaming regulation. The proposal foresees the regulation to apply also after 31 July 2012 (when the so-called Phase II of roaming regulation expires). The proposal expects that regulatory action in the area of international roaming will be expanded; the regulatory measures applied to date (price regulation) are to be joined from 1 July 2014 by giving customers the option to choose a different roaming provider to the provider of their national mobile service. The proposal is subject to approval by the European Parliament and the Council of Ministers of the EU.

Imposition of duties related to the provision of the Universal Service

Telefónica provided the following services during 2011 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 service 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 2011; the duty to operate public payphones as part of the Universal Service concerns municipalities with 4,999 or more residents. The CTO reviewed the service under (a) and decided to uphold the Universal Service obligation until the end of 2013 for municipalities with 4,999 or more residents, and, for municipalities with a population under 1,999, until the end of 2014. The CTO also commenced the process to select a provider of the public payphone service under the Universal Service, which is expected to conclude in mid-2012.

As to the services under (c), the Czech Telecommunications Office imposed on Telefónica CR the duty to offer special pricing under the Universal Service obligation, for a period of three years commencing on 2 July 2011.

Funding of the Universal Service

Telefónica CR submitted its claim for compensation for the loss incurred as a result of Universal Service provision (including the loss incurred as a result of offering special price plans for people with disabilities) in 2010. The CTO then proceeded with verifying the amount of the loss and examining the supporting documents, and made the payment in December 2011.

The CTO published a final and conclusive decision determining the amount of the loss incurred as a result of Universal Service provision in 2009, and the loss incurred as a result of Universal Service provision (including the loss incurred as a result of offering special price plans for people with disabilities) in 2010.

State policy and support 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 delivering on the above objectives, the Ministry of Industry and Trade released a draft paper setting out the development criteria for the planned auction of frequencies in the range of the so-called digital dividend in September 2011.

Also in September 2011, the CTO published guiding principles for the upcoming unction of 800 MHz, 1 800 MHz and 2.6 GHz frequencies.

Structural funding from the EU continued to support various projects in the area of ICT development in public institutions. The support went in the direction of mainly regional networks connecting public institutions, as well as the private sector.

In April 2011, the European Commission called a public consultation on the Community Guidelines concerning the state aid rules with regard to fast roll-out of broadband networks.

Telefónica CR is a member of prominent industry associations that work to develop the market in electronic communications in the Czech Republic: ICTU (Association for Information Technologies and Telecommunications), APMS (Association of Mobile Network Operators), ČAT (Czech Telecommunications Association) and ČAEK (Czech Association of Electronic Communications).

The Company is also a member of several other structures that are important for Telefónica's activities: HK ČR (Chamber of Commerce of the Czech Republic), SDT (Association for Telematics in Transport) and others.

The Government of the Czech Republic started the process of programming the EU Structural Funds for the period 2014–2020. With regard to the overall objectives of the EU, as expressed in the policy paper Digital Agenda for Europe 2020, we can expect that support will focus also on the field of ICT.

Telefónica CR submitted its comments on the proposed development criteria and on the guiding principles of the planned frequency auction – on its own behalf and also jointly as a member of the above associations.

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. Telefónica successfully participated in tenders for projects co-funded from Structural Funds.

Consumer segment

In 2011, Telefónica CR launched its first awareness-building campaign focusing on the uses of internet in a mobile. The campaign featured ways of using smartphones and how a regular user can benefit from having a smartphone. The campaign was executed jointly with Google, and helped to significantly boost the uptake of mobile internet.

As in the previous years, also in 2011 the customers benefited from the programme Reward for Top-up, a loyalty scheme for prepaid customers. The popularity of the programme shows also in the fact that other partners (Seat, GE Money Bank) have joined it.

Another important event was the CSI Leadership customer satisfaction survey in the prepaid segment, which was conducted in the fourth quarter of 2011, for the first time in the Company's history.

In 2011, Telefónica CR had a lot of successes also in the online sphere. The revamped website www.O2.cz won the Web Top 100. An online self-service zone, My O2, opened, giving the customers control over the configuration of their services, billing reports, and payments, which they can now review or make online.

The online activities of the Company were now, however, limited to the website www.O2.cz. In 2011, Telefónica CR was very active on social networks such as Twitter, Facebook or YouTube. O2 Guru was one of such noteworthy projects, which gave customers support and assistance via social networks and video tutorials, all on the platform of the dedicated portal www.O2guru.cz.

A special portal for smartphones was launched in an online and mobile version. Applications can be downloaded for iOS, Android and Windows Phone operating systems.

Online activities also included the testing of new online sales channels. To this end, an affiliate programme was debuted in 2011, with rewards for selling O2 products and services via third party websites.

Thirty new brand stores opened in 2011. In more than fifty brand stores, Telefónica CR offered the services of a dedicated sales associate specialising in data services and smartphones. The dummy smartphone models were replaced with real devices for customers to try.

Mobile internet and prepaid voice cards were offered also in the indirect sales channels of O2, such as ALZA.cz, CZC.cz, eD'system Czech, 100MEGA distribution, Billa and many others. New providers of direct top-up for prepaid services were acquired: Česká pošta, Fortuna and Unipay. Last but not least, the capacity indirect sales, namely in the area of contract voice and data acquisition, was significantly enhanced.

As for the call centres, a notable event of the year was the consolidation of call centre activities in the consumer segment. A new organisation and the consolidation in 2011 produced substantial savings, lower staff turnover in the expanded locations, and gave career prospects and the option to switch departments to competent employees.

Internet

Telefónica CR made the billing for mobile data more advantageous. The first hour of connection cost CZK 15, and the full day of access was capped at CZK 30 (FUP 30 MB/day), which was appreciated mainly be those customers who go online only from time to time.

The key event in the area of fixed internet access was the launch of the VDSL technology, which brought faster data transmission. The launch and expansion of the VDSL technology allowed up to two times faster home internet for many customers – this is also why the key motif of the successful communication campaign was a runner. People could test the availability and the possible speed of their home internet at www.zrychlujeme.cz, where, after a brief questionnaire, they could enter a competition for prizes, which included also choice of discounts from the partners in the O2 Extra programme.

In 2011, Telefónica CR continued with an aggressive expansion of its 3G network coverage and strengthened its leadership in this area.

The campaign 'Smart Network from O2' explained the benefits of fast mobile data to customers; it was recognised as the 'best advertising campaign of 2011' in its category (Other Services) and claimed a Golden Effie at the prestigious 2011 Effie Awards.

Fixed access and IP TV

As in the previous quarters, also in the fourth quarter of 2011 the Company saw a solid growth in the number of broadband customers and a slowdown in the rate of decline in the number of fixed lines.

In February, Telefónica CR debuted its economy tariffs and bundles featuring fixed calls to all mobile networks in the Czech Republic and to fixed numbers abroad. The new tariffs and bundles, O2 Calling and O2 Calling International, can be combined based on the most frequent calling destinations of the customer.

From July until the end of the year, Telefónica CR ran an acquisition promotion of its internet tariffs. New customers of Internet Optimal or Internet Aktiv, who committed for 12 months, regardless whether they were natural or legal persons, enjoyed reduced subscription for the duration of their commitment. Starting from the 13th month, standard listed prices apply (CZK 750 for Internet Optimal and CZK 850 for Internet Aktiv).

Between 1 September and 31 October 2011 Telefónica CR ran a special acquisition promotion for new customers who subscribed to Internet Optimal and the digital television O2 TV Flexi and committed for 12 months. The promotional price of Internet Optimal was CZK 400 per month and CZK 250 for O2 TV Flexi per month, during the first 12 months of service. Starting from the 13th month, standard listed prices apply.

During 2011, the number of O2 TV customers went up 5% to 136 thousand; in the fourth quarter alone it was an increase by 5 thousand, which is credited to the successful Christmas campaign that promoted the service in an economy-priced bundle together with broadband internet.

Mobile services

From July 2011, Telefónica CR offered its prepaid customers free calls, SMS and MMS to one O2 number of choice.

O2 Nejbližší, a new service for friends and families with free or preferentially billed calls to a select group of numbers, was launched in September 2011. What made it unique was that the 'friends and family' group could include numbers in Slovakia.

From 1 November Telefónica CR offers benefits for the prepaid O2 card to both new and existing customers, on the condition that they top up a minimum of CZK 200 per month. This got them calls to all networks for CZK 3.50 per minute and SMS for CZK 1.50. Customers could buy a new card with the pre-set conditions or reconfigure their existing card until 31 December 2011. Contract customers received double the amount of free monthly units (minutes, SMS) from Telefónica CR, in exchange for extending their commitment or switching to a higher tariff. New customers had the benefits set up for them automatically.

In November 2011, Telefónica CR premiered an innovation to the topping up of the prepaid O2 cards. Customers with prepaid cards could use a payment card for a single top-up online, set up an automatic top-up or top up via SMS. The holder of the payment card could also manage several O2 cards, which made it ideal for families. Customers also received extra 10% every time they topped up via the new channel before the end of 2011. The first top-up after the registration in the system attracted a bonus of 20% from the amount of the top-up.

The other noteworthy campaigns included the Christmas mobile voice promotion. Customers of prepaid voice services could get calls to all networks for CZK 3.50 per minute and SMS for CZK 1.50. Contract customers received double the amount of their free units (minutes, SMS) to all networks.

Business and SME

A new service model based on a differentiated approach to customer care was implemented in the segment of small and medium enterprises in 2011.

A new sales channel focused on customer care and retention was also implemented, and considerably helped with stopping the customers from leaving for the competition. A customer is now put directly through to a live operator, and trained specialists and dedicated desks for business customers were instituted in the brand stores.

According to surveys regularly commissioned by the Company, the changes were very well received and reflected positively on the overall customer experience.

Internet

VDSL (Very High Speed DSL) technology which offers faster data transmission was launched in 2011. The campaign featuring a 'runner' was communicated only at a local level (in the so-called GEO locations), which allowed for more focused targeting of potential customers with the proposition. GEO locations for the SME segment are different for the field force channels, whether the brands stores and franchises are the same as in the consumer segment.

Fixed access

The same activities as in the consumer segment were pursued in the fixed access area. The traditional fixed voice and ISDN lines did not get a priority for communication; only internet telephony (VoIP) was offered together with VDSL as part of the Unlimited Line bundle with xDSL and supported with a price promotion. In December 2011, a test pilot campaign for the self-installation kit for the no-VPN variant of the O2 Unlimited Line service.

Mobile access

A campaign to promote the family of tariffs O2 Business was ran during the course of 2011. It featured two main characters, Telefónica CR's rep Lucie and entrepreneur Martin who is a customer. The campaign was a success and the number of subscribers of these tariffs doubled during the year to more than 20,000.

The majority of offers in the consumer segment was open also to SME customers – subsidised smartphones with internet access or the Christmas campaign doubling the number of free minutes. Both the above-mentioned bonuses were eligible for O2 Neon and O2 Business tariffs.

Corporate and government

Telecommunications services

To be able to continue to drive its business and that of its customers forward, Telefónica CR radically reassessed its telecommunications services delivery model: a major customer now gets a comprehensive solution of his telecommunications needs, as well as the many benefits that can only be offered by a single provider capable of meeting all and any needs.

Telefónica CR does not take the customers' trust for granted; the Company decided to cultivate it through its new programme O2 Exclusive, which offers the best level of care, a regular audit of delivered services at dedicated meetings, as well as many other benefits that make the customers' everyday lives easier. This approach helped us secure a number of prestigious corporate accounts in 2011:

In the past, Accenture was courted by Telefónica CR several times, with offers of fixed voice services, which the client always deemed uncompetitive. In 2011 we succeeded with overcoming the initial pessimism that the client brought to the negotiating table, and secured the presence of the decision-makers. The client responded well to the comprehensive proposition in all product lines under the umbrella of O2 Exclusive, and we walked away with a new contract for all types of telecommunications services.

After a commitment to our mobile service, Český Rozhlas became an exclusive client, receiving almost all types of telecommunications services from Telefónica CR. The contract for mobile services is for four years. It was to Telefónica CR's great advantage that the client had a longstanding experience of the quality we deliver through the data and fixed voice services.

In June 2011, ČSA invited tenders for the delivery of a call centre operation from the rather populated sector of ICT providers. Together with its partner Atlantis Software, Telefónica CR beat all the competition and secured the contract. The iCC call centre will go online in April 2012.

Two years ago, Telefónica CR took over WAN connection for the brick-and-mortar branches of Fortuna, from GTS, the previous provider. We repeated the coup in 2011. For Telefónica CR, the contract brings up to 3,000 new lines to Fortuna's POS network in the next two years, separate MPLS central lines, internet connectivity and two independent database and application server centres.

Telefónica CR became a primary provider of data connectivity to the newly built data centre of Synot IC; the contract is presently for five years. This relationship carries a substantial up-sell potential for other O2 services in the region. Moreover, we managed to expand the portfolio of services by 3,000 data and voice SIM cards. Synot Holding became another exclusive customer of Telefónica CR, relying 100% on our service.

In 2011, a contract for WAN service was signed with Moravia Steel. After taking over from GTS, Telefónica CR will provide data and internet services for a contractual period of 24 months.

In addition to its large corporate clients, in 2011 Telefónica CR also acquired several major customers from the government sector; Lesy ČR, is one such client, with a contract for telecommunications services including IP telephony and LAN redesign.

SZIF (State Agricultural Intervention Fund) is another, with a contract for operating and technical support. Telefónica CR bid the lowest price, secured the contract and helped the fund save up to CZK 100 million.

The Czech Army is now also a client of Telefónica CR, with a contract for mobile and fixed voice services which was signed for 48 months. The same extent of service, plus IT infrastructure monitoring, Telefónica CR will provide to the state-owned company DIAMO. The state-owned companies Povodí Ohře and Palivový kombinát Ústí are now the clients of O2 Car Control.

Our new business acquisition activities were also successful with public organisations at the regional level. Telefónica CR is proud to have been chosen to implement the communication infrastructure of the Karlovy Vary and Pilsen regions.

ICT

The Corporate Division was reorganised in the first half of 2011, to make its structure more focused on the marketing of ICT solutions over telecommunications services.

In June 2011, the Board of Directors approved an ICT strategy for the next three years, which focuses on 'machine2machine' verticals, cloud computing and security/networking developed globally at the level of the whole Telefónica Group.

O2 Cloud was the first product to be put on the market in September 2011. The technology behind O2 Cloud offers corporate customers the service of virtual data centres – server capacity, disk arrays, data back-up and restoration. The service has an interactive user and administrator interface, flexible scaling and monthly capacity allotments, all with full functionality guarantees. Customers appreciate the lower cost of this solution compared to operating a proprietary infrastructure.

National and international wholesale services

Interconnection

The consolidation within the electronic communications marketplace continued also in 2011; companies merged, specific services or customer segments were sold off both in the mobile and fixed access segment.

In the area of interconnection of our fixed network with those of other operators, changes occurred in connection with the mergers and acquisitions in the electronic communications marketplace. At the end of 2011, our fixed network was interconnected with 15 other operators of fixed public electronic communications networks and 3 operators of mobile electronic communications networks.

As regards Local Loop Unbundling, the order volume is strong but some services, for which promotions of our clients have ended, are getting cancelled. As a result, the number of active unbundled loops is growing at only a moderate pace.

In 2011, the number of customers who used the services of other operators based on our Wholesale Line Rental (WRL) proposition, continued to grow. On the other hand, the number of customers for CS/CPS continued to decline, albeit at a slower rate. The total volume of CS/CPS traffic is falling only slightly as these services are still used by mostly corporate customers of operators who are interconnected with us.

We achieved our sales targets for 2011, despite the pronounced effect of the interconnection rates cuts (especially mobile termination rates) and the escalating financial crisis in Europe that pas produced an overall economic stagnation and recession

International wholesale services

International data and internet
The growing demand for international transmission capacity of our partners means also an increased demand for transmission capacity from us. The services of international IP connectivity and Ethernet-based services also saw a growth.

International voice
In the area of international wholesale voice, we implemented a new NGN international interconnection platform in our network. The reason for this investment was also the growing demand for capacity propelled by higher volumes of mutually provided services and the continued expansion of our commercial activities, especially in Eastern Europe, Russia and the Near and Middle East. The new technology will help us in following the modern trend in VoIP interconnection.

We achieved our sales targets for 2011. We increased the number of our direct interconnections to new mobile and fixed network operators.

Compared to 2010, the transit voice traffic grew 16% to a record of almost 2.025 billion minutes. The high quality of voice service was maintained. In the area of international services, we continue to build on our cooperation across the Telefónica Group with the international operator TIWS (Telefónica International Wholesale Services)

National wholesale services

The year 2011 was the year of stabilisation of the telecommunications market. As in the previous year, telecommunications operators contained their costs and implemented austerity measures. The measures affected mainly the network operations area, which resulted in a pressure to drive down the wholesale data prices. At the same time, the intensive construction of the mobile 3G networks continued. The Wholesale Division was actively involved in this exercise, which spurred the demand for backbone data services and the related revenues. The project of 3G network sharing with T-Mobile also continued.

All mobile operators in the Czech Republic also forged ahead with their strategies to transform their operation for a purely mobile business to an integrated telecommunications business offering a wider portfolio of services, including fixed access. Consequently, the strong demand for the wholesale ADSL service continued, with a 25% year-on-year increase in the number of accesses to 89,000 at the end of 2011. The upside was facilitated by adding the technology variant of VDSL to the portfolio, which allows for higher transmission speeds.

The demand for our Ethernet-based data services also increased. The Company responded by expanding the coverage and introducing changes to the product portfolio in favour of 1Gbit/s and faster speeds.

Payment services

Telefónica CR 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 2011, was opted for by 435 thousand customers per month on average. 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 913, up 21.1% year on year. The total of funds used to pay for goods and services, via the two aforementioned methods of payment, reached CZK 806 million in our network alone in 2011.

Also in 2011, Telefónica CR, in collaboration with other mobile operators, members of the Association of Mobile Network Operators, continued its campaign 'Plať mobilem' (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. Telefónica CR offers the service, m-platba, in its portfolio.

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.

Delays in the launch of a new mobile payment service under the brand Mobito (a project by Mopet), which were caused by a change in the supplier of the transaction platform (August 2011), were shortened to the maximum by an intensive effort put in by all participating partners. The launch of the pilot service is planned in the first half of 2012.

As in the previous years, also in 2011 Telefónica CR continued its pilot of NFC (Near Field Communication) for mobile devices. In cooperation with Komerční banka, Citibank, Globus, Visa Europe and the suppliers of NFC technology (G&D and Oberthur), Telefónica CR launched a contactless Visa card in the mobile application O2 Wallet in July 2011. In November, the project was expanded to include the already ongoing project of the Pilsen travel card in a mobile. In 2012, both pilot projects will be seamlessly carried over to a live operation of contactless mobile NFC services.

Comments on the financial results

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

Consolidated financial results

Revenues, Operating Costs and OIBDA

The total consolidated revenues reached CZK 52.4 billion in 2011, down 5.7% year on year. In the second half of the year, revenues performance improved due to a stabilisation of spend in the mobile residential segment and the solid revenues from ICT and business solutions. At the same time, revenues in 2011 continued to be impacted by the prevailing competitive pressures largely in the corporate and SMB mobile segments and by the regulatory measures (mobile termination rates, MTR, cuts and lower roaming prices). Other income reached CZK 487 million in 2011 compared to CZK 242 million in 2010. The higher gains from the disposal of fixed assets were the key driver of this growth. The total consolidated operating costs declined 5.1% year on year, reaching CZK 31.1 billion in 2011, as a result of a strict financial discipline in this area.

Operating income before depreciation and amortization (OIBDA) amounted to CZK 21.8 million, down 20.4% year on year. The year-on-year OIBDA comparison in 2011 has been significantly impacted by impairment reversal (CZK 4,344 million) booked in the third quarter of 2010. Excluding this item, OIBDA declined 5.4% year on year in 2011. On a fully comparable basis[1], OIBDA declined 5.1% year on year, reaching CZK 22.9 billion in 2011, while the comparable OIBDA margin[2] improved 0.3 percentage point year on year to reach 43.7% in 2011 on the back of a focus on cost efficiency and the positive and growing OIBDA in Slovakia. OIBDA adjusted for guidance[3] declined 5.0% year on year, within the guidance range of -1% to -5%, to reach CZK 22.9 billion.

[1] OIBDA excluding royalty fees and management fees (2010: CZK 1,057 million, 2011: CZK 1,080 million) and impairment reversal of CZK 4,344 million in 2010.

[2] Comparable OIBDA over revenues.

[3] In terms of 2011 guidance calculation, OIBDA excludes royalty fees and management fees (2010: CZK 1,057 million, 2011: CZK 1,080 million). In addition, 2010 OIBDA base excludes impairment reversal of CZK 4,344 million. 2011 guidance excludes changes in consolidation, includes potential capital gains from non-core asset sales, assuming constant FX rates of 2010.

Operating Income, Income before Tax and Net Income

The consolidated operating income and consolidated income before tax went down 34.7% year on year and reached CZK 10.1 billion and CZK 10.0 billion, respectively, in 2011, largely due to the above-mentioned impairment reversal. The consolidated net income amounted to CZK 8.7 billion in 2011, down 29.3% year on year, due to a combination of the above-mentioned impairment reversal booked in 2010 and the deferred tax in Slovakia booked in 2011 (CZK 709 million). Excluding the impact of impairment reversal on the OIBDA, depreciation and amortisation, and the corporate income tax both in 2010 and 2011, and the impact of the deferred tax income in Slovakia booked in 2011, the net income declined 5.7% year on year to CZK 8.5 billion, largely due to the decline in OIBDA, which was not fully compensated by lower depreciation and amortization, financial expenses and income tax expense.

Cash and Debt levels

On 31 December 2011, the Group's consolidated financial debts (long-term and short-term) amounted to CZK 3.1 billion, broadly in line with the 2010 year-end situation. The amount of cash and cash equivalents reached CZK 7.0 billion as at the end of 2011, compared to CZK 4.8 billion the year before. The combination of cash and debt balances resulted in a net leverage[4] of -5.6% and a gross leverage[5] of 4.4% as at the end of 2011, compared to -2.4% and 4.1%, respectively, as at 31 December 2010.

Capital expenditure

The total consolidated capital expenditure (excluding additions from WiFi acquisition) amounted to CZK 5.6 billion in 2011, down 0.7% year on year, in line with the Group's full year guidance (CAPEX around CZK 5.7 billion). The Group continued to direct investments into the capacity expansion and quality improvement of the 3G network. In addition, the CAPEX budget was spent on a further expansion of the 3G network coverage, including coverage of areas currently without service, on the basis of a network sharing contract with T-Mobile. At the end of December 2011, the Company covered already 1,699 towns and cities in the Czech Republic with its 3G network, representing around 73% coverage of the population. Additionally, the Group focused its investments into the upgrade of its fixed broadband service with the VDSL technology, aiming at strengthening its position on highly competitive fixed broadband market in the Czech Republic and improving customer experience. Also, the relevant part of the CAPEX budget was spent on improving the Company's systems (CRM), to further enhance the customer relationship, simplify and streamline processes and to consequently increase the operating efficiency. In Slovakia, CAPEX went largely into additional network investments related to the launch and expansion of the 3G network. At 2011 year-end, the 3G coverage reached close to 35% of the Slovak population.

Cash Flow

The total consolidated free cash flows[6] declined 8.6% year on year and reached CZK 15.0 billion in 2011; a combination of a 5.6% decline in cash from operating activities, which was broadly in line with the OIBDA decline, and an 3.8% increase in cash used in investing activities, which was driven by higher cash payments on investment in property, plant and equipment and intangible assets, and partially offset by higher proceeds from the disposal of non-core assets.

[4] Long and short term financial debts less cash and cash equivalents over equity.
[5] Long and short term financial debts over equity.
[6] Net cash from operating activities and net cash used in investing activities.

Over view of consolidated revenues

The total consolidated revenues in 2011 reached CZK 52.4 billion, down 5.7% year on year, mainly due to further cuts in the mobile termination rates, lower roaming prices and the continued strong competitive pressures largely in the corporate and small and medium business segments.

Revenues from voice services (voice – outgoing, interconnection and other wholesale services) reached CZK 18.2 billion in 2011, down 12.6% year on year. Voice revenues declined 12.0% to reach CZK 10.5 billion due to a lower volume of voice traffic generated in the fixed network, more minutes bundled in the monthly charges and the competitive pressure on per-minute charges. Revenues from interconnection and other wholesale services amounted to CZK 7.7 billion in 2011, down 13.3% year on year, on the back of the mobile termination rates cuts, lower incoming mobile voice traffic and the lower transit revenues.

The total volume of mobile traffic[7] generated by customers in the Czech Republic reached 8,956 million minutes in 2011, up 1.9% year on year; it was supported by the higher number of contract customers and the Christmas campaign to promote contract services that offered to double the free airtime included in the monthly subscription charge. Voice traffic generated in the fixed network declined 13.4% year on year in 2011 to 1,507 million minutes due to the continued trend of voice access losses and the effect of fixed-to-mobile substitution.

Revenues from monthly charges declined 4.9% year on year to CZK 12.9 billion in 2011, largely due to the lower number of fixed voice lines. This has not been fully compensated by a growth in the contract customer base in the Czech Republic and Slovakia.

The total mobile customer base in the Czech Republic reached 4,942 thousand at the end of December 2011, a 2.1% increase year on year. In 2011, the company recorded 103.1 thousand net additions in its mobile customer base, compared to only 5.0 thousand in 2010 (excluding the disconnection of inactive contract customers in the second quarter of 2010). The number of contract customers went up 6.5% year on year, reaching 3,049 thousand at the end of 2011, with 185.7 thousand net additions in the year (+15.9% year on year, excluding the disconnection of 111 thousand inactive contract customers in 2Q 2010). This performance continued to be supported by customers migrating from the prepaid to the contract segment, the positive effect of the growth in the number of mobile broadband customers, a higher smartphone penetration and a lower churn. At the end of December 2011, contract customers represented already 61.7% of the base, a 2.5 percentage point growth year on year, which was the highest figure ever. The number of prepaid customers reached 1,892 thousand at the end of 2011, down 4.2% year on year, with 82.6 thousand net losses in 2011 – compared to 155.2 thousand in 2010. Moreover, their number increased by 5.5 thousand in the fourth quarter of 2011, which was the first positive quarterly performance since 3Q 2009; it was credited to the successful Christmas campaign and the lower rate of churn.

The mobile blended monthly average churn rate in the Czech Republic reached 1.85% in 2011, posting a year-on-year decrease of 0.5 percentage point. This is a result of the continuous improvements in the churn rate of contract customers, which was contained to 1.09% in 2011 and was only 0.99% in the fourth quarter alone. It is historically the lowest figure, which represents a year-on-year decrease of 0.3 percentage point. The churn rate in the prepaid segment also

[7] Inbound and outbound, including roaming abroad, excluding inbound roaming.

improved to 3.03% in 2011, down 0.4 percentage point year on year; it was largely helped by our increased focus on the acquisition of higher-worth customers and the success of the Company's loyalty scheme innovation which offered rewards for regular top-ups.

In 2011, the mobile blended ARPU[8] reached CZK 423.7, down 9.6% year on year, as a result of the continued effect of the MTR cuts and increased competition. Excluding the impact of MTR cuts, total ARPU in 2011 declined 5.7% year on year. The voice ARPU dilution driven by persistent competition was the key contributor to the decline. The contract ARPU reached CZK 577.9 in 2011, down 12.4% year on year (-8.9% year on year, not accounting for the effect of the MTR cuts). The prepaid ARPU decreased 9.6% year on year in 2011 down to CZK 186.2. The data ARPU declined 2.4% year on year in 2011 down to CZK 117.2. The Decrease in data roaming prices and continuous SMS/MMS bundling were the key drivers behind data ARPU dilution. Nevertheless, excluding these two items (SMS/MMS and roaming), data ARPU would improve 2.4% year on year in 2011 with mobile internet customer base uptake remaining the key driver of the improvement.

The total number of fixed accesses declined 5.2% year on year to 1,582 thousand at the end of 2011, while net losses were 87.3 thousand in 2011, well below 101.4 thousand in 2010 (-13.9% year on year). This is largely a result of the lower losses in the traditional fixed voice access (-22.4% year on year) and the continuous solid growth of naked access (+45% year on year).

In 2011, the total number of customers in Slovakia went up to 283.7 thousand as a result of the solid contract uptake. Consequently, the total subscriber base reached 1,164 thousand at the end of December 2011, posting a 32.2% year-on-year growth. The number of contract customers grew 48.9% year on year, reaching 498 thousand at the end of 2011, while the number of prepaid customers increased 22.0% year on year and closing at 666 thousand. Thus, the customer mix in Slovakia further improved and contract customers represented already a significant 42.8% of the total customer base, up 4.8 percentage point year on year.

Total data revenues were flat year on year and reached CZK 11.5 billion in 2011. Of that, revenues from leased lines and fixed data services recorded a 9.5% year-on-year decline to CZK 2.8 billion, mainly due to lower revenues from leased lines, which were not fully compensated by a growth in IP based data services. Internet revenues improved 2.8% year on year to CZK 5.5 billion, positively impacted by a growth in the number of xDSL customers and the migration of higher-value customers to VDSL. Revenues from mobile data grew 9.7% to CZK 2.6 billion. This is a result of our successful marketing campaign focused on the promotion of smartphone sales, which accelerated the smartphone penetration to a level close to 20% at the end of 2011. In addition, the growth in mobile broadband customer base and our higher revenues in Slovakia related to the launch of 3G services contributed positively to the increase of mobile data revenues.

The number of xDSL accesses reached 872 thousand at the end of December 2011, up 8.1% year on year. In 2011, the number increased 65.6 thousand. As for the VDSL service which was launched in May, already 103.2 thousand customers subscribed to this service at the end of 2011; the VDSL segment now represents 12% of the total xDSL base and some ¼ of the total addressable existing base. The total number of O2 TV customers reached 136 thousand at the end of 2011, up 5.0% year on year, with 5.0 thousand net additions in the fourth quarter alone – a result of our successful Christmas bundling proposition with broadband Internet.

[8] Including inter-segment revenues.

Other consolidated revenues increased 1.1% in total year on year and reached CZK 9.8 billion in 2011. Of that, revenues from SMS, MMS, PRMS and contents grew 0.9% to CZK 4.8 billion, mainly due to the revenue growth in Slovakia, while in the Czech Republic, the revenues went down as a result of more integrated SMS/MMS bundling. Revenues from equipment and activation charges reached CZK 1.7 billion in 2011, which translates into a 13.2% year-on-year growth thanks to the higher revenues from handsets and broadband equipment sales. Revenues from ICT and business solutions reached CZK 2.4 billion – a respectable amount, considering the austerity measures in the public sector, which has been the principal client in this area.

Overview of consolidated operating expenses

Despite the higher expenses related to our intensified commercial activities, the total consolidated operating expenses of Telefónica CR Group declined 5.1% year on year to CZK 31.1 billion in 2011. Our continued campaign of strict financial discipline, which is aimed at offsetting the declining revenues to the maximum achievable degree, was the key driver for the savings of operating expenses.

Consolidated interconnection and roaming expenses went down 9.6% year on year to CZK 9.2 billion in 2011, in line with the lower interconnection revenues; this trend was largely due to the cuts in the mobile termination rates and the roaming prices. The cost of goods sold reached CZK 2.2 billion in 2011, representing a 13.0% year-on-year growth, which was expected with regard to the higher revenues from the sale of devices. Other direct costs of sales grew 7.9% year on year in total to CZK 3.4 billion. Of that, the cost of telecommunications services, content and other cost of sales went down 33.3% year on year to CZK 665 million, while sub-deliveries increased 20.5% to CZK 1 billion due to a higher volume of sub-deliveries in connection with ICT projects. Commissions went up 30.7% to CZK 1.7 billion due to more intensive commercial activity.

Staff costs including redundancy payments reached CZK 6.2 billion in 2011, down 12.6% compared to 2010. Excluding redundancy payments (CZK 174 million in 2011 and CZK 458 million in 2010) staff costs declined 9.2% year on year, as a result of a restructuring program executed in 2010 and 2011. The total Group headcount declined 8.4% in 2011 and as at 31 December 2011 it stood at 6,890 employees. In the fourth quarter of 2011 alone, the headcount reduction has been facilitated by the outsourcing of IT support services to Telefónica Global Technology, which is to provide IT support for Telefónica's businesses in the Czech Republic, Slovakia and Germany.

Other operating expenses including capitalized own expenses on fixed assets reached CZK 10.1 billion in 2011, down 3.1% year on year. Lower expenses associated with marketing and call centre operation (-9.0% year on year, down to CZK 1.6 billion as a result of improved operating efficiency) were the key contributors to the decline. Significant savings have been recorded also in billing and collection and in the provisions for bad and doubtful debts, which decreased 13.3% year on year in total, down to CZK 831 million. In other categories, it is worth noting the decline in the cost of leases, buildings and vehicles (-4.4% down to CZK 2.1 billion) brought on by our campaign for more efficient utilization of buildings and the car pool optimization. Savings have been reported also in consultancy and professional fees and other external services, which declined 12.2% year on year to CZK 735 million. On the other hand, network & IT repairs and maintenance went up 6.0% year on year to CZK 2.7 billion due to the outsourcing of network-related activities. The growth, however, has been more than compensated by the savings in the related personnel costs. In addition, the Group recorded a higher cost of the utilities, which amounted to CZK 1.1 billion in 2011, up 5.0% year on year, which was mainly caused by the higher energy prices.

The outlook for 2012

In 2012, the Group will continue focusing on improving customer experience through a proposition of the new services that have value for the customer and on products that meet the customer's needs. Additional investments in process optimization will aim to further improve the relationship with our customers and reduce the number of complaints – ultimately giving a greater customer experience. In line with the strategy to strengthen our market leadership, the Group will focus on customer value management in all segments. The Group believes that these activities will help it to better manage ARPU and churn, thus lowering the pressure in the highly competitive market environment.

Additionally, the Group will continue to enhance its fixed broadband proposition through additional expansion of the VDSL network coverage and to upgrade the speeds for the current accessible base. The Group will also pursue a gradual FTTx deployment with a view to strengthen its market share. In the mobile broadband area, the Group intends to further expand its 3G network coverage while enhancing the capacity and quality of the network, including a backhaul to exploit the opportunity of smartphone and data uptake. Moreover, it will closely monitor and analyze the conditions of the upcoming auction of new frequencies, in which the Group intends to tender for an LTE licence, which would allow it to build a 4G network and remain competitive in the mobile broadband market. In the segment of ICT, the Group will market a standard portfolio of services and solutions, so that the dependency on one-off projects is reduced. This should lead to an improvement in the revenue sustainability in this area.

Telefónica Slovakia will continue in its value- and simplicity-based commercial proposition, targeting higher value customers to maintain a solid subscriber growth while keeping a focus on further improvement of its financial performance through a lean approach to its operations.

The Group expects that, compared to 2011, the fixed and mobile broadband revenues, together with increasing revenues in Slovakia, will be the key drivers for the improvement of the top line performance in 2012. At the same time, the anticipated additional MTR cuts and pressure on ARPU from fierce competition will continue to affect mobile revenues in 2012. The Group will keep its focus on OPEX efficiency improvement, especially in operational areas (implementation of a leaner and more efficient organizational structure and processes, consolidation and optimization of call centre operations), through which it aims to maintain our best-in-class profitability. The investments will continue to go primarily in the direction of upgrades to the fixed and mobile broadband network and improvements of the mobile broadband capability, which are seen as vehicles of growth in the future.

With regard to the above, the Group gives the following guidance for 2012:

	2011 base	**2012 guidance**
Business revenues	-5.7% year-on-year	improving trends vs. 2011
OIBDA margin[9]	43.7%	limited margin erosion y-o-y
CAPEX[10]	CZK 5.6 billion	up to CZK 6.2 billion (flexibility to manage CAPEX/Revenue evolution)

[9] OIBDA before brand fees & management fees; 2012 guidance excludes changes in consolidation, includes potential capital gains from non core asset sales, assuming constant FX rates of 2011.

[10] Excluding business acquisitions.