

Registered Number: 1743099

O2 (UK) Limited

Annual Report and Financial Statements
11 months ended 31 December 2006

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O2 (UK) Limited

Directors

J Campbell
V Dev
R Dunne
R Harwood
M Key
P Whelan

Secretary

O2 Secretaries Limited

Registered office

260 Bath Road
Slough
SL1 4DX

Registered auditors

Ernst & Young LLP
1 More London Place
London
SE1 2AF

O2 (UK) Limited Directors' report

The Directors present their annual report and financial statements for the 11 months ended 31 December 2006.

Corporate Structure

O2 (UK) Limited (the "Company") is a private limited company registered in England and Wales under the number 1743099. The registered address is 260 Bath Road, Slough, Berkshire SL1 4DX. It is a wholly owned subsidiary of Telefónica O2 Europe plc, its indirect UK parent, incorporated in England and Wales, which is itself a wholly owned subsidiary of Telefónica, S.A. ("Telefónica"), a company incorporated in Spain.

Events after the balance sheet date

The Company has changed its accounting reference date from 31 January to 31 December.

Between 15 and 21 June 2007, the Company subscribed for a total of 3,643 ordinary shares of 1p each in the capital of O2 Pine Limited, a subsidiary undertaking.

On 15 June 2007, the Company became a member of O2 Willow Limited, a private company limited by guarantee, agreeing, in the event of dissolution, to contribute a sum (not exceeding £1) towards the payment of that company's debts and liabilities incurred during membership, or in the 12 months after the Company ceased to be a member. On 21 June 2007, the Company made capital contributions totalling £1,001 million to O2 Willow Limited.

On 14 September 2007, as required by local law, the Company established a Branch Office in Northern Ireland.

From financial year 2008, the UK corporation tax rate will be reduced from 30% to 28%. It is estimated that as a result, the Company's deferred tax liability will decrease by £5 million. Further changes are anticipated in relation to capital allowances although the impact on the related deferred tax asset is not yet quantifiable.

Principal activities

The principal activities of O2 (UK) Limited (the "Company") during the year were the operation of a cellular communications network and the sale of network airtime services to service providers and the Company's customer bases.

The Company's network operates under a licence granted by the Department of Trade and Industry on 22 March 1994 under the Telecommunications Act 1984. This licence replaced one originally granted in 1985.

On 20 June 2006 the Company acquired 100% of Be Un Limited, an ADSL provider based in the UK, adding broadband capability to its portfolio. The total cost of the acquisition was £51 million.

On 28 July 2006, the Company announced it had reached agreement to acquire the remaining 60% of its associate, The Link Stores Limited, a retailer of mobile cellular phones, from DSG International plc. The acquisition completed on 16 September 2006. Following completion of the acquisition, the trade and assets of the Link Stores Limited, and its wholly owned subsidiary The Link Financial Services Limited, were hived up into O2 (UK) Limited.

O2 (UK) Limited Directors' report

Business review

Strategy

The Company performed strongly throughout the 11 months ended December 2006 in an increasingly competitive market. There were 1.7 million new customers added in the 12 months to December 2006, taking the total mobile customer base to 17.6 million, 10% higher than last year. The growth in customer numbers was driven by both the acquisition of new customers and the improved retention of existing customers. A detailed operating review of the business is provided below.

Operating review

The operating review contains a discussion of the following metrics:

- Customer numbers – represent customers who are active. Customers are treated as being active if they have used the network in the preceding three months.
- Average Revenue Per User ("ARPU") – is calculated by dividing total service revenue from sales to customers for the preceding 12 months by the weighted average number of active customers for the same period. Total service revenue excludes revenue from inbound roaming. ARPU is calculated using gross service revenue before deduction of wholesale discounts.
- Churn – is calculated by expressing the sum of disconnections for the preceding 12 months as a percentage of the weighted average number of active customers for the same period.

The Company's revenue for the 11 months ended 31 December 2006 was £4,276 million (10 months ended 31 January 2006: £3,474 million). The Company's operating profit for the 11 months ended 31 December 2006 was £351 million (10 months ended 31 January 2006: £368 million).

A total of 716,000 net new contract customers and 936,000 net new pre-pay customers were added during the 12 month period to 31 December 2006, driven by higher gross additions and lower churn.

The Company's blended ARPU of £273 at 31 December 2006 was £6 higher than the previous year and prepay ARPU at £143 was also higher by £7. Contract ARPU of £513 was £4 lower than December 2005. Data ARPU increased to £84 at 31 December 2006 from £77 at 31 December 2005 driven by growth in both SMS and non-SMS data. SMS volumes sent in the year to 31 December 2006 were 18.2 billion.

The successful acquisition of DSG Retail Limited's 60% stake in The Link Stores Limited, completed on 16 September 2006, has provided additional stores, which complement O2's existing retail footprint. On 20 June 2006 the Company acquired 100% of Be Un Limited, an ADSL provider based in the UK, adding broadband capability to its portfolio.

Financial Position of the Company as at 31 December 2006

The balance sheet of the Company has remained broadly consistent with prior years.

Risks and Uncertainties

The Company faces increasing competition from new and existing providers of mobile services

The Company is competing increasingly with new mobile service providers, virtual network operators and resellers of mobile services. Also, competition from existing service providers may be more intense than anticipated, driving down prices. Failure to compete effectively could result in a decrease in customers, revenues and profitability.

Key talent may leave the business reducing the Company's ability to achieve anticipated returns

Insufficient retention mechanisms and development opportunities for high potential employees may result in the loss of key figures in the business. This loss of talent could result in a negative impact to the Group's business and operational results.

The Company faces competing technologies

The Company faces competition from communications technologies that are under development or that will be developed in the future, including cordless technologies and private and shared radio networks. As a result of current trends in the telecommunications industry in Europe, such as the rapid convergence of technologies, the Company expects there to be further technological advances in the future. Failure to compete and implement a winning model in these areas, e.g. mobile internet, could result in a decrease in customers, revenues and profitability as existing voice/text revenue is eroded.

Alleged health risks associated with mobile telecommunications could lead to decreased usage of the Company's services and products, increased difficulty in obtaining transmitter sites or potential liability

Public concern about the alleged or perceived health risks of mobile communications could have a detrimental impact on the Company's business through negative customer perception of the Company's brand, services or products, difficulties in retaining or attracting customers, reduced usage times per customer of mobile telecommunications services or increased difficulty in obtaining transmitter sites. There can be no assurance that further medical research and studies will refute a link between the radio frequency emissions of wireless handsets and base stations and these health concerns. Government authorities could increase regulation of wireless handsets and base stations as a result of these health concerns, or wireless companies, including the Company, could be held liable for costs or damages associated with these concerns, which could have a negative impact on the Company's businesses.

In addition, regulators may reduce the prescribed limits for exposure to electromagnetic radiation, which would mean that the exclusion areas around the Company's antennas may have to increase in some situations. In this event the Company may suffer additional costs associated with repositioning the Company's network equipment and the Company may experience delays in the roll-out of the Company's networks.

O2 (UK) Limited Directors' report

The Company may fail to positively differentiate the Company's customer experience and/or fail to implement the Company's customer plan

Slower implementation timetables, higher costs and poorer customer experience may undermine the value of the Company's brand and could limit the Company's ability to attract and retain high value customers, which in turn could have a negative impact on the Company's business and results of operation.

Service issues such as a serious outage due to either lower than expected resilience in some of our primary services or outgrowing the capacity of our legacy systems would have a similarly negative effect on the customer experience.

The value of the O2 brand is undermined by mis-use of the Company's networks by the Company's customers through fraud or in a way that damages the Company's reputation

Certain customers may misuse the Company's networks in ways which damage the Company's reputation, for example using the network to make inappropriate contact with children, spamming or propagation of viruses.

Certain customers may also misuse the Company's networks in ways which impact the Company's costs or revenues, including fraud. Insufficient network security could in these circumstances present a further concern as leaked critical information or un-authorised disclosure of customer records could result in fines, reputational damage and diminished data revenue opportunities.

Competition Law and Regulatory Risks

The Company operates in a highly regulated market that limits its flexibility to manage its business

The Company must comply with an extensive range of requirements that regulate and supervise the licensing, construction and operation of its networks and the provision and pricing of its products and services. The Company must also co-operate with agencies or other governmental authorities that regulate and supervise the allocation of radio spectrum and which monitor and enforce regulation and competition laws which apply to the mobile telecommunications industry. The Company's business and results of operations could be materially adversely affected by changes in law, regulation or government policies directed at the mobile telecommunications market in which it operates. In particular, decisions by regulators and competition authorities relating to the allocation of spectrum, tariffs, interconnection, the effects of expansion into new markets, or the accessibility of the Company's network to mobile virtual network operators and service providers could all have a negative impact on the Company's business and results of operations.

Under the regulatory powers provided under the EU regulatory framework for the electronic communications sector (the EU Regulatory Framework) new or more onerous regulatory obligations could be imposed on the company. Depending upon the obligations imposed, this could have a significant effect on the profitability of the Company's businesses. The European Commission is currently conducting a review of the EU Regulatory Framework. If new regulatory obligations are imposed on the Company as a result of the review, this could also have a significant effect on the profitability of the Company's business.

O2 (UK) Limited Directors' report

Action by national regulators may result in a decrease in mobile termination revenues

New or more onerous regulatory obligations may be imposed on the Company in relation to call termination charges. In March 2007, the UK regulator (Ofcom) adopted a decision requiring further reductions to UK operators' termination charges for the period from April 2007, and in May 2007 British Telecommunications plc (BT) and Hutchison 3G UK Limited (H3G) lodged appeals of Ofcom's decision. BT and H3G have argued that call termination charges should be reduced still further. If call termination regulation is extended or becomes more onerous then this could have a negative impact on the Company's business and results of its operations.

Financial Risk Management Objectives, Policies and Exposure

Details of the Company's approach to financial risk management are set out in the financial statements on page 21.

Research and development

The Company has incurred research and development expenditure during the 11 months ended 31 December 2006 of £1 million (10 months ended 31 January 2006: £3 million) in order to improve the competitive position of its network services.

Results and proposed dividend

The Company's profit after taxation for the 11 months ended 31 December 2006 was £374 million (10 months ended 31 January 2006: profit of £392 million)

The Directors do not recommend the payment of a final dividend for the 11 months ended 31 December 2006 (10 months ended 31 January 2006: £310 million interim dividend paid).

Directors and secretary

The Directors who held office during the period were as follows:

P Bramwell	resigned 31 October 2006
J Campbell	appointed 31 October 2006
V Dev	
R Dunne	
R Harwood	
M Key	
P Whelan	

The Secretary who held office during the period was O2 Secretaries Limited.

Directors' indemnities

Telefónica O2 Europe plc (the Company's ultimate UK parent) has granted an indemnity in the form permitted by the Qualifying Third Party Indemnity Provisions of the Companies Act 1985 to directors of its subsidiary companies and the Directors of the Company are accordingly covered by this indemnity. This continues until such time as any relevant limitation periods for bringing claims (as defined in the indemnity) against the director has expired, or for so long as the past director, where relevant, remains liable for any losses (as defined in the indemnity).

O2 (UK) Limited Directors' report

Employees

During the last financial period, the Company operated a number of employee share schemes, including savings-related option schemes, which encouraged regular saving and enabled employees to acquire options over shares in O2 plc, and an all-employee share ownership plan allowing employees to buy shares in O2 plc. These schemes have ceased to operate following O2 plc's acquisition by Telefónica, although an all-employee cash incentive arrangement has been introduced by the Company for 2006 and 2007 to focus employees on shared business goals.

The Company is committed to providing effective communication with its employees to ensure that they fully understand the Company's objectives and its operational and financial performance. Particular emphasis is placed on two-way communication through face-to-face meetings, team briefings, audios, and the use of the comprehensive vitalO2 intranet, which includes the distribution of the O2 newsletter. In addition, the Company conducts an annual attitudes survey and maintains a constructive dialogue with unions, employee representative bodies and works councils.

The energy, innovation and creativity of our people add value to the Company. The Company is committed to the development of all people in the organisation and actively promotes this through many training and development initiatives. People are encouraged and supported in maintaining personal development plans.

The Company is committed to employment policies that follow best practice, based on equal opportunities for all, and recognises the diversity of its people. This approach extends to the fair treatment of people with disabilities in relation to their recruitment, training and development. Full consideration and every effort is given to the retention of people who become disabled during employment. The Company is a member of the Employers' Forum on Disability.

Policy and practice on payment of creditors

The Company aims to pay all of its creditors promptly. The payment terms for major contracts are agreed at the same time as other terms are negotiated with individual suppliers. It is the Company's policy to make payments for other purchases within 30 working days of the invoice date, provided that the relevant invoice is presented in a timely fashion and is complete.

The Company had 33 days' purchases outstanding as at 31 December 2006 (31 January 2006: 30 days'), based on the average daily amount invoiced by suppliers during the year.

Political and charitable contributions

The Company made no political contributions during the 11 month period ended 31 December 2006 (10 months ended 31 January 2006: nil). Donations to charities during the 11 months ended 31 December 2006 amounted to £263,524 (10 months ended 31 January 2006: £445,703), all of which went to charities in the United Kingdom.

O2 (UK) Limited Directors' report

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and those International Financial Reporting Standards (IFRS) adopted by the European Union.

Company law requires the Directors to prepare financial statements for each financial period that give a true and fair view of the state of affairs of the Company as at the end of the financial period and of the profit or loss of the Company for that period. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state that the financial statements comply with IFRS, as adopted by the European Union, subject to any material departures being disclosed and explained in the notes to the financial statements;
- provide additional disclosure when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

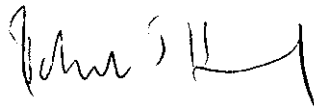
O2 (UK) Limited Directors' report

Auditors

PricewaterhouseCoopers LLP ("PwC") were the auditors of the Company until 18 September 2006 when they resigned and were replaced by Ernst & Young LLP. In accordance with Section 394 of the Companies Act 1985, PwC confirmed that there were no circumstances connected with their resignation which they considered should be brought to the notice of the shareholders or creditors of the Company. This change of auditors was done in order to ensure consistency with the rest of the Telefónica group of companies.

So far as each Director is aware, there is no relevant audit information of which the Company's auditors were unaware. The Directors have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

By Order of the Board



for and on behalf of O2 Secretaries Limited
Company Secretary
30 October 2007

Independent auditors' report to the members of O2 (UK) Limited

We have audited the financial statements of O2 (UK) Limited for the 11 months ended 31 December 2006 which comprise the Income Statement, the Balance Sheet, the Statement of Changes in Equity, the Cash Flow Statement and the related notes 1 to 26. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the financial statements in accordance with applicable United Kingdom law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether the information given in the directors' report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the directors' report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Independent auditors' report to the members of O2 (UK) Limited

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the company's affairs as at 31 December 2006 and of its profit for the 11 months then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the directors' report is consistent with the financial statements

Ernst & Young LLP

Ernst & Young LLP
Registered auditor
London
31 October 2007

Income statement
11 months ended 31 December 2006

	Note	11 months ended 31 December £m	10 months ended 31 January £m
Revenue		4,276	3,474
Cost of sales		(2,546)	(2,112)
Gross profit		1,730	1,362
Administrative expenses		(1,166)	(994)
Operating profit before provision for impairment of intercompany receivables		564	368
Provision for impairment of intercompany receivables	2	(213)	-
Operating profit	2	351	368
Financial income	3	60	25
Financial expense	3	(23)	(22)
Profit before taxation		388	371
Taxation	4	(14)	21
Profit for the period attributable to equity shareholders		374	392

The accompanying notes are an integral part of these financial statements.

There was no other recognised income or expense other than those shown above.

Balance sheet
As at 31 December 2006

	Note	31 December 2006 £m	31 January 2006 £m
Non-current assets			
Property, plant and equipment	5	1,927	1,853
Intangible assets	7	1,987	2,136
Investments	8	4,205	4,116
		8,119	8,105
Current assets			
Inventories		70	67
Trade and other receivables	9	1,539	1,597
Other financial assets	10	240	278
Cash and cash equivalents	11	665	-
		2,514	1,942
Current liabilities			
Borrowings	12	(236)	(269)
Trade and other payables	13	(1,764)	(1,491)
Current tax liabilities		(4)	(1)
Provisions	14	(3)	(6)
		(2,007)	(1,767)
Net current assets		507	175
Total assets less current liabilities		8,626	8,280
Non-current liabilities			
Borrowings	12	(234)	(279)
Deferred tax liabilities	16	(69)	(59)
Provisions	14	(44)	(37)
		(347)	(375)
Net assets		8,279	7,905
Equity			
Ordinary share capital	17	10	10
Share premium		8,799	8,799
Retained earnings	18	(530)	(904)
Total equity		8,279	7,905

The accompanying notes are an integral part of these financial statements.

These financial statements were approved by the Board of Directors on 30 October 2007 and were signed on its behalf by:



Director

Statement of changes in equity
11 months ended 31 December 2006

	Called up share capital Note 17 £m	Share premium £m	Retained earnings Note 18 £m	Total equity £m
At 1 April 2005 as previously reported	10	8,799	(976)	7,833
Prior period adjustment (Note 1)	-	-	(42)	(42)
At 1 April 2005 as restated	10	8,799	(1,018)	7,791
Total recognised income relating to the period	-	-	392	392
Dividends (620p per share)	-	-	(310)	(310)
Share based payments	-	-	10	10
Deferred tax recognised in equity	-	-	22	22
At 31 January 2006 as restated	10	8,799	(904)	7,905
Total recognised income relating to the period	-	-	374	374
At 31 December 2006	10	8,799	(530)	8,279

The prior period adjustment had no effect on the income statement.

O2 (UK) Limited

Cash flow statement 11 months ended 31 December 2006

	Note	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Operating profit		351	368
Depreciation and amortisation charges		576	576
Loss/(gain) on disposal of non-current assets		11	(3)
Decrease/(increase) in inventories		13	(21)
Decrease/(increase) in trade and other receivables		168	(53)
Increase/(decrease) in trade and other payables		162	(154)
Increase/(decrease) in provisions		4	(48)
Other non cash transactions		1	10
Net cash from operating activities		1,286	675
Acquisition of companies		(66)	-
Purchase of property, plant and equipment		(492)	(362)
Proceeds from sale of property, plant and equipment		1	6
Purchase of intangible assets		(54)	(68)
Dividends received		6	-
Net cashflow used in investing activities		(605)	(424)
Repayment of borrowings including finance leases		(5)	(5)
Interest received		8	-
Dividends paid		-	(310)
Net cashflow used in financing activities		3	(315)
Net increase in cash and cash equivalents		684	(64)
Cash and cash equivalents at start of period		(49)	15
Cash and cash equivalents at end of period	11	635	(49)

The accompanying notes are an integral part of these financial statements.

During the period, the Company acquired software with an aggregate cost of nil (10 months ending 31 January 2006: £1 million) by means of finance leases.

Included within operating profit is an amount of £1 million (10 months ending 31 January 2006: £10 million) relating to costs of the share-save plans administered by Telefónica O2 Europe plc for the Company's employees. These costs are settled by share based payments of Telefónica O2 Europe plc. £0.7 million was due to cash-settled plans and £0.3 million due to equity-settled plans.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies

Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and International Financial Reporting Interpretations Committee ("IFRIC") interpretations, as adopted for use in the EU. In addition the financial statements have been prepared in accordance with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. The financial statements have been prepared using historical cost principles.

The Company's accounting reference date was changed to 31 December in order for it to be coterminous with that of Telefónica. Amounts presented for the current period are therefore for the 11 month period from 1 February 2006 to 31 December 2006.

In the previous accounting period, the accounting reference date was changed from 31 March to 31 January to align the period end date more closely to the date on which Telefónica acquired the O2 Group. Accordingly comparative amounts presented are for the 10 months from 1 April 2005 to 31 January 2006. Therefore the comparative amounts for the income statement, statement of changes in equity and related notes are not entirely comparable.

The principal accounting policies of the Company applied in the preparation of these financial statements are set out below. The IFRS accounting policies have been applied consistently to all periods presented except where detailed below.

In accordance with s228 of the Companies Act 1985, consolidated financial statements have not been prepared as the Company and its subsidiaries are included in the group financial statements of Telefónica O2 Europe plc.

Presentation of financial information

Operating items in the income statement are derived from the primary operations of the Company as a telecommunications provider. Items in the income statement recognised below operating profit represent activities that are not directly attributable to the Company's primary operations.

Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation. The cost of property, plant and equipment includes directly attributable incremental costs incurred in their acquisition and installation. Subsequent costs are included in the assets' carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably.

Depreciation is provided on property, plant and equipment from the date they are brought into use over their estimated useful lives on a straight-line basis. The lives assigned to property, plant and equipment are:

Freehold buildings	40 years
Leasehold land and buildings	Unexpired portion of lease or 40 years, whichever is the shorter
Network assets	5 to 15 years
Computers and office equipment	2 to 5 years
Motor vehicles	5 years

The assets' useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. No depreciation is provided on freehold land or assets in course of construction.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Other intangible assets

Licences

Licence fees paid to Governments, which permit telecommunications activities to be operated for defined periods, are capitalised at cost less impairment losses and are amortised from the date of commercial launch of the service to the end of the licence period on a straight line basis. Their estimated useful lives are between 14 and 15 years.

Software

Software is capitalised and measured at the cost incurred to acquire and bring into use the specific software. These costs are amortised over their estimated useful lives of between 2 and 6 years on a straight line basis. Costs that are directly associated with the production of identifiable unique software products controlled by the Company, which are expected to generate economic benefits over a period of more than one year, are recognised as intangible assets. Computer software development costs recognised as intangible assets are amortised over their estimated useful lives not exceeding 6 years on a straight line basis.

Impairment of non financial assets

Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment. Assets with a definite useful life are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows ("cash-generating units").

Revenue

Revenue, which excludes value added tax and other sales taxes, comprises the value of services provided, *equipment sales and other revenue*.

Mobile telecommunications service revenue includes revenue earned for usage of the Company's wireless network for voice and data transmission by the Company's customers, subscription fees, inbound roaming and interconnect revenue. Post-pay customers are billed in arrears based on their subscription fees and usage and revenue is recognised when the service is rendered with deferred revenue recognised on the balance sheet to the extent of the services paid but not used. Revenue for pre-pay customers is recorded as deferred revenue prior to commencement of services and is recognised as the pre-pay services are rendered. Inbound roaming revenue, earned from other mobile operators whose customers roam onto the O2 network, and outbound roaming revenue, earned from the Company's customers roaming outside their domestic coverage area, are recognised based upon usage. Subscription fees are recognised evenly throughout the periods to which they relate.

Hardware revenue principally consists of revenue from the sale of handsets. The revenue and related expenses associated with the sale of wireless handsets and accessories are recognised when the products are delivered and accepted by the customer. Other sales include connection charges which are deferred and recognised over the estimated customer relationship period.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Revenue (continued)

Promotional offers and packages including different elements are assessed to determine whether it is necessary to separate out each component and apply a revenue recognition policy to each element. Total revenue is split among the identified elements based on their respective fair values.

Revenue is recognised on a gross basis where the Company's role is that of principal in a transaction. The gross basis represents the gross value of the billing to the customer after trade discounts, with any related costs being charged to operating expenses. Where the Company acts as agent in a transaction, the net revenue earned is recognised as revenue.

Deferred income, included in trade and other payables, includes the amount relating to purchases made by customers of prepaid cards that at the period end had still not been earned and recognised as revenue since the customers had not consumed the total amount of minutes relating to their cards.

Roll-over minutes

During 2006 the Company changed its policy on the recognition of revenue relating to the subscription fees received from contract customers. Previously, subscription fee revenue was recognised fully in the month in which it became payable. Subscription fee revenue is now deferred to the extent it relates to unused minutes received by customers ("roll-over" minutes) in a monthly bundle until such minutes are utilised or expire. This adjustment to the accounting policy has been applied retrospectively from 1 April 2005 and is considered more appropriate as it aligns more closely with practice in the telecommunication industry and is consistent with Telefónica Group policy.

As at 1 April 2005 the Company's deferred revenue relating to roll-over minutes was £42 million (31 January 2006: £42 million), with a corresponding decrease in retained earnings at those dates. There was no change to the reported profit for the ten month period ended 31 January 2006.

Subscriber acquisition costs

Subscriber acquisition and retention costs, other than loyalty programme costs, are recognised as an expense for the period in which they are incurred. Advertising, promotion, sponsoring, communication and brand marketing costs are also expensed as incurred. Loyalty programme costs are recorded as a reduction in revenues as earned. The balance sheet includes the related accrual based on estimates of the value of points accumulated at the year end under trade and other payables.

Research and development

Expenditure on research activities is recognised in the income statement as an expense as incurred. Development expenditure is written off as incurred unless it meets the following criteria; the Company can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale, its intention to complete and its ability to use or sell the asset, how the asset will generate future economic benefits, the availability of resources to complete the asset and the ability to measure reliably the expenditure during the development. Where these recognition criteria are met, intangible assets are capitalised and amortised over their useful economic lives.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Foreign currencies

Transactions denominated in foreign currencies are translated at the exchange rate on the day the transaction occurred to the functional currency of the entity. Monetary assets and liabilities denominated in foreign currencies are translated at the rates ruling at the balance sheet date.

Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currency are translated at the foreign currency exchange rate ruling at the dates the non monetary assets and liabilities are recognised.

Employee benefits

Employee benefits - Pension obligations

A defined benefit plan is a pension plan that sets the amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation. A defined contribution plan is a pension plan under which the Company pays fixed contributions on behalf of employees and under which there is no legal or constructive obligation to pay further contributions for employees' service in the current and prior periods.

The Company participates in the O2 Pension Plan ("O2 PP"), a scheme sponsored by Telefónica O2 Europe plc that provides benefits for the majority of UK employees in the Telefónica O2 Europe plc Group. The O2 PP has both defined benefit and defined contribution sections and covers all employees of the O2 Group. The defined benefit sections are closed to new entrants. The assets of the schemes are held independently of the Company's finances.

In its capacity as a participating employer of the defined contribution section of the O2 PP, the Company pays contributions into the Plan on behalf of employees. The Company has no further payment obligations once the contributions have been paid. The contributions are recognised as employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

The Company accounts for the defined benefit section of the O2 PP as though it were a defined contribution plan as there is no arrangement for charging out the net defined benefit cost between participating employers. The net defined benefit cost of the defined benefit sections, as assessed in accordance with the advice of a qualified, independent actuary using the projected unit method and taking assets at market value, is recognised by the sponsoring employer. Accordingly the defined benefit deficit of the O2 PP is not recognised on the balance sheet of the Company because the sponsoring employer is Telefónica O2 Europe plc. Disclosures of the defined benefit sections of the O2 PP are provided below. Additional disclosure in line with the requirements of IAS 19 for both the current and previous accounting periods is provided in the consolidated Annual Report and Financial Statements of Telefónica O2 Europe plc for the 11 months ended 31 December 2006.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Taxation

The charge for current tax is based on the results for the period as adjusted for items which are non-assessable or disallowed.

Deferred income tax is provided in full, using the balance sheet liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax and current tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Income tax relating to items recognised directly in equity is recognised in equity not in the income statement.

Cash and cash equivalents

Cash and cash equivalents are carried in the balance sheet at cost. Cash and cash equivalents includes cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities on the balance sheet.

Inventories

Inventories comprise mainly handsets and are stated at the lower of cost and net realisable value (which reflects the value to the business of the handset in the hands of the subscriber) on a first-in, first-out basis, after provisions for obsolescence. Cost comprises costs of purchase and costs incurred in bringing inventory to its current location and condition.

Trade and other receivables

Trade and other receivables are carried at original invoice amount less provision for doubtful debts. A provision for doubtful debts is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Provisions are made based on an analysis of balances by age, previous losses experienced, disputes and ability to pay. The amount of the provision is the difference between the carrying amount and the present value of estimated future cash flows. Changes in the provision against receivables are recognised in the income statement within cost of goods sold.

Borrowing costs

Borrowings are recognised initially at the proceeds received, less attributable transaction costs. Subsequent to initial recognition, borrowings are stated at amortised cost with any difference between the cost and the redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis. Where borrowings are part of a fair value hedge relationship, an adjustment is made to the borrowing carrying value to reflect the hedged risk. Accrued interest on borrowings is included within the carrying value.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Provisions

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate of the amount can be made. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

The Company recognises a provision for onerous contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract. Restructuring provisions comprise employee termination payments, and these are recognised in the period in which the Company becomes legally or constructively committed to payment. A provision is made for the present value of the cost of restoration of mast sites at the date of acquisition of the site.

Leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Rentals under operating leases are charged to the income statement in equal annual instalments over the periods of the leases.

Leases which the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. Assets held under finance leases are capitalised at the lower of the present value of the minimum lease payments and the fair value of the asset at the inception of the leases and depreciated over the estimated useful economic lives of the assets. Finance charges are allocated over the period of the leases in proportion to the capital amount outstanding and are charged to the income statement.

Dividends

Final dividend distributions to the Company's shareholders are recognised as a liability in the Company's financial statements in the period in which the dividends are approved by the Company's shareholders. Interim dividend distributions to the Company's shareholders are recognised in the Company's financial statements when paid.

Financial risk factors and management

The Company's operations expose it to a variety of financial risks including currency risk, credit risk and liquidity risk.

On 23 January 2006 the O2 Group was acquired by Telefónica. Following the acquisition of the Group by Telefónica, the financial risk management policies adopted by the Company have been amended to comply with those policies in place within the Telefónica Group.

The principal financial risks of the Company and how the Company managed these risks are discussed below.

Credit risk

The Company's principal credit risks are attributable to its trade receivables.

Trade receivables as presented in the balance sheet are net of provision for doubtful debts, estimated by the Company's management based on prior experience and their assessment of the current economic environment. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis.

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

At the balance sheet date there were no significant concentrations of credit risk, with exposure spread over a large number of counter-parties and customers. The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivative financial instruments, in the balance sheet. The Company does not require collateral in respect of financial assets.

Liquidity risk

Management of the Company's liquidity risk is achieved mostly through being a part of the larger Telefónica Group, which operates group wide policies in this area. The Company also maintains its own committed borrowing facilities, and holds financial assets primarily in short-term deposits with a central Telefónica group company that are readily convertible to known amounts of cash. These measures help keep liquidity risk low.

Foreign currency risk

Foreign exchange risk arises from recognised assets and liabilities, where these are denominated in a currency that is not the entity's functional currency, net investments in foreign operations, where the overseas entity's functional currency is not the Company's functional currency, and transactional flows denominated in foreign currencies.

Fair value estimation

The fair value of the trade and other receivables, trade and other payables, cash at bank and short-term borrowings approximates to the book carrying value due to the short-term or on demand maturity of these instruments. The fair value of other financial assets for disclosure purposes has been calculated using market values provided by third parties where available, or where not available, based on discounted cash flows. The fair value of other financial assets is £242 million at 31 December 2006 (31 January 2006: £282 million). The fair value of finance lease liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Company for similar instruments. The fair value of finance lease liabilities approximates their book value at 31 December 2006 and 31 January 2006.

New accounting standards and IFRIC interpretations

Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for accounting periods beginning on or after 1 March 2006 or later periods but which the Group has chosen not to early adopt. The new standards and interpretations which will be adopted by the Group in future periods as appropriate are as follows:

Standards and amendments to standards		Effective date
IFRS 7	Financial Instruments: Disclosures	1 January 2007
Amendments to IAS 1	Presentation of Financial Statements - Capital Disclosures	1 January 2007
Guidance on implementing the revised IFRS 4 Insurance contracts		1 January 2007
IFRS 8	Operating Segments	1 January 2009

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Interpretations		Effective date
IFRIC 7	Applying the Restatement Approach under IAS 29 'Financial Reporting in Hyperinflationary Economies'	1 March 2006
IFRIC 8	Scope of IFRS 2	1 May 2006
IFRIC 9	Reassessment of Embedded Derivatives	1 June 2006
IFRIC 10	Interim Financial Reporting and Impairment	1 November 2006
IFRIC 11	IFRS 2 – Group Treasury and Share Transactions	1 January 2008
IFRIC 12	Service Concession Arrangements	1 January 2008
IFRIC 13	Customer Loyalty Programmes	1 July 2008

The Company does not expect that the first-time adoption of these interpretations will have a significant impact on its financial statements.

Critical accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise judgement in the process of applying the Company's accounting policies. A significant change in the facts and circumstances on which these estimates are based could have a material negative impact on the Company's earnings and financial position. The areas involving a higher degree of judgement or complexity and areas where assumptions and estimates are significant to the Company's financial statements are discussed below.

Property, plant and equipment and UMTS licences

Accounting for property, plant and equipment and UMTS licences involves the use of estimates and judgements for determining the useful lives over which they are to be depreciated or amortised and the existence and amount of any impairment.

Property, plant and equipment and UMTS licences are depreciated or amortised on a straight line basis over their estimated useful lives. When the Company estimates useful lives various factors are considered including expected technological obsolescence and the expected usage of the asset. The Directors regularly review these asset lives and change them as necessary to reflect the estimated current remaining lives in light of technological changes, future economic utilisation and physical condition of the assets concerned. A significant change in asset lives can have a significant change on depreciation and amortisation charges for the period.

It is not practicable to quantify the impact of changes in property, plant and equipment asset lives on an overall basis as asset lives are individually determined and there are a significant number of asset lives in use. The impact of any change would vary significantly depending on the individual changes in assets and the classes of assets impacted. A reduction in the estimated useful lives of the Company's UMTS licences from 17-18 years to 9 years at the start of the asset's life would have increased the UMTS licence amortisation charge for the 11 months ended 31 December 2006 by approximately £104 million (10 months ended 31 January 2006: £95 million).

The Company assesses the impairment of property, plant and equipment and UMTS licences whenever there is reason to believe that the carrying value may not exceed the fair value and where a permanent impairment in value is anticipated. The determination of whether the impairment of these assets is necessary, involves the use of estimates that includes, but are not limited to, the analysis of the cause of potential impairment in value, the timing of such potential impairment and an estimate of the amount of the impairment. The Company considers technological obsolescence, discontinuance of services and other changes in circumstances that indicate a need to perform an impairment test. A significant change in the facts and circumstances that were relied upon in making the estimates may

O2 (UK) Limited

Notes to the financial statements

1. Accounting policies (continued)

Property, plant and equipment and UMTS licences (continued)

trigger the requirement for recording an impairment and may have a material adverse impact on the operating results and financial condition of the Company.

Deferred tax assets and liabilities

The Company evaluates the recoverability of deferred tax assets based on estimates of future earnings. The ability to recover these taxes depends ultimately on the Company's ability to generate taxable earnings over the course of the period for which the deferred tax assets remain deductible. This analysis is based on the estimated reversal of deferred taxes as well as estimates of taxable earnings, which are sourced from internal projections and are updated to reflect the latest trends.

The appropriate classification of tax assets and liabilities depends on a series of factors, including estimates as to the timing and materialisation of deferred tax assets and the forecast tax payment schedule. Actual income tax receipts and payments could differ from the estimates made by the Company as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

Provisions

Provisions are recognised when an event in the past gives rise to a current obligation for the Company, the settlement of which requires an outflow of resources that is considered probable and can be estimated reliably. This obligation may be legal or constructive, deriving from regulations, contracts, normal practices or public commitments that lead third parties to reasonably expect that the Company will assume certain responsibilities. The amount of the provision is determined based on the best estimate of the outflow of resources required to settle the obligation, taking into account all available information.

No provision is recognised if the amount of liability cannot be estimated reliably. In this case, the relevant information is disclosed in the notes to the financial statements.

Given the uncertainties inherent in the estimates used to determine the amount of provision, actual outflows of resources may differ from the amounts recognised originally on the basis of the estimates.

Trade receivables provision for doubtful debts

The Company provides services to individuals and business customers on credit terms. The Company expects that some debts due will not be paid as a result of the default of a small number of customers. The Company uses estimates based on historical results and future expectations, the economic and competitive environment and other relevant factors to determine the provision for doubtful debts. A significant, unanticipated downturn in the major economies that the Company operates in or negative industry trends could require an increase in the estimated level of debts that will not be collected, which would negatively impact the operating results. The level of provision required is reviewed on an ongoing basis.

O2 (UK) Limited

Notes to the financial statements

2. Operating profit

The following items have been included in arriving at operating profit.

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Depreciation of property, plant and equipment (note 5)	373	324
Amortisation of intangible assets (note 7)	203	252
Staff costs (note 23)	342	279
Auditors remuneration		
Audit	0.4	0.4
Non-audit	0.2	-
Inventories		
Cost of inventories recognised as an expense (included in cost of sales)	745	642
Write downs of inventories recognised in the period	1	1
Operating lease rentals payable	117	99
Provision for doubtful debts	23	17

In addition to the provision for doubtful debts, in the 11 months ended 31 December 2006, the Company has recognised a provision for certain amounts owed by non-trading subsidiary undertakings of the Telefónica O2 Europe plc group which are unlikely to be recoverable. The amount provided totalled £213 million.

3. Net financial income

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Financial income		
Interest income on cash, cash equivalents and other financial assets	23	11
Dividend received from subsidiaries	6	-
Interest income from other group companies	31	14
Total financial income	60	25
Financial expense		
Interest payable to other group companies	(9)	(8)
Other financial costs	(14)	(14)
Total financial expense	(23)	(22)
Net financial income	37	3

O2 (UK) Limited
Notes to the financial statements

4. Taxation

Analysis of charge/(credit) in period

	11 months ended 31 December 2006	10 months ended 31 January 2006
	£m	£m
Deferred tax - current year movement	106	(22)
Deferred tax - adjustment in respect of prior periods	(92)	1
Taxation	14	(21)

Tax on items charged to equity

Deferred tax credit on stock options	-	(22)
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The tax for the period is lower than the standard rate of corporation tax in the UK of 30%. The difference is explained below:

	11 months ended 31 December 2006	10 months ended 31 January 2006
	£m	£m
Profit before taxation	388	371
Profit before taxation multiplied by rate of corporation tax in the UK of 30%	116	112
Effects of:		
Expenses not deductible for tax purposes	9	13
UK – UK transfer pricing adjustment	9	-
Non-taxable fair value adjustment	11	-
Adjustments in respect of share options	-	(7)
Utilisation of losses brought forward previously unrecognised	-	(200)
Temporary differences not recognised	55	60
Group relief not paid for	(162)	-
Adjustments in respect of prior periods	(92)	1
Non-deductible provision for impairment of intercompany receivables	64	-
Other	4	-
Total taxation	14	(21)

O2 (UK) Limited
Notes to the financial statements

5. Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Assets in the course of construction £m	Total £m
Cost				
At 1 April 2005	312	3,126	301	3,739
Additions	-	-	380	380
Transfers	52	274	(326)	-
Disposals	(20)	(38)	-	(58)
At 31 January 2006	344	3,362	355	4,061
Additions	-	4	443	447
Hive up of assets	-	12	-	12
Transfers	34	472	(506)	-
Reclassification	(3)	3	-	-
Disposals	(46)	(227)	-	(273)
At 31 December 2006	329	3,626	292	4,247
Depreciation				
At 1 April 2005	154	1,788	-	1,942
Charge for the period	36	288	-	324
Disposals	(20)	(38)	-	(58)
At 31 January 2006	170	2,038	-	2,208
Charge for the period	38	335	-	373
Reclassification	(3)	3	-	-
Disposals	(46)	(215)	-	(261)
At 31 December 2006	159	2,161	-	2,320
Net book value				
At 31 December 2006	170	1,465	292	1,927
At 31 January 2006	174	1,324	355	1,853

Included within plant and equipment are finance leased assets with a net book value of £263 million (31 January 2006: £286 million).

6. Goodwill

	Goodwill £m
Cost	
At 1 February 2006 and 31 December 2006	196
Amortisation and impairment	
At 1 February 2006 and 31 December 2006	196
Net book value	
At 31 December 2006	-
At 31 January 2006	-

O2 (UK) Limited
Notes to the financial statements

7. Intangible assets

	UMTS licence £m	Software £m	Assets in the course of construction £m	Total £m
Cost				
At 1 April 2005	4,030	882	67	4,979
Additions	-	-	68	68
Transfers	-	44	(44)	-
Disposals	-	(6)	-	(6)
At 31 January 2006	4,030	920	91	5,041
Additions	-	-	54	54
Transfers	-	133	(133)	-
Disposals	-	(28)	-	(28)
At 31 December 2006	4,030	1,025	12	5,067
Amortisation and impairment				
At 1 April 2005	2,125	531	-	2,656
Charge for the period	95	157	-	252
On disposals	-	(3)	-	(3)
At 31 January 2006	2,220	685	-	2,905
Charge for the period	104	99	-	203
On disposals	-	(28)	-	(28)
At 31 December 2006	2,324	756	-	3,080
Net book value				
At 31 December 2006	1,706	269	12	1,987
At 31 January 2006	1,810	235	91	2,136

Included within software are finance leased assets with a net book value of £44 million (31 January 2006: £35 million).

The UMTS licence is an individual asset permitting the Company to operate its "3G" network. The remaining life of this asset is approximately 15 years.

O2 (UK) Limited

Notes to the financial statements

8. Investments

	Shares in subsidiary undertakings £m
Cost	
At 1 April 2005 and 1 February 2006	4,116
Additions	89
At 31 December 2006	4,205
Amortisation and impairment	
At 1 April 2005, 1 February 2006 and 31 December 2006	-
Net book value	
At 31 December 2006	4,205
At 31 January 2006	4,116

Investments in subsidiaries are held at historical cost less any write downs for impairment.

On 20 June 2006 the Company acquired 100% of Be Un Limited, an ADSL provider based in the UK, adding broadband capability to its portfolio. The total cost of the acquisition was £51 million. This comprised £43 million cash, £5 million deferred consideration, £2 million of loan notes and £1 million of costs directly attributable to the acquisition. The cash outflows associated with the acquisition totalled £45 million. These include £43 million cash, £1million of legal fees and a £1 million acquired overdraft. On 31 August 2006 the Company made a post acquisition cash injection of £9 million.

On 28 July 2006, the Company announced it had reached agreement to acquire the remaining 60% of its associate, The Link Stores Limited, a retailer of mobile cellular phones, from DSG International plc. The acquisition completed on 16 September 2006. The total cost of the acquisition was £29 million, comprising £27 million of cash and £2 million of directly attributable acquisition expenses. The cash outflow was £21 million consisting of £27 million of cash and £6 million of cash acquired. Following completion of the acquisition, the trade and assets of the Link Stores Limited, and its wholly owned subsidiary The Link Financial Services Limited, were hived up into O2 (UK) Limited.

A list of principal subsidiary undertakings is given below.

Name	Country of incorporation and operation	Activity	Portion of ordinary shares held %
Be Un Limited	England & Wales	Trading	100% ordinary
The Link Stores Limited	England & Wales	Non trading	100% ordinary
Pacific Shelf 873 Limited	Scotland	Non trading holding company	100% ordinary
mmO2 Europe Limited	England & Wales	Non trading holding company	100% ordinary
Mobile Phone Stores Limited	England & Wales	Non trading.	100% ordinary
O2 Third Generation ⁽¹⁾	England & Wales	Non trading.	76.5% ordinary

(1) Held through an intermediate holding company.

O2 (UK) Limited

Notes to the financial statements

8. Investments (continued)

The financial summary of the Company's associate, The Link Stores Limited, before it became a fully owned subsidiary, is as follows:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Assets	-	88
Liabilities	-	(26)
Revenue	143	267
Loss	(19)	(2)

9. Trade and other receivables

	31 December 2006 £m	31 January 2006 £m
Trade receivables	464	360
Other receivables	1	5
Prepayments	65	49
Accrued income	151	144
Amounts owed by subsidiaries	-	6
Amounts owed by associates	-	2
Amounts owed by other group companies	858	1,031
	1,539	1,597

Amounts due from holding company and fellow subsidiaries are unsecured, interest free and repayable on demand with the exception of an amount of £635 million (31 January 2006: £637 million) that bears interest at LIBOR plus 42 basis points.

10. Other financial assets

	31 December 2006 £m	31 January 2005 £m
Hire purchase contract deposit	240	278

Included in other financial assets are deposits of £240 million (31 January 2006: £278 million) held in trust to meet the O2 UK hire purchase obligations disclosed in note 12.

O2 (UK) Limited
Notes to the financial statements

11. Cash and cash equivalents

	31 December 2006 £m	31 January 2006 £m
Short term deposits	665	-
Cash and cash equivalents	665	-
Bank overdraft included in borrowings (note 12)	(30)	(49)
Cash and cash equivalents per cash flow statement	635	(49)

12. Borrowings

	31 December 2006 £m	31 January 2006 £m
Current unsecured borrowings		
Bank overdrafts	30	49
Amounts owed to other group companies	182	192
Loan notes	5	6
	217	247
Obligations under finance leases	19	22
	236	269
Non-current unsecured borrowings		
Obligations under finance leases	234	279

Amounts due to other group companies are unsecured, interest free and repayable on demand.

Loan notes of £132 million were issued by the Company between March 1999 and April 2000 for the purchase of certain businesses. At 31 December 2006 loan notes totalling £5.2 million (31 January 2006: £6.5 million) were outstanding and repayable on demand.

Loan notes outstanding at 31 December 2006 and 31 January 2006 consisted of the following amounts:

	31 December 2006 £'000	31 January 2006 £'000
Issued in connection with the acquisition of Lumina Limited on 28 February 1999:		
Loan stock A: due on 30 June 2006; and bearing interest at 0.5% above base lending rate of Barclays Bank plc	1,743	2,993
Loan stock: due on 2 September 2009; repayable, in whole or in part, at the note holder's option at any time after 2 March 2000; and bearing interest at LIBOR	3,500	3,500
	5,243	6,493

During the 11 months ended 31 December 2006, note holders exercised their options to demand repayment of £1,250,000 of the above loan notes.

O2 (UK) Limited
Notes to the financial statements

12. Borrowings (continued)

Obligations under finance leases

The minimum lease payments under finance leases fall due as follows:

	Minimum lease payments	Finance charges	Present value	Minimum lease payments	Finance charges	Present value
	31 December 2006	31 December 2006	31 December 2006	31 January 2006	31 January 2006	31 January 2006
	£m	£m	£m	£m	£m	£m
Within one year	32	13	19	37	15	22
Between one and five years	153	34	119	202	47	155
After five years	129	14	115	143	19	124
	314	61	253	382	81	301

Obligations under finance leases and hire purchase contracts are mainly in respect of hire purchase agreements for plant and equipment.

On 30 March 2001 and 9 April 2001 hire purchase financing contracts were signed between the Company and a number of US leasing trusts. Under the contracts the Company sold and repurchased material portions of its GSM radio and switching equipment. The Company has deposited sufficient funds with a trust company to meet the future hire purchase obligations. The deposit account is included in current asset investments. The hire purchase agreement is for 16 years with an early buy out option after 12 years. In accordance with the Separation Agreement signed on demerger, BT Group Plc continues to guarantee all future hire purchase obligations of the Company which has provided a counter indemnity to BT Group Plc for this guarantee.

The Company has also entered into an agreement with IBM in respect of certain computer equipment, which is included in the figures above.

13. Trade and other payables

	31 December 2006 £m	31 January 2006 £m
Trade payables	126	69
Amounts owed to other group companies	370	348
Other taxation and social security	102	43
Other payables	13	17
Accrued expenses	902	797
Deferred income	251	217
	1,764	1,491

Amounts due to other group companies are unsecured, interest free and repayable on demand.

O2 (UK) Limited
Notes to the financial statements

14. Provisions

	31 December 2006			31 January 2006		
	Restructuring £m	Other provisions £m	Total £m	Restructuring £m	Other provisions £m	Total £m
Current	1	2	3	5	1	6
Non-current	31	13	44	29	8	37
	32	15	47	34	9	43

	Restructuring £m	Other provisions £m	Total £m
At 1 February 2006	34	9	43
Charge for the period	7	7	14
Utilised in the period	(9)	(1)	(10)
At 31 December 2006	32	15	47

Restructuring provision

Provision has been made in full for the costs in regards to business closures, redundancy and building closures as part of the Company's restructure. The provision has been recognised based on estimated total costs of the restructure.

Other provision

Other provisions include legal claims against the Company and the expected restoration of certain leased assets to their original condition.

15. Pension costs

The total operating charge included in the income statement for all the Company's pension schemes is as follows:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Defined contribution	21	17

The actuarial valuation of the O2 PP as at 30 September 2005 has been updated to 31 January 2006 and 31 December 2006 by an independent qualified actuary in accordance with the requirements of IAS 19. In accordance with IAS 19, the defined benefit liabilities have been measured using the projected unit method. Plan assets are stated at fair value.

O2 (UK) Limited

Notes to the financial statements

15. Pension costs (continued)

The main assumptions adopted for the O2 PP under IAS 19 are as follows:

	11 months ended 31 December 2006 %	10 months ended 31 January 2006 %
Nominal rate of increase in salaries	4.25-4.75	4.05-4.55
Nominal rate of increase of pensions in payment		
– Pension increases with inflation	3.00	2.80
– Pension increases with inflation limited to 5 per cent p.a.	2.80	2.60
Discount rate	5.20	4.70
Inflation assumption	3.00	2.80
Expected long-term return for:		
– Equities	7.50	7.20
– UK Government bonds	4.30	3.90
– Other bonds	4.80	4.70
– Other	4.30	3.90

Mortality assumptions are based on the '92 series' tables, issued by the Institute and Faculty of Actuaries, appropriate to the member's year of birth. The post-retirement mortality assumptions incorporate an additional allowance for projected longevity improvements in line with the Continuous Mortality Investigation Bureau's 'medium cohort' tables.

Movements in the present value of defined benefit obligations in the current and preceding period were as follows:

	31 December 2006 £m	31 January 2006 £m
At start of period	593	443
Current service cost	32	24
Vested past service cost	1	-
Interest cost	26	21
Actuarial (gains)/losses	(43)	106
Benefits paid	(3)	(1)
At end of period	606	593

Movements in fair value of scheme assets in the current and preceding period were as follows:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
At start of period	533	340
Expected return on scheme assets	35	22
Actuarial gains	13	66
Employer contributions	22	100
Contributions from scheme members	6	6
Benefits paid	(3)	(1)
At end of period	606	533

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15. Pension costs (continued)

The amount included in the consolidated balance sheet of Telefónica O2 Europe plc arising from its obligations in respect of the O2 PP, as well as the analysis of schemes assets, is as follows:

	31 December 2006 £m	31 January 2006 £m
<i>Fair value of assets comprises:</i>		
– Equities	551	482
– UK Government bonds	50	24
– Other bonds	-	23
– Other	5	4
Fair value of assets	606	533
Present value of defined benefit obligations	(606)	(593)
Net liability recognised in the consolidated balance sheet of Telefónica O2 Europe plc	-	(60)

16. Deferred taxation

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 30% (10 months ended 31 January 2006: 30%).

The movement on the deferred tax account is as shown below:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
At 1 February 2006	(59)	(102)
Hive up of assets	4	-
(Charge)/credit to income statement	(14)	21
Credit to equity – stock options	-	22
At 31 December 2006	(69)	(59)

Deferred tax assets have been recognised in respect of all tax losses and other temporary differences giving rise to deferred tax assets because it is probable that these assets will be recovered.

Deferred tax assets and liabilities are only offset where there is a legally enforceable right of offset and there is an intention to settle the balances net.

Deferred tax liabilities

	Unremitted earnings £m
At 1 February 2006	(62)
Charge to income statement	(46)
At 31 December 2006	(108)

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16. Deferred taxation (continued)

Deferred tax assets	Accelerated tax depreciation £m	Provisions £m	Tax losses £m	Other £m	Total £m
At 1 February 2006	(153)	17	112	27	3
Hive up of asset	-	-	-	4	4
Charge/(credit) to income statement	166	(13)	(112)	(9)	32
Charge/(credit) to reserves	22	-	-	(22)	-
At 31 December 2006	35	4	-	-	39

Net deferred tax liability	£m
At 31 December 2006	(69)
At 31 January 2006	(59)

17. Share capital

	31 December 2006		31 January 2006	
	Number of shares	£	Number of shares	£
Authorised				
Ordinary A shares of 20 pence each	10,010,200	2,002,040	10,010,200	2,002,040
Ordinary B shares of 20 pence each	40,010,800	8,002,160	40,010,800	8,002,160
Total shares	50,021,000	10,004,200	50,021,000	10,004,200

Called up, allotted and fully paid

Ordinary A shares of 20 pence each				
At 31 December 2006/31 January 2006	10,001,000	2,000,200	10,001,000	2,000,200
Ordinary B shares of 20 pence each				
At 31 December 2006/31 January 2006	40,004,000	8,000,800	40,004,000	8,000,800
Total shares	50,005,000	10,001,000	50,005,000	10,001,000

Pursuant to a Written Resolution dated 14th September 2004, the Company increased its authorised share capital to £10,004,200 by the creation of 10,000 ordinary A shares of £0.20 each and 10,000 ordinary B shares of £0.20 each. 3,200 ordinary B shares of 20p each were issued to O2 Networks Limited for consideration of £3,746,079,200 and 800 ordinary A shares of 20p each were issued to O2 Cedar Limited for a consideration of £936,519,800. All shares rank pari passu with existing A and B shares of the Company.

All classes of share capital hold equal rights to vote at General Meetings, receive dividends and receive residual assets on a winding up.

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18. Reconciliation to distributable reserves

On the transfer of the UMTS licence from O2 Third Generation Limited in July 2003, the directors revalued the UMTS licence by way of an impairment and considered the value of all of the other fixed assets of the Company to confirm that they were satisfied that the aggregate value of the fixed assets was not less than the aggregate amount at which they were stated. In these accounts the directors have reconsidered the value of all of the fixed assets without actually revaluing those fixed assets and are satisfied that their aggregate value is not less than the aggregate amount at which they are stated. In accordance with Section 275 of the Companies Act 1985 the Company's provision against the UMTS licence is not classified as a realised loss to the extent that the UMTS licence has not been amortised and the distributable reserves of the Company are £1,268 million as analysed below:

	31 December 2006 £m	31 January 2006 £m
Profit and loss account	(530)	(904)
Provision against intangible fixed asset	2,068	2,068
Realisation of provision against intangible fixed assets	(270)	(160)
Distributable reserves	1,268	1,004

19. Financial commitments and contingent liabilities

Operating lease commitments

At 31 December 2006 the Company was committed to making the following payments in respect of operating leases:

	31 December 2006 £m	31 January 2006 £m
Lease payments		
Within one year	102	88
Between one and five years	269	314
After five years	206	305
	577	707

The Company leases various offices, shops, vehicles and mast sites under non-cancellable operating lease agreements. These leases have various terms and renewal rights.

The total future minimum sublease payments expected to be received under non-cancellable subleases at the 31 December 2006 are £13 million (31 January 2006: £49 million).

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19. Financial commitments and contingent liabilities (continued)

Other commitments

	31 December 2006 £m	31 January 2006 £m
Contracts placed for capital expenditure not provided in the accounts – intangible assets	-	38
Contracts placed for capital expenditure not provided in the accounts – property, plant and equipment	103	113
Total other commitments	103	151

20. Related party disclosures

During the year the Company entered into transactions with related parties as follows:

	31 December 2006 £m	31 January 2006 £m
Revenue		
Other group undertakings	29	11
Associates	9	19
Purchases		
Other group undertakings	(31)	(42)
Associates	(27)	(54)
Total net transactions	(20)	(66)

All related party transactions relate to regular trading activities of the Company on an arms length basis.

Other related party transactions are detailed in notes 3, 9 and 12.

Related party transactions with Directors and key management are detailed in note 22.

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21. Auditors' remuneration

The aggregate fees paid to auditors during the year for audit and other services are analysed below:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Audit services:		
UK statutory audit fees	0.4	0.4
Other assurance services	0.2	-
Total audit and audit-related fees	0.6	0.4

The fees in the 11 months ended 31 December 2006 were paid to Ernst & Young LLP and the fees in the 10 months ended 31 January 2006 were paid to PricewaterhouseCoopers LLP.

22. Key management and Directors' compensation

The compensation of key management for the 11 months ended 31 December 2006 was as follows:

	11 months ended 31 December 2006 £000	10 months ended 31 January 2006 £000
Salaries and short-term employee benefits	1,836	1,724
Post-employment benefits	120	41
Share based payments	102	1,209
Total key management compensation	2,058	2,974

The key management of the Company are the same as the Directors of the Company.

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22. Key management and Directors' compensation (continued)

The emoluments of the Directors for the 11 months ended 31 December 2006 was as follows:

	11 months ended 31 December 2006 £000	10 months ended 31 January 2006 £000
Aggregate emoluments in respect of qualifying services	1,836	1,724
Aggregate amount of company contributions paid to a pension scheme	83	52
Total key management compensation	1,919	1,776

The number of Directors that exercised options over shares of Telefónica O2 Europe plc during the 11 months ended 31 December 2006 was three (10 months ended 31 January 2006: three). The number of Directors who received shares under long term incentive schemes during the 11 months ended 31 December 2006 was three (10 months ended 31 January 2006: three).

Retirement benefits are accruing to one Director (10 months ended 31 January 2006: one) under a defined benefit scheme at 31 December 2006.

In respect of the highest paid Director:

	11 months ended 31 December 2006 £000	10 months ended 31 January 2006 £000
Total amount of emoluments and amounts (excluding shares) receivable under long-term incentive schemes	732	713

The highest paid Director exercised options over the shares of Telefónica O2 Europe plc during the current and previous period and was awarded shares under long term incentive schemes.

The value of accrued pension of the highest paid Director was £207,372 (31 January 2006: £148,000).

23. Employees

	11 months ended 31 December 2006 No.	10 months ended 31 January 2006 No.
Average number of full time employee equivalents (including executive Directors):		
Technology	2,020	1,709
Customer operations	7,661	6,201
Administration	1,835	1,620
Total employees	11,516	9,530

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23. Employees (continued)

The benefits expense incurred in respect of these employees were:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Wages and salaries	294	237
Social security costs	27	25
Pension costs (note 15)	21	17
Total employee benefits expense	342	279

The Company's employees and Directors participated in a number of employee incentive share schemes operated by Telefónica O2 Europe plc. (see note 24 for further details).

24. Share based payments

Until the acquisition of the O2 Group by Telefónica, S.A. on 23 January 2006, employees of the Company participated in a number of employee incentive schemes including a Sharesave Plan and various executive option and award schemes over shares in O2 plc.

The acquisition by Telefónica on 23 January 2006 resulted in the early vesting of all schemes. All schemes except the 2005 Performance Share Plan ('2005 PSP') vested to employees shortly after acquisition. The PSP also vested, but under the terms of vesting, a cash payment to employees was deferred until 23 January 2007 and was conditional on employment by the Company at that time.

Since acquisition, two new employee incentive schemes based on the shares of Telefónica, S.A. have been introduced. These are described in more detail below.

The costs of share options and awards are charged to the income statement over the vesting period, based upon the fair value of the share award or option at the award date adjusted for the likelihood of vesting under the share award or option plan.

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24. Share based payments (continued)

The amounts recognised in the income statement for share based payment transactions with employees for the 11 months ended 31 December 2006 was as follows:

	11 months ended 31 December 2006 £m	10 months ended 31 January 2006 £m
Equity settled share based payments	-	10
Cash settled share based payments	1	13
Total share based payments	1	23

The amounts recognised in the Company's income statement for Employers' National Insurance on share based payments for the 11 months ended 31 December 2006 was nil (10 months ended 31 January 2006: £5 million).

The liability recognised in the balance sheet for share based payments at 31 December 2006 totalled nil (31 January 2006: £18 million). The total intrinsic value of share based payment liabilities that had vested at 31 December 2006 was nil (31 January 2006: £18 million). At 31 January 2006 this related to Employer's National Insurance obligations and cash compensation due to Sharesave Plan members.

Share option plans

The share option plans operated by the Company during the 11 months ended 31 December 2006 are:

Telefónica Performance Share Plan

The Telefónica Performance Share Plan was approved at the Telefónica, S.A. AGM held on 21 June 2006 and awards shares in Telefónica, S.A. to participants subject to the achievement of certain performance criteria.

The plan has an expected duration of seven years which is divided into five cycles of three years each, with the first cycle commencing on 1 July 2006. At the inception of each cycle, a number of shares are awarded to each participant in the plan, with the final number of shares vesting being based on the level of achievement against the performance criteria.

The performance criterion is the Total Shareholder Return (TSR) of Telefónica, S.A. against a comparator group, over a fixed three year period as follows:

TSR ranking	% shares vest
Below median	0%
Median	30%
Upper quartile	100%

Vesting occurs on a straight line basis between median and upper quartile performance.

The number of shares Telefónica, S.A. granted in the 11 months ended 31 December 2006 is 457,032.

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24. Share based payments (continued)

As this plan will be settled by the physical delivery of Telefónica, S.A. shares to employees, the income statement charge for the 11 months ended 31 December 2006 has been recognised against equity.

The fair value of the rights granted to the participants at the grant date is €6.43 per share. This value has been established by reference to the price of an instrument with the same conditions and requirements of the plan, which was acquired by Telefónica, S.A. from a financial institution. This is the best estimate of the fair value of the rights granted to the employees, as it results from a current market transaction.

O2 Performance Cash Plan

This plan mirrors the conditions of the Telefónica Performance Share Plan and awards employees a given number of notional shares in Telefónica, S.A. These notional shares entitle the beneficiary to a cash payment equivalent to their market value on vesting. The cash payment is capped at three times the value of the notional shares at the date of award. The value of the notional shares is set using a weighted average trading price for the 30 days prior to the start of each cycle. As an exception, the value of those notional shares awarded in the first cycle was determined using the weighted average share price for the 30 days prior to 11 May 2006. As such their notional value is €12.83.

This plan also has an expected duration of 7 years with 5 cycles of 3 years each commencing on 1 July.

As with the Telefónica Performance Share Plan, the entitlement to a payment at the end of each cycle is dependent on the TSR of Telefónica, S.A. in relation to the comparator group over a fixed three year period as follows:

TSR ranking	% Shares vest
Below median	0%
Median	30%
Upper quartile	100%

Vesting occurs on a straight line basis between median and upper quartile performance.

The number of notional shares awarded was 409,710.

25. Parent company and controlling party

The Company's immediate parent companies are O2 Networks Limited and O2 Cedar Limited. Up to 23 January 2006 the ultimate parent company and controlling party of the Company was O2 plc (now renamed as Telefónica O2 Europe plc). Subsequent to this date the ultimate parent company and controlling party became Telefónica, S.A.

At the end of the period the ultimate parent company and controlling party was Telefónica, S.A., a company incorporated in Spain. Copies of the consolidated financial statements of Telefónica, S.A. may be obtained from Gran Vía 28, 28013, Madrid, Spain.

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26. Events after the balance sheet date

The Company has changed its accounting reference date from 31 January to 31 December.

Between 15 and 21 June 2007, the Company subscribed for a total of 3,643 ordinary shares of 1p each in the capital of O2 Pine Limited, a subsidiary undertaking.

On 15 June 2007, the Company became a member of O2 Willow Limited, a private company limited by guarantee, agreeing, in the event of dissolution, to contribute a sum (not exceeding £1) towards the payment of that company's debts and liabilities incurred during membership, or in the 12 months after the Company ceased to be a member. On 21 June 2007, the Company made capital contributions totalling £1,001 million to O2 Willow Limited.

On 14 September 2007, as required by local law, the Company established a Branch Office in Northern Ireland.

From financial year 2008, the UK corporation tax rate will be reduced from 30% to 28%. It is estimated that as a result, the Company's deferred tax liability will decrease by £5 million. Further changes are anticipated in relation to capital allowances although the impact on the related deferred tax asset is not yet quantifiable.