Registered Number: 1743099

Telefónica O2 UK Limited
(formerly O2 (UK) Limited)

Annual Report and Financial Statements
Year ended 31 December 2007

Telefónica O2 UK Limited (formerly O2 (UK) Limited)

Contents

Telefónica O2 UK Limited (formerly O2 (UK) Limited)

Directors

J Campbell
V Dev
R Dunne
R Harwood
R Ros
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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Directors' report

The Directors present their annual report and financial statements for the year ended 31 December 2007

Corporate structure

Telefónica O2 UK Limited (formerly 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 SL1 4DX It is a wholly owned subsidiary of Telefónica 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 The Company also has a branch office registered in Northern Ireland, with the branch registration number FC004216

Events after the balance sheet date

On 30 May 2008, the Company changed its name from O2 (UK) Limited to Telefónica O2 UK Limited

On 14 February 2008, the Company received a dividend of £1,040,018,334 from a subsidiary undertaking, O2 Pine Limited

Principal activities

The principal activities of the Company during the year were the operation of a cellular communications network, the sale of network airtime services to service providers and the Company's customer base and the provision of fixed broadband services

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

Business review

Strategy

The Company performed strongly throughout the year ended 31 December 2007 in an increasingly competitive market There were 749,000 new customers added in the year, taking the total mobile customer base to 18 4 million, 4% 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 year ended 31 December 2007 was £5,057 million (11 months ended 31 December 2006 £4,276 million) The Company's operating profit before provision for intercompany receivables for the year ended 31 December 2007 was £660 million (11 months ended 31 December 2006 £351 million)

A total of 591,000 net new contract customers and 158,000 net new pre-pay customers were added during year to 31 December 2007, driven by higher gross additions and lower churn

The Company's blended ARPU of £24 per month at 31 December 2007 was £1 higher than the previous year and prepay ARPU at £12 per month was also higher by £0 50 Contract ARPU of £43 per month was also £0 50 higher than December 2006 Data ARPU increased to £8 per month at 31 December 2007 from £7 per month at 31 December 2006 driven by growth in both SMS and non-SMS data SMS volumes sent in the year to 31 December 2007 were 22 0 billion, up from 18 2 billion in the year to 31 December 2006

Financial position of the Company as at 31 December 2007

During the year the Company made capital contributions totalling £1,001m to O2 Willow Limited, recording a reduction in cash and cash equivalents, and a corresponding increase in investments

Aside from this, the balance sheet of the Company has remained broadly consistent with prior years

Risks and uncertainties

The Company operates in highly regulated markets and action by the European Commission or Regulators could limit its flexibility to manage its business

Mobile operators must comply with an extensive range of requirements that regulate and supervise the licensing, construction and operation of their networks and the provision and pricing of their products and services in the countries in which they operate

The European Commission is currently conducting a review of the EU Regulatory Framework and its regulatory powers for the electronic communications sector Any new or more onerous regulatory obligations imposed would affect the Company, and, depending upon the obligations imposed, this could have a significant effect on the profitability of the Company's businesses, particularly in respect of international roaming charges, spectrum allocation tariffs, interconnection or the accessibility of the Company's network to mobile virtual network operators and service providers

New or more onerous regulatory obligations may also be imposed on the Company in relation to call termination charges 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

Increased competition may reduce overall market profitability or the Company may fail to differentiate its customer experience from other networks

The Company is competing increasingly with new mobile service providers, virtual network operators, resellers of mobile services and 'all you can eat' IP-based services Competition from existing service providers may be more intense than anticipated driving down prices and failure to compete effectively could result in a decrease in customers, revenues and profitability as well as increased competition and costs in acquiring spectrum

Likewise, the Company must ensure that its customer experience stands out, as slower implementation timetables, higher costs or poorer customer experience could undermine the value of the Company's brand and limit the Company's ability to attract customers and win market share, which in turn could have a negative impact on the Company's business and operational results

Customer plan activities have been rolled out to confront these risks and the market is continuously monitored but owing to the unpredictability of competitor activity these risks cannot be fully mitigated

Delayed network development or failure to compete with new technologies could affect the Company's ability to offer new products and services and therefore its market position

Service and handset technology is continuously evolving in the telecommunications industry and the Company's success depends on remaining at the forefront of fresh and innovative technological development

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 Current trends in the telecommunications industry in Europe, such as the rapid convergence of technologies, indicate that further technological advances should be expected in the future and whilst industry developments are monitored, a failure to compete could allow them to erode the position of our services resulting in a decrease in customers, revenues and profitability

Risks and uncertainties (continued)

Anxiety about alleged health risks associated with mobile phones could lead to decreased usage of the Company's services and products

Public concern about the alleged health risks of mobile communication could have a detrimental impact on the Company's business through negative customer perception of the Company's brand, services or products Whilst there is no evidence confirming a link between radio frequency emissions and health problems, and the Company continues to comply with good practice codes, there can be no assurance of what future medical research may suggest

The Company could be affected by misuse of our networks by third parties in ways which damage our reputation and/or revenue

Certain customers could 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 It also must be considered that they could misuse the network in ways which impact the Company's costs or revenues, such as fraud or hacking resulting in fines and loss of reputation and trust The Company has controls to prevent this risk occurring

Financial risk management objectives, policies and exposure

Details of the Company's approach to financial risk management are set out in the financial statements in note 1 'Accounting Policies'

Research and development

The Company has incurred research and development expenditure during the year ended 31 December 2007 of nil (11 months ended 31 December 2006 £1 million)

Results and proposed dividend

The Company's profit after taxation for the year ended 31 December 2007 was £529 million (11 months ended 31 December 2006 profit of £374 million)

The Directors do not recommend the payment of a final dividend for the year ended 31 December 2007 (11 months ended 31 December 2006 nil)

Directors and secretary

The names of all current Directors of the Company are shown below All Directors held office throughout the year, except where indicated otherwise

J Campbell
V Dev
R Dunne
R Harwood
M Key (resigned 14 May 2008)
R Ros (appointed 1 May 2008)
P Whelan

The Secretary who held office during the year was O2 Secretaries Limited

Directors' indemnities

Telefónica 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)

Employees

The Company has a wide range of communication channels with employees including face-to-face meetings, team briefings, audio conferences and a comprehensive intranet that includes a regular newsletter The aim of all these channels is to ensure employees fully understand the Company's objectives and its operational and financial performance In addition the Company conducts annual engagement surveys and maintains a constructive dialogue with unions, employee representative bodies and works councils

The Company continues to be 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 has invested in e-learning technology to give people better access to a wide range of learning opportunities

The Company is committed to employment policies that follow best practice, based on equal opportunities for all, and recognises the diversity of its people The 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 35 days' purchases outstanding as at 31 December 2007 (31 December 2006 33 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 year ended 31 December 2007 (11 months ended 31 December 2006 nil) Donations to charities during the year ended 31 December 2007 amounted to £660,000 (11 months ended 31 December 2006 £264,000), all of which went to charities in the United Kingdom

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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Directors' report

Auditors

Pursuant to a shareholders' resolution under Section 386 of the Companies Act 1985, the Company is not obliged to re-appoint its auditors annually

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
21 July 2008

Independent auditors' report to the members of Telefónica O2 UK Limited

We have audited the financial statements of Telefónica O2 UK Limited for the year ended 31 December 2007 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 judgements 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 Telefónica 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 2007 and of its profit for the year 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
Registered auditor
London
23 July 2008

Income statement
Year ended 31 December 2007

	Note	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Revenue		**5,057**	4,276
Cost of sales		**(2,967)**	(2,546)
Gross profit		**2,090**	**1,730**
Administrative expenses		**(1,430)**	(1,166)
Operating profit before provision for impairment of intercompany receivables		**660**	**564**
Provision for impairment of intercompany receivables	2	**-**	**(213)**
Operating profit	2	**660**	**351**
Financial income	3	**92**	60
Financial expense	3	**(21)**	(23)
Profit before taxation		**731**	**388**
Taxation	4	**(202)**	(14)
Profit for the period attributable to equity shareholders		**529**	**374**

The accompanying notes are an integral part of these financial statements

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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)

Balance sheet
As at 31 December 2007

	Note	31 December 2007 £m	31 December 2006 £m
Non-current assets			
Property, plant and equipment	5	**2,031**	1,927
Intangible assets	7	**1,812**	1,987
Investments	8	**5,206**	4,205
		9,049	**8,119**
Current assets			
Inventories		**59**	70
Trade and other receivables	9	**1,760**	1,539
Other financial assets	10	**222**	240
Cash and cash equivalents	11	**470**	665
		2,511	**2,514**
Current liabilities			
Borrowings	12	**(299)**	(236)
Trade and other payables	13	**(2,044)**	(1,764)
Current tax liabilities		**(59)**	(4)
Provisions	14	**(17)**	(3)
		(2,419)	**(2,007)**
Net current assets		**92**	**507**
Total assets less current liabilities		**9,141**	**8,626**
Non-current liabilities			
Borrowings	12	**(213)**	(234)
Deferred tax liabilities	16	**(69)**	(69)
Provisions	14	**(50)**	(44)
		(332)	**(347)**
Net assets		**8,809**	**8,279**
Equity			
Ordinary share capital	17	**10**	10
Share premium		**8,799**	8,799
Retained earnings	18	**-**	(530)
Total equity		**8,809**	**8,279**

The accompanying notes are an integral part of these financial statements

These financial statements were approved by the Board of Directors on 21 July 2008 and were signed on its behalf by

Ramon Ros
Director

Telefónica O2 UK Limited (formerly O2 (UK) Limited)

Statement of changes in equity
Year ended 31 December 2007

	Called up share capital	Share premium	Retained earnings	Total equity
	Note 17		Note 18	
	£m	£m	£m	£m
At 31 January 2006	**10**	8,799	**(904)**	**7,905**
Total recognised income for the period	-	-	374	**374**
At 31 December 2006	**10**	8,799	**(530)**	**8,279**
Total recognised income for the year	-	-	529	**529**
Share based payments	-	-	1	**1**
At 31 December 2007	**10**	8,799	-	**8,809**

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Cash flow statement
Year ended 31 December 2007

	Note	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Operating profit		**660**	351
Depreciation and amortisation charges		**627**	576
Loss on disposal of non-current assets		**-**	11
Decrease in inventories		**11**	13
(Increase)/Decrease in trade and other receivables		**(112)**	168
Increase in trade and other payables		**116**	162
Increase in provisions		**18**	4
Corporation tax paid		**(43)**	-
Other non cash transactions		**1**	1
Net cash from operating activities		**1,278**	1,286
Acquisition of companies		**(1,001)**	(66)
Purchase of property, plant and equipment		**(436)**	(492)
Proceeds from sale of property, plant and equipment		**-**	1
Purchase of intangible assets		**(60)**	(54)
Dividends received		**-**	6
Net cashflow used in investing activities		**(1,497)**	(605)
Repayment of borrowings including finance leases		**(5)**	(5)
Increase in borrowings		**14**	-
Increase in loans receivable		**(70)**	-
Interest received		**28**	8
Dividends received		**16**	-
Net cashflow used in financing activities		**(17)**	3
Net (decrease)/ increase in cash and cash equivalents		**(236)**	684
Cash and cash equivalents at start of period		**635**	(49)
Cash and cash equivalents at end of period	11	**399**	635

The accompanying notes are an integral part of these financial statements

Telefónica O2 UK Limited (formerly 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 previous period are therefore for the 11 month period from 1 February 2006 to 31 December 2006 Accordingly 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 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

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

1 Accounting polices (continued)

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 remaining estimated useful lives are 14 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, outbound roaming and interconnect revenue Post-pay customers are billed in advance for their monthly subscription fees and in arrears for call and other charges 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 not yet billed is accrued and recognised on the balance sheet

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 foreign 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

Interconnect revenue, earned from other telecommunications operators whose customers terminate calls on the Company's network, is recognised based on usage

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

1 Accounting polices (continued)

Revenue (continued)

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, contains two elements prepay top-ups and monthly subscription fees billed in advance In both cases revenue is deferred to the extent of the services paid but unused

Roll-over minutes

Subscription fee revenue is 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

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

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 can demonstrate the following

- 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,
- 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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

1. Accounting polices (continued)

Foreign currencies

Transactions denominated in foreign currencies are translated at the exchange rate ruling on the day the transaction occurred into sterling 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 Europe plc that provides benefits for the majority of UK employees in the Telefonica Europe plc Group The O2 PP has both defined benefit and defined contribution sections 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

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 surplus of the O2 PP is not recognised on the balance sheet of the Company because the sponsoring employer is Telefónica Europe plc Disclosures over the defined benefit sections of the O2 PP are provided in note 15 Additional disclosure in line with the requirements of IAS 19 for both the current and previous accounting periods is provided in the Annual Report and Financial Statements of Telefónica Europe plc for the year ended 31 December 2007

1. Accounting polices (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 predominantly comprise 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

1 Accounting polices (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 contacts 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 in 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 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

1. Accounting polices (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 £222 million at 31 December 2007 (31 December 2006 £240 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 2007 and 31 December 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 January 2007

Standards and amendments to standards implemented in the year

		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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

1. Accounting polices (continued)

Standards and amendments to standards to be implemented in future periods

Interpretations		**Effective date**
Amendments to IAS 23	Borrowing Costs	1 January 2009
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 life of the Company's UMTS licence from 18 years to 9 years at the start of the asset's life would have increased the UMTS licence amortisation charge for the year ended 31 December 2007 by approximately £113 million (11 months ended 31 December 2006 £104 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 as indications of the need to perform an impairment test A significant change in the facts and circumstances that were relied upon in making the estimates may trigger the requirement for recording an impairment and may have a material adverse impact on the operating results and financial condition of the Company

1. Accounting polices (continued)

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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

2. Operating profit

The following items have been included in arriving at operating profit

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Depreciation of property, plant and equipment (note 5)	**392**	373
Amortisation of intangible assets (note 7)	**235**	203
Staff costs (note 23)	**429**	343
Auditors remuneration		
Audit	**0 7**	0 4
Non-audit	**0 4**	0 2
Inventories		
Cost of inventories recognised as an expense (included in cost of sales)	**909**	745
Write downs of inventories recognised in the period	**7**	1
Operating lease rentals payable	**132**	117
Provision for doubtful debts	**38**	23

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 Europe plc group which are unlikely to be recoverable The amount provided totalled £213 million

3. Net financial income

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Financial income		
Interest income on cash, cash equivalents and other financial assets	**37**	23
Dividend received from subsidiaries	**16**	6
Interest income from other group companies	**39**	31
Total financial income	**92**	60
Financial expense		
Interest payable to other group companies	**(11)**	(9)
Other financial costs	**(10)**	(14)
Total financial expense	**(21)**	(23)
Net financial income	**71**	37

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

4. Taxation

Analysis of charge in period

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Current tax - current year movement	202	-
Deferred tax - current year movement	96	106
Deferred tax - adjustment in respect of prior periods	(96)	(92)
Taxation	202	14

The tax expense for the year is lower than the standard rate of corporation tax in the UK of 30% The difference is explained below

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Profit before taxation	731	388
Profit before taxation multiplied by rate of corporation tax in the UK of 30%	219	116
Effects of		
Expenses not deductible for tax purposes	10	9
UK – UK transfer pricing adjustment	3	9
Non-taxable fair value adjustment	-	11
Temporary differences not recognised	74	55
Group relief not paid for	-	(162)
Adjustments in respect of prior periods	(96)	(92)
Non-deductible provision for impairment of intercompany receivables	-	64
Effect on closing deferred tax balances of change in tax rate	(5)	-
Other	(3)	4
Total taxation	202	14

The statutory rate of corporation tax in the UK will reduce to 28% with effect from 1 April 2008 Deferred tax assets and liabilities in the UK have been re-calculated at the tax rate appropriate to when they are expected to reverse The effect on the current year tax charge is a credit of £5m

Telefónica O2 UK Limited (formerly 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 February 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
Additions	-	-	60	60
Transfers	-	53	(53)	-
Disposals	-	(89)	-	(89)
At 31 December 2007	**4,030**	**989**	**19**	**5,038**
Amortisation				
At 1 February 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
Charge for the year	114	121	-	235
Disposals	-	(89)	-	(89)
At 31 December 2007	**2,438**	**788**	-	**3,226**
Net book value				
At 31 December 2007	**1,592**	**201**	**19**	**1,812**
At 31 December 2006	1,706	269	12	1,987

Included within software are finance leased assets with a net book value of £42 million (31 December 2006 £44 million)

The UMTS licence is an individual asset permitting the Company to operate its "3G" network The remaining life of this asset is 14 years

8 Investments

	Shares in subsidiary undertakings £m
Cost	
At 1 February 2006	4,116
Additions	89
At 31 December 2006	4,205
Additions	1,001
At 31 December 2007	**5,206**
Amortisation and impairment	-
At 1 February 2006, 31 December 2006 and 31 December 2007	-
Net book value	
At 31 December 2007	**5,206**
At 31 December 2006	4,205

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

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 14 February 2008, O2 Pine Limited paid a dividend of £1,040,018,334 to Telefónica O2 UK Limited

On 15 June 2007, the Company became a member of O2 Willow Limited, a private company limited by guarantee, agreeing, in the event of a 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

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
O2 Willow 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

9. Trade and other receivables

	2007 £m	2006 £m
Trade receivables	**584**	465
Prepayments	**72**	65
Accrued income	**153**	151
Amounts owed by other group companies	**951**	858
	1,760	1,539

Amounts due from holding company and fellow subsidiaries are unsecured, interest free and repayable on demand with the exception of an amount of £703 million (31 December 2006 £635 million) that bears interest at LIBOR plus 42 basis points

In accordance with IFRS 7 "Financial Instruments Disclosures", the following disclosures are presented regarding the trade receivable balances

			Not impaired but overdue on the reporting date			
	Carrying Amount £m	Neither impaired or overdue on the reporting date £m	Less than 90 days £m	Between 90 to 180 days £m	Between 180 to 360 days £m	Over 360 days £m
Trade receivables as at 31 December 2007	**584**	**521**	**35**	**8**	**9**	**11**
Trade receivables as at 31 December 2006	465	382	63	13	1	6

Amounts above are presented including VAT, which is reclaimable from Her Majesty's Revenue and Customs ("HMRC") upon write off of the underlying trade receivable Of the balance due in greater than 90 days most is expected to be recoverable in full from HMRC

For the debtors which are not impaired and which are overdue at the reporting date, there has been no indication that their payment obligations will not be met

The movement in the trade receivables provision for doubtful debts during the year is as follows

	£m
Bad debt provision at 31 January 2006	153
Reductions/amount paid	(7)
Bad debt provision at 31 December 2006	146
Additions	38
Bad debt provision at 31 December 2007	**184**

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

10. Other financial assets

	2007 £m	2006 £m
Hire purchase contract deposit	**222**	240

Other financial assets comprise are deposits of £222 million (31 December 2006 £240 million) held in trust to meet the Company's obligations under finance leases disclosed in note 12

11. Cash and cash equivalents

	2007 £m	2006 £m
Short term deposits	**470**	665
Cash and cash equivalents	**470**	665
Bank overdraft included in borrowings (note 12)	**(71)**	(30)
Cash and cash equivalents included in cash flow statement	**399**	635

12. Borrowings

	2007 £m	2006 £m
Current unsecured borrowings		
Bank overdrafts	**71**	30
Amounts owed to other group companies	**207**	182
Loan notes	**5**	5
	283	217
Obligations under finance leases	**16**	19
	299	236
Non-current unsecured borrowings		
Obligations under finance leases	**213**	234

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 2007 loan notes totalling £5 million (31 January 2006 £5 million) were outstanding and repayable on demand

Loan notes outstanding at 31 December 2007 and 31 December 2006 consisted of the following amounts

	31 December 2007 £000	31 December 2006 £000
Loan stock A due on 1 April 2008, repayable, and bearing interest at 0 5% above base lending rate of Barclays Bank plc	**1,743**	1,743
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 0 75% below LIBOR	**3,500**	3,500
	5,243	5,243

Telefónica O2 UK Limited (formerly 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 2007	31 December 2007	31 December 2007	31 December 2006	31 December 2006	31 December 2006
	£m	£m	£m	£m	£m	£m
Within one year	28	12	16	32	13	19
Between one and five years	153	28	125	153	34	119
After five years	95	7	88	129	14	115
	276	47	229	314	61	253

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

	2007	2006
	£m	£m
Trade payables	121	126
Amounts owed to other group companies	532	370
Other taxation and social security	118	102
Other payables	35	13
Accrued expenses	997	902
Deferred income	241	251
	2,044	1,764

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

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

14. Provisions

	Restructuring £m	Other provisions £m	2007 Total £m	Restructuring £m	Other provisions £m	2006 Total £m
Current	14	3	17	1	2	3
Non-current	-	50	50	31	13	44
	14	53	67	32	15	47

	Restructuring £m	Other provisions £m	Total £m
At 31 January 2007	32	15	47
Charge for the period	19	6	25
Utilised in the period	(5)	(6)	(11)
Reclassifications	(32)	32	-
Other adjustments	-	6	6
At 31 December 2007	**14**	**53**	**67**

Restructuring provision

Provision has been made in full for the costs in regards to planned business restructuring programmes The provision has been recognised based on estimated total costs of the restructure

Other provision

Other provisions include onerous lease contracts and future estimated site restoration costs

15. Pension costs

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

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Pension costs	29	21

The actuarial valuation of the O2 PP as at 31 December 2006 has been updated to 31 December 2007 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

15. Pension costs (continued)

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

	Year ended 31 December 2007 %	11 months ended 31 December 2006 %
Nominal rate of increase in salaries	**4 65-5 15**	4 25-4 75
Nominal rate of increase of pensions in payment		
– Pension increases with inflation	**3 40**	3 00
– Pension increases with inflation limited to 5 per cent p a	**3 20**	2 80
Discount rate	**5 70**	5 20
Inflation assumption	**3 40**	3 00
Expected long-term return for		
– Equities	**7 60**	7 50
– UK Government bonds	**4 40**	4 30
– Other bonds	**5 00**	4 80
– Other	**4 40**	4 30

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

	2007 £m	2006 £m
At start of period	**606**	593
Current service cost	**33**	32
Vested past service cost	**-**	1
Interest cost	**32**	26
Actuarial gains	**(16)**	(43)
Curtailment gain	**(11)**	-
Benefits paid	**(7)**	(3)
At end of period	**637**	606

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

	Year 31 December 2007 £m	11 months ended 31 December 2006 £m
At start of period	**606**	533
Expected return on scheme assets	**45**	35
Actuarial gains	**5**	13
Employer contributions	**27**	22
Contributions from scheme members	**4**	6
Benefits paid	**(7)**	(3)
At end of period	**680**	606

15. Pension costs (continued)

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

	2007 £m	2006 £m
Fair value of assets comprises		
– Equities	609	551
– UK Government bonds	53	50
– Other bonds	-	-
– Other	18	5
Fair value of assets	680	606
Present value of defined benefit obligations	(637)	(606)
Net asset recognised in the consolidated balance sheet of Telefónica Europe plc	43	-

16. Deferred taxation

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 30% (11 months ended 31 December 2006 30%)

The movement on the deferred tax account is as shown below

	£m
At 1 February 2006	(59)
Hive up of assets	4
Credit to income statement	(14)
At 31 December 2006	(69)
Prior year credit to income statement	96
Current year charge to income statement	(101)
Effect of change in statutory tax rate	5
At 31 December 2007	**(69)**

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 January 2007	(108)
Charge to the income statement	(20)
Effect of change in statutory tax rate	8
At 31 December 2007	**(120)**

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

16. Deferred taxation (continued)

Deferred tax assets	Accelerated tax Depreciation	Provisions	Total
	£m	£m	£m
At 1 January 2007	35	4	39
Charge to income statement	19	(4)	15
Effect of change in statutory tax rate	(3)	-	(3)
At 31 December 2007	**51**	**-**	**51**

Net deferred tax liability	£m
At 31 December 2007	**(69)**
At 31 December 2006	(69)

17. Share capital

	31 December 2007 Number of shares	31 December 2007 £	31 December 2006 Number of shares	31 December 2006 £
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 2007/31 December 2006	**10,001,000**	**2,000,200**	**10,001,000**	**2,000,200**
Ordinary B shares of 20 pence each				
At 31 December 2007/31 December 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**

The Company has two classes of issued and authorised share capital comprising Ordinary A and Ordinary B shares of 20 pence each Each share class ranks pari passu Subject to the Company's Articles of Association and applicable law, the Company's shares confer on the holder the right to receive notice of and vote at General Meetings, the right to receive surplus assets on a winding up of the Company, and an entitlement to receive any dividend declared on ordinary shares

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 February 2006	344	3,362	355	4,061
Additions	-	4	443	447
Hive up of assets	-	12	-	12
Transfers	34	472	(506)	-
Reclassification	(3)	3	-	-
Disposal	(46)	(227)	-	(273)
At 31 December 2006	329	3,626	292	4,247
Additions	-	-	496	496
Reclassification	81	428	(509)	-
Disposals	(7)	(74)	-	(81)
At 31 December 2007	**403**	**3,980**	**279**	**4,662**
Depreciation				
At 1 February 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
Charge for the year	39	353	-	392
Reclassification	27	(27)	-	-
On disposals	(7)	(74)	-	(81)
At 31 December 2007	**218**	**2,413**	**-**	**2,631**
Net book value				
At 31 December 2007	**185**	**1,567**	**279**	**2,031**
At 31 December 2006	170	1,465	292	1,927

Included within plant and equipment are finance leased assets with a net book value of £240 million (31 December 2006 £263 million)

6. Goodwill

	Goodwill £m
Cost	
At 1 February 2006, 31 December 2006 and 31 December 2007	**196**
Amortisation and impairment	
At 1 February 2006, 31 December 2006 and 31 December 2007	**196**
Net book value	
At 31 December 2006	**-**
At 31 December 2006	-

18. Reconciliation of retained earnings to distributable reserves

On the transfer of the UMTS licence from O2 Third Generation 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 £1,675 million (31 December 2006 1,268 million) as analysed below

	2007	2006
	£m	£m
Profit and loss account	-	(530)
Provision against intangible fixed asset	2,068	2,068
Realisation of provision against intangible fixed assets	(390)	(270)
Distributable reserves	1,678	1,268

19. Financial commitments and contingent liabilities

Operating lease commitments

At 31 December 2007 the Company was committed to making the following payments in respect of operating leases

	2007	2006
	£m	£m
Lease payments		
Within one year	112	102
Between one and five years	317	269
After five years	218	206
	647	577

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 2007 are £52 million (31 December 2006 £13 million)

Other commitments

	2007	2006
	£m	£m
Contracts placed for capital expenditure not provided in the accounts – property, plant and equipment	119	103
Total other commitments	119	103

20. Related party disclosures

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

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Revenue		
Other group undertakings	41	29
Associates	-	9
Purchases		
Other group undertakings	(64)	(31)
Associates and Joint Ventures	-	(27)
Total net transactions	(23)	(20)

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, 12 and 13

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

21. Auditors' remuneration

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

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Audit services		
UK statutory audit fees	0 7	0 4
Other assurance services	0 4	0 2
Total audit and audit-related fees	1 1	0 6

The fees in the current year were paid to Ernst & Young LLP

22. Key management and Directors' compensation

The compensation of key management for the year ended 31 December 2007 was as follows

	Year ended 31 December 2007 £000	11 months ended 31 December 2006 £000
Salaries and short-term employee benefits	1,894	1,836
Post-employment benefits	322	120
Share based payments	411	102
Total key management compensation	2,627	2,058

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

22. Key management and Directors' compensation (continued)

The emoluments of the Directors for the 12 months ended 31 December 2007 was as follows

	Year ended 31 December 2007 £000	11 months ended 31 December 2006 £000
Aggregate emoluments in respect of qualifying services	**1,894**	1,836
Aggregate amount of company contributions paid to a pension scheme	**300**	83
	2,194	1,919

No Directors exercised options over shares of Telefónica Europe plc during the year (11 months ended 31 December 2006 three) The number of Directors who received shares under long term incentive schemes during the year ended 31 December 2007 was three (11 months ended 31 December 2006 three)

Retirement benefits are accruing to one Director (11 months ended 31 December 2006 one) under a defined benefit scheme at 31 December 2007

In respect of the highest paid Director

	Year ended 31 December 2007 £000	11 months ended 31 December 2006 £000
Total amount of emoluments and amounts (excluding shares) receivable under long-term incentive schemes	1,264	732

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

The value of accrued pension of the highest paid Director was nil (31 December 2006 £207,372)

23 Employees

	Year ended 31 December 2007 No.	11 months ended 31 December 2006 No
Average number of full time employee equivalents (including executive Directors)		
Technology	**1,569**	2,020
Customer operations	**7,462**	7,661
Administration	**1,938**	1,835
Total employees	**10,969**	11,516

23. Employees (continued)

The benefits expense incurred in respect of these employees were

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Wages and salaries	360	294
Social security costs	38	27
Pension costs (note 15)	29	21
Cash settled share based payments (note 24)	2	1
Total employee benefits expense	**429**	343

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

24 Share based payments

Two employee incentive schemes based on the shares of Telefónica, S A are currently in operation

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

The amounts recognised in the income statement for share based payment transactions with employees for the year ended 31 December 2007 was as follows

	Year ended 31 December 2007 £m	11 months ended 31 December 2006 £m
Equity settled share based payments	1	-
Cash settled share based payments	2	1
Total share based payments	**3**	**1**

The amounts recognised in the Company's income statement for Employers' National Insurance on share based payments for the year ended 31 December 2007 was nil (11 months ended 31 December 2006 nil)

The liability recognised in the balance sheet for share based payments at 31 December 2007 totalled nil (31 December 2006 £nil) The total intrinsic value of share based payment liabilities that had vested at 31 December 2007 was nil (31 December 2006 £nil)

Share option plans

The share option plans operated by the Company during the year ended 31 December 2007 are

Telefónica O2 UK Limited (formerly O2 (UK) Limited)
Notes to the financial statements

24. Share based payments (continued)

Telefónica Performance Share Plan

The Telefonica 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 year ended 31 December 2007 is 430,733 (11 months ended 31 December 2006 457,032)

As this plan will be settled by the physical delivery of Telefónica, S A shares to employees, the income statement charge for the year ended 31 December 2007 has been recognised against equity

The fair value of the rights granted to the participants at the grant date is €7 72 per share (2006 grant €6 43) 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

24. Share based payments (continued)

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 during the year was 337,754 (11 months ended 31 December 2006 409,710)

25. Parent company and controlling party

The Company's immediate parent companies are O2 Networks Limited and O2 Cedar Limited

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 Via 28, 28013, Madrid, Spain

26 Events after the balance sheet date

On 30 May 2008, the Company changed its name from O2 (UK) Limited to Telefónica O2 UK Limited

On 14 February 2008, the Company received a dividend of £1,040,018,334 from a subsidiary undertaking, O2 Pine Limited