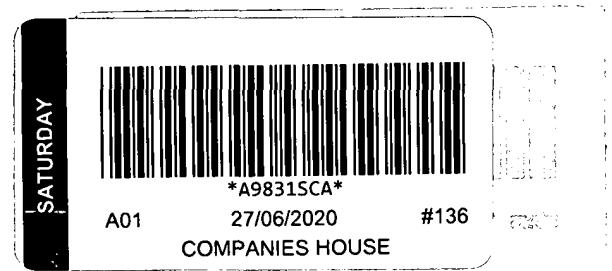


Registered Number: 02604354

O2 Holdings Limited

Annual Report and Financial Statements

Year ended 31 December 2019



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COMPANY INFORMATION

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STRATEGIC REPORT

O2 Holdings Limited (the "Company") is a member of the Telefonica group of companies (the Telefonica Group). The ultimate parent company is Telefonica S.A. headquartered in Spain and primarily listed on the Spanish stock exchange.

The Company does not trade and does not have any significant suppliers. Its purpose is to act as an intermediate holding company for the majority of the Telefonica Group operations in the UK (The UK Group).

This consolidated strategic report consists of the strategic review of the operating wholly owned subsidiaries in the UK which are:

- Telefonica UK Limited (O2), a mobile network operator (MNO) trading in the UK under the brand name O2, providing mobile telecommunications and related services to a growing customer base; and
- giffgaff Limited (giffgaff), a mobile virtual network operator (MVNO) running on the O2 network.

In accordance with section 414A(4) of the Companies Act 2006 the strategy review gives greater emphasis to the matters that are significant to O2 as the principal undertaking included in the consolidation.

O2

The purpose of our principal brand O2, is to make every day better through personal experiences that count through a Customer Led Mobile First Strategy. Our key objective is to enhance and enrich the everyday lives of our customers by embracing new technology through our commitments to:

- (1) Our Customers:** We're focused on delivering a simple and personal customer experience, helping customers get the most out of mobile connectivity through our customer promise that every product, service and experience they have with us will help them to live better lives.
- (2) Our Propositions:** We offer mobile phones, tablets and wearable devices to our customers as well as a range of mobile services and products, including mobile voice, messaging and data services. We also provide Wi-Fi, cloud services, digital payment services, fixed-line services for businesses and some insurance products.
- (3) Our Sales and Service:** We provide our products and services through a multitude of channels and work in partnership with a portfolio of strong brands to support the delivery of putting our customers first.
- (4) Our People:** We have a diverse and inclusive workforce. Our ambition is to create an employee experience, centred on our values of Bold, Open and Trusted, that sets O2 apart in the eyes of our current and future talent.
- (5) Our Technology:** We continue to invest in our network infrastructure, the technology to innovate whilst making sure we operate in an efficient and cost-effective way.
- (6) Our corporate responsibility approach:** Our sustainability approach centres on doing the right thing for our customers, our people and society. As a responsible business, we'll continue helping to reduce our (and our customers') impact on the environment while increasing the positive social impact we deliver. We continue to work closely with all our regulatory authorities to ensure we influence on areas which matter to our customers and our business.

Each of our priorities are discussed further in the sections that follow.

STRATEGIC REPORT (CONTINUED)

1: Our Customers

Our Customer Led strategy means that all our products and services are designed with the customer in mind. Our commitment is to put the customer at the heart of everything we do in order to achieve high levels of advocacy that will make us one of the leading customer experience organisations in the UK.

Our customer experience priorities are:

Creating a culture focused around customer experience – fostering an environment and mindset that encourages all our people to deliver the best experience for our customers

Customer led design capability – We embed our Customer Experience Principles (see below) throughout the organisation to create a consistent 'best in class' experience across all our products and services

Some examples of things we have implemented as a result of customer feedback in 2019:

- **Introduced a Premium Service checker** that helps prevent bill shock by enabling customers to understand which Premium Services they have contracted/subscribed to.
- **Promoted Fair Deal**, as many of our customers did not realise that existing customers always get the same or better deals than new customers.
- **Launched clear and concise communications** to keep customers up to speed during periods of network disruption
- **Introduced an improved welcome experience** to ensure that all our customers get a warm and helpful welcome to O2
- **Improving Advocacy through Net Promoter Score (NPS)** – we strive to continually improve our customer experience by listening to our customers and understanding how we can deliver the best possible experience to create true brand advocates. NPS measures the willingness of customers to recommend a company's products or services to others. We maintained our market leading position in overall NPS ending 2019 at 18.

Customer Experience Principles

In 2019 we continued our focus on the Customer Experience Principles and introduced the Net Promoter Score, our focus was to embed NPS through our culture plan activities supported by our Customer Experience (CEX) Principles.

Our Customer Experience Principles are:

We treat you like a friend: We offer a personalised touch as we care about what our customers are interested in. We take time to listen to our customers and treat them as an individual with their own needs through our Customer Promise.

We look out for you: We proactively look out for the best interests of the customer. For example, our approach to vulnerable customers and those with disabilities as set out in our Accessibility & Vulnerable Customers Policy Statement on our website. Our aim is to provide support to those customers who may be vulnerable when they interact with us and ensure that they receive a consistent approach which takes into account their circumstances, meets their particular needs and delivers a great experience.

We work on your terms: Whatever lies ahead we're right there with our customers. Adapting to what our customer needs, not the other way around. As demonstrated through the variety of offerings such as Custom Plans, O2 Extras, Family Tariff – which is the extension of family tariff into Pay as you go and Unlimited.

STRATEGIC REPORT (CONTINUED)

1: Our Customers (continued)

Customer Experience Principles (continued)

We make your life easier: We make everything frictionless, quicker, simpler, better for our customers, so that our customers can focus on what's important to them. Such as access to bill providing a PDF bill for Small Medium Business (SMB) customers for easy access and an improvement to the natural language in the Integrated Voice Response (IVR) tuning cycle 3 to make it easier.

We do right by you: Fairness, respect, transparency, security - nothing matters more to us than doing right by our customers, through:

- Our Fair Deal makes sure existing customers get as good or better deals than new customers.
- Closing the loop allows customers who have expressed dissatisfaction, issues and queries via surveys to book an appointment with us at a time of their convenience.
- Our Refresh and Custom Plan propositions means that Customers do not pay once their contract ends.
- The Premium service checker allow customers to see what their premium charges are for.

2. Our Propositions

Consumer

In 2019, we continued to offer mobile phones, tablets and wearables to our customers, as well as a range of mobile services and products, including mobile voice, messaging and data services. Custom Plans, our revolutionary pay monthly proposition, helps customers to benefit from flexibility and affordability when purchasing their mobile device direct from O2. During the year we introduced greater flexibility by moving the tenure from 36 months to 48 months on premium tablet devices which includes the Apple Watch.

Our fair deal promise underpins the Bold, Open and Trusted values we hold at O2, as we have continued to invest in our Value Management Programmes, offering our customer not just a simple but more meaningful and a much more personal experience. This ensures existing customers can always access the same deals (or better) as new customers and ultimately maintain our industry leading levels of churn which stood at 1% for Q4 in 2019.

We also introduced unlimited data tariffs and launched O2 Extras. O2 Extras gives our customers the ability to pick an Extra provided by one of our partners such as Amazon Music and Melody VR to enjoy alongside all the usual benefits of their tariff. As an example, when we launched 5G, we offered our customers the opportunity to receive an Oculus Go & Melody VR subscription on selected 5G tariffs, bringing live music and gigs to life.

We consolidated and re-launched our prepay proposition, Pay & Glo, which offers a new introductory £5 entry point, aligning to the changing market behaviours we have seen within this segment.

We also introduced eSIM for Smartphones and will continue to build on that capability in 2020.

We have a number of product and proposition areas that support our mobile services, namely accessories, mobile device insurance, O2 Drive (our car insurance product), offering competitively priced car insurance both to our customers and the market. We also have our O2 Recycle proposition which allows customers to trade-in their old devices in a sustainable way.

Our Priority reboot refreshed our reward proposition, providing a great opportunity for us to remind our customers how important they are. Through Priority we give our customers great offers from high street brands, tickets and experiences, as well as access to the best in entertainment.

STRATEGIC REPORT (CONTINUED)

2. Our Propositions (continued)

Consumer (continued)

Priority Tickets allows access to some of the best artists in the world. They are available through our 22 sponsored venues, including The O2. Awareness of Priority Tickets continues its steady incline – up a couple of points from 2018 - for both customers and prospects. Customers who use Priority Tickets have higher NPS and increased consideration of the brand awareness.

O2 Business

Our Small Medium Business, Enterprise and Public sector businesses trade under the O2 Business brand.

Small Medium Business (SMB)

Our SMB strategy is to help support UK businesses grow, making life as easy as possible for small and medium businesses so they can focus on the things that matter to them. Our Small and Medium Business segment (SMB) includes customers from one man bands to companies up to 500 employees. We have propositions to serve the variety of needs of the different size of business organisations that we serve. We offer communications solutions for our SMB customers, from our strong core mobile offerings to the use of digital advisors to help our customers select the right cloud applications for their business. Our strategy is to serve our SMB customers through their channels of choice whether is through our Retail stores, our online channels or through our dedicated sales and service teams. Our priority is to ensure our SMB customers can get the right level of service that works for them.

Enterprise and Public sector

We have focused on building true partnerships with our Enterprise customers, through understanding the business outcomes they want to achieve and delivering in partnership with them. From new product development and innovation, to how we evolve our core offering, everything we do is built around our customers aligned to our strategy of being Customer Led, Mobile First. Enterprise has specific teams of advisors with Service Delivery Managers and Client Managers and we are committed to keeping our business customers connected, 24 hours a day, 7 days a week, 365 days a year.

Our Enterprise customers need to optimise and transform their Information and Communications Technology (ICT) assets, migrate to cloud services and digitise their employee and customer experiences, all within a secure environment. Our unique connectivity propositions delivered via our Gateway platform allow Enterprise customers to connect their business and their customers across secure WAN, Wifi and mobile services via any device.

Customers are demanding a new approach to products and asking us to support their transformation strategies. They are looking to work more effectively and provide greater engagement with their own customers. O2 aims to be a strategic transformational partner to these organisations and connectivity is the foundation of this relationship. This gives us permission to grow our offerings and explore future opportunities.

The propositions are made up of two product areas - 'Core Offerings', and 'Non-Core Offerings'. The areas focus on creating, maintaining and improving existing products, as well as building a long-term product roadmap aligned to our strategy that our sales team can offer our customers.

Our Enterprise strategy is built on 3 key pillars.

1. Grow our mobile share, continuing to make significant mobile network investment.

As part of our expansive and growing relationship with Capita we have signed a new agreement with Capita Public Sector to extend our mobility offering into its client estate on a supported resale basis. This aligns to Capita's digital transformation strategy for Local Government sector. The agreement is based on a framework which, over an initial 3 year term, allows us the opportunity to bid which could generate up to 25,000 new connections. We launched 5G for Business and became a mobile service provider with managed digital workplace application for one of the hospitals in London.

STRATEGIC REPORT (CONTINUED)

2. Our Propositions (continued)

Enterprise and Public sector (continued)

2. Focus on high ICT growth areas such as secure connectivity, collaboration, digital workplace and cyber security.

As part of a wider drive into the Enterprise security market in 2019, we launched our own SOC (Security Operations Centre) providing the capability to offer managed security services to our customers.

We have progressed the delivery of critical communications services to Saint-Gobain Limited in the UK, including the extension of the Fixed telephony services until 2023, the provision of Hosted Telephony services to 1,059 sites as well as 2,101 Managed Mobile Data Terminals now being live for Saint-Gobain's Transport team.

3. Create future growth platforms across IoT, 5G, Commerce and Data and insights

We took a collaborative innovation approach to discuss with our customers and leadership of FTSE 100 in order to gain insight and identify how 5G could transform the way things are done. In collaboration with Ericsson and Northumbrian Water we conducted a series of initial 5G trials to harness the power of 5G connectivity to revolutionise the way the Durham-based company operates, as it supplies 1.1 billion litres of water a day to customers. We have entered into agreement to provide 5G connectivity for the testing of connected and autonomous vehicles (CAVs) in the world's most advanced urban testbed, the Smart Mobility Living Lab (SMLL) in London. In addition, we delivered our cloud platform and first of our Smart Cities products.

We commenced a trial for connectivity for a new "Smart Ambulance" that has the potential to revolutionise patient diagnosis, transport and treatment. The project will involve equipping a standard ambulance with state-of-the-art devices and connectivity to create a "Smart Ambulance" that will simulate 5G connectivity, transforming the vehicle into a unique remote consultation room.

We won the following awards in 2019 which is testament to the partnerships we have built with both suppliers and customers: Best Business Network at the Mobile Industry Awards, Supplier of the Year at Transport for London's Annual Awards, Deal of the Year at the Gamma Annual Awards and SIP Reseller of the Year at the Gamma Annual Awards.

Commercial partnerships

Commercial Partnerships are fundamental to how we deliver the best products, propositions, communications and experiences to our customers. Through our relationships with product manufacturing partners such as Apple and Samsung we can secure great products for our customers, as well as insights into best practice from across the globe.

As we build relationships with new partners like Amazon, Netflix, Calm, Cafeyn, Melody VR and Oculus we can bring new and exciting offers to our customers. We are also able to learn from them to constantly improve the customer experience, such as the way customers can redeem their subscription, through to reminders not to forget their O2 Extra is waiting for them.

Sponsorship

For over a decade our sponsorship portfolio has focused on four longstanding deals. AEG (The O2), Live Nation (Priority Tickets), Academy Music Group (O2 Academy venues) and the RFU (England Rugby Men's and Women's Teams). This focus has allowed us to develop strong, integrated partnerships and given us the tools to build relevant, ongoing communications with customers outside of our core business.

We support live music at every level to inspire and engage fans and create a deeper connection to live music for O2. Being more meaningful and more relevant in people's lives enables O2 to appeal to fans, our customers and our people beyond traditional benefits-built loyalty. It also allows us to be the stand-out brand in an increasingly saturated music industry. Importantly it demonstrates clear customer benefits and the flexibility to talk to targeted audiences whilst remaining authentic and feeling inherently O2.

STRATEGIC REPORT (CONTINUED)

2. Our Propositions (continued)

Sponsorship (continued)

Wear the Rose Live

To celebrate the announcement of the official Rugby World Cup (RWC) England squad we hosted 'Wear the Rose Live' in Bristol, an unmissable experience for 3,200 O2 customers, colleagues and the entire England squad. The event was aimed at igniting support at the heart of the rugby community ahead of the official launch of our England RWC campaign including events being live streamed via England Rugby channels to over 100,000 fans.

3. Our Sales and Service

Our omni-channel approach allows customers to engage with us through their channel of choice, including stores, online, voice and digital self-serve

We operate the following channels:

- 251 Company-Owned Stores, fully owned and operated by O2
- 205 Franchise stores, operated by 13 Franchise partners
- Our website, www.o2.co.uk
- The MyO2 app, available to existing customers
- Our customer service voice teams, provided by our partner Capita

Our omni-channel approach includes our Click & Collect proposition which enables customers to place an order Online or over the phone, and pick up their order from any store. Channels play a critical role in delivering on our promise to Customers. Customers can deal with simple service queries via MyO2. For more complex queries or for customers who are more comfortable getting support from O2 in a face-to-face setting (e.g. vulnerable groups), customers can visit any of our stores for expert advice and service or pick up the phone to talk to one of our expert advisors.

We work with a number of partners to provide mobile connectivity through indirect partnerships and MVNOs.

Our stores

Direct

Our company owned stores are located across the UK giving customers the opportunity to browse and buy O2 products and services. All our stores focus on customer inspiration with digital exploration taking centre stage. In 2019 we refurbished 30 stores, and this will continue next year helping customers to learn about and be inspired by the latest technology available.

Franchisee stores

Our Franchise Business Partners tap into innovation and growth opportunities which enables us to work towards a credible omni-channel model in-line with our own long-term customer experience principles. We have partnerships with 13 Franchisees who collectively operate 45% of the O2 store estate. Engagement with them is critical, to ensure that they operate their stores with consistency, align with O2's customer experience principles and ethical standards helping to maintain a strong relationship as business partners.

STRATEGIC REPORT (CONTINUED)

3. Our Sales and Service (continued)

o2.co.uk

We have a website, o2.co.uk, which gives Consumer and SMB customers the ability to shop online and to access their account securely to check billing and tariff information. We also provide information on the products and services we sell including mobile devices, accessories, tariffs and value-added services such as international calling, voicemail and coverage/live network status. Our customers are able to find out more about our business and leadership team. Through our website, customers can talk to us via our online web chat service for help with general support and account enquiries.

My O2

MyO2 is our app available to our SMB and Consumer customers which enables them to check their bill, add or change the services they take from O2, or to deal with simple issues. It is the most popular customer destination and the highest volume service channel where customers are choosing to self-serve rather than use traditional channels. More capability has been added to the MyO2 app such as personalised tariff and device recommendations for customers close to upgrade and improvements to the upgrade experience to protect customers and our business against elements of fraud. SMBs have a dedicated service team with sector focus.

Customer service

Customers expect to interact through their channel of choice - voice, online, chat and apps.

The traditional voice contact centre has fast become the home of the most complex query as customers choose to use self-serve digital options (My O2) for simple options such as checking their bills, minutes/data allowance and use, adding additional extras and requests to change tariffs. Consequently, we continue to see a reduction in voice calls.

We have a long-standing strategic partnership with Capita who support our Consumer and Business customers across our voice and digitally assisted channels. Our customer service strategy delivers simplicity and visibility in our partner management approach and provides a clear line of accountability for the experience of customers across our assisted channels.

Customer Service has improved performance across both contact centre metrics and the number of complaints which can be seen in the statistics published by Ofcom.

| Ofcom complaints (per 100k Customers) | Q1 | Q2 | Q3 | Q4 |
|---------------------------------------|----|----|----|----|
| 2018 | 3 | 3 | 3 | 3 |
| 2019 | 2 | 2 | 3 | 2 |

Source: <https://www.ofcom.org.uk/research-and-data/multi-sector-research/telecoms-complaints-data>

STRATEGIC REPORT (CONTINUED)

3. Our Sales and Service (continued)

Indirect Partners

Consumer

Consumer Indirect sells mobile connectivity via several Indirect partners in two business categories; Pay Monthly and Pre-Pay.

Pay Monthly trading occurs via four Indirect Partners; Dixons Carphone, Mobile Phones Direct, A1 Comms and TalkTalk.

Pre-Pay trading occurs via a number of Distributors, Retailers (Tesco & Argos) and via Dixons Carphone.

We work closely with our partners, regularly engaging with them to foster an environment and mind-set of partnership, keeping them informed and working together to understand how we can deliver the best possible customer experience.

Small Medium Business

Our Small Medium Business (SMB) Indirect is made up of 35 x direct relationships with Partners who sell O2 products and services to business customers either directly or through their network of resellers. They offer us the opportunity to reach into different market segments and increase choice to our business customers. These Partners often deliver a compelling service wrap and product range which complements our direct routes to market.

We have an Indirect Channel Sales Team with a designated responsibility to work with these Partners and to support them and helping to grow their O2 sales, and overall business.

The SMB indirect have been awarded a number of external recognitions from the Partners such as Aerial Direct: Comms National Awards - Customer Service Award (Above £5m). Plan.com: Tech Track 100 – Placing 28th <https://www.fasttrack.co.uk/league-tables/tech-track-100/league-table/> and Sunday Times Best Small Company to Work For – Placing 7th <https://www.b.co.uk/the-lists/small-companies/>. 2019 Mobile News Awards - Best Airtime Distributor.

Mobile Virtual Network Operator (MVNO)

The MVNO strategy is to partner with major brands that can extend our reach beyond our owned brands and/or existing distribution channels (online, telesales direct and indirect)

Our award-winning network and focus on the customer have helped us build a roster of successful partnerships with: Tesco Mobile, Sky Mobile, Lycamobile, Truphone and Manx Telecom. The extension of agreements with Sky Mobile and Lycamobile further optimises usage of our assets allowing us to continue to invest while helping these businesses grow their mobile customer offer.

4. Our People

People are the UK Group's most valuable asset and their enthusiasm and commitment are key to the success for the UK Group. O2 is the principal employer for the UK Group and is responsible for the People related policies for the UK Group.

Our people strategy is focused on creating an environment that enables and empowers our people to perform at their best. In 2019 we piloted agile working, supported by the creation of collaborative workspaces and coaching support. These are examples of enabling our people to work cross-functionally and at pace.

Our daily activities are underpinned by our O2 company values, (Bold, Open and Trusted), our Business Principles and a clear focus on putting customers at the heart of everything we do.

STRATEGIC REPORT (CONTINUED)

4. Our People (continued)

Our employee experience principles support an employee-centric design approach to all our people processes and policies while business wide action plans ensure the employee experience is created across all physical, human and digital interactions.

Campus is our digital learning platform. In 2019 we added the ability for all our people to build and share their own learning playlists alongside access to LinkedIn learning. This provides an extensive amount of additional material and creates a space where people can connect, learn and grow.

Our communication and engagement approach utilise multiple channels including companywide face to face events, streams, (via our Workplace platform) and quarterly updates on the Company's performance. These engage our people in our strategic priorities and bring teams together to celebrate success. Alongside this there is regular activity aligned to our business priorities and people strategy such as online campaigns to bring about discussion and engagement.

Our development programme 'Big Chats Little Chats' supports our leaders to have brilliant continuous two-way conversations with our people to inspire, and to listen and understand. Meanwhile our listening tours see the Executive and Senior Management visiting our frontline teams to hear directly from our people.

A number of KPIs are tracked monthly in order to measure performance against our people strategy including our annual employee engagement survey made up of 17 core group questions and 10 additional local UK specific questions. Group questions focus on measuring Employee Net Promotor Score (eNPS) and our progress against our global People Strategy.

Local UK specific questions measure O2's progress in creating a culture that is Bold, Open & Trusted, and our people's level of overall motivation. Our target was set at 30.0% which we exceeded at 35.2% overall. To track our progress, eNPS questions will be asked quarterly via pulse surveys.

Our Glassdoor real time rating gives O2 an external measure of the experience we create for our people again linking to customer experience. Additionally, it gives us as a view of our employer brand and how we compare in the market to other employers, a factor in attracting and retaining talent. We consistently achieved our aim of maintaining a 4+ rating throughout 2019.

Human Rights, Diversity and Inclusion

We continue to work to create a diverse and inclusive environment across the UK Group to ensure we have the right skills and mindset now and, in the future. We achieved bronze status in the National Inclusion Standard for the work we do on inclusion. Some of the work that helped to achieve this includes launching our new family policy giving all employees up to 14 weeks paid time off and raising awareness of Menopause and Transitioning in the workplace.

Our Diversity and Inclusion policy provides clear guidance regarding our approach. It emphasizes that all our people have the right to be free from harassment, bullying, discrimination or unwanted behaviour regarding gender, gender identity, race, disability, generation, nationality, marital status, caring responsibilities, sexual orientation or political or religious beliefs. It commits us to ensuring that everyone has the same opportunities to achieve their potential and contribute to our success. It also highlights that we won't tolerate any discrimination.

We continue to review our people policies and practices to ensure they are inclusive and supportive of all groups and create an environment where difference is acknowledged, and everyone's views and opinions are respected and valued. Regular reverse mentoring sessions run by employee groups with the O2's Executive Leadership Team ensure these views are shared directly with the Executives.

STRATEGIC REPORT (CONTINUED)

4. Our People (continued)

Human Rights, Diversity and Inclusion (continued)

In addition, we have several other people policies covering the full range of employee lifecycle situations including family and timeout policy, employee benefits, performance management, disciplinary and grievance. We ensure fair treatment of people with disabilities in relation to their recruitment, training, and development including reasonable adjustments and practical considerations relating to disabilities and increasing the accessibility of our services making them more inclusive for disabled people. All our policies are reviewed and revised as required regularly.

O2 uses a number of measures to track diversity and inclusion.

| KPI | 2018 | 2019 |
|--|------------------------------------|-----------------------------|
| Median gender pay gap | 22.0% | 21.2% |
| Percentage of female employees | 39.5% | 40.0% |
| Percentage of black, Asian and minority ethnic (BAME) employees; | 6.7% (disclosure rate approx. 50%) | 16.1% (disclosure rate 81%) |

In October O2 was ranked 44th (and the only telco within the Top 50) as UK employers for social mobility on the Social Mobility Index. This recognises the work we do to champion social mobility and the actions we have taken to make sure we access and progress talent from different social backgrounds.

Operating Model

We regularly review our Operating Model to ensure our people and ways of working are set up to be the best they can be. We are focused on delivering a great service for our customers in an extremely competitive environment. In order to do this, we sometimes need to evaluate how our business operates. As a result, we decided to make some changes to our employee resources in consultation with our union partners, employee representatives and our people. The first phase of the restructure was completed in Q1 2020 and the second phase has been suspended due to COVID-19 and is likely be resumed during the course of 2020.

5. Our Technology

Our technology investment plan sets out how we can continue to thrive and grow, whilst delivering efficiencies by making focused decisions along the way. We will continue to invest in delivering differentiated customer experiences through the provision of innovative propositions and products, extending our award-winning network whilst deploying new IT platforms to drive efficiency and effectiveness. Our plans are underpinned by significant investment in:

- Network – our network will continue to evolve to provide increased capacity, 5G expansion, IoT (Internet of Things) and Smart Metering (SMIP).
- Core capabilities – transformation for our Consumer and SMB segment;
 - Enabling consistent, personalised, joined up journeys across all channels wherever customers are in their sales and/or service lifecycle
 - Innovating and delivering at pace by making it simpler and easier for internal collaboration
 - Simplifying and refreshing our IT infrastructure, replacing siloed systems with an integrated and open platform
- Information Technology - through 3 specific activities
 - Timely and accurate reporting through Business Intelligence Evolve
 - Data decisioning - deliver real-time decisions for customers next best actions
 - Data and Artificial Intelligence (AI) – using technology advancements in AI to deliver better insight and service to our customers.

STRATEGIC REPORT (CONTINUED)

5. Our Technology (continued)

Network

Our Network priority is to deliver a stable, competitive and customer centric network. We have progressed a network strategy that strives to expand coverage and deploy 5G with the intent to improve customer experience. In October 2019 we launched our 5G network in six towns and cities across the UK and by the end of December we had 5G service in 21 towns and cities across the UK.

Our continuing network sharing arrangement with Vodafone will enable active rollout of 5G through site sharing. The Shared Rural Network (SRN) is based on collaboration and partnership between the Government, Ofcom and MNOs to invest helping to deliver increased coverage for remote areas. In March 2020 we announced that the UK landmass that receives 4G coverage from all four of the UK's mobile network operators will increase from 66% to 84%; each operator will provide 4G to at least 90% of the country's landmass; Partial Not Spots will be virtually eliminated; and over 1,800sq miles of the country will get 4G for the first time.

We continue to:

- invest in our network to help our customers, remain competitive and exploit the potential that 5G technology can provide.
- to optimise our spectrum utilisation and deliver capacity to meet the growing demand and expectation of our customers.
- further develop our core network capability and resilience.

Throughout the year we conducted independent drive testing of our network performing a series of voice calls and mobile data tests to ensure these represent a true customer experience. Reports are produced against a number of KPIs including call completion success rates and data speeds. We also and crowdsource information from Tutela. This enabled us to get a technical comparison against our competitors and a customer experience view on our network. This helped to identify locations where the service was not as we expected and to improve it for our customers.

Our external recognition for our Network in 2019 includes: Uswitch Best Network for Coverage, Mobile News Awards Best Network Performance and Mobile Industry Awards Best Network for Business.

Network Incident

After our 6 December 2018 network incident, Ofcom opened an investigation to examine whether O2 had taken all appropriate steps to protect, so far as possible, the availability of its network. After reviewing a substantial body of evidence gathered in their investigation, Ofcom found that O2 had operated in accordance with its obligations. Ofcom concluded that, in the specific circumstances of the case, O2 had taken all appropriate steps to protect the availability of its network; and it acted appropriately to restore it. Ofcom therefore decided to close their investigation.

We commissioned an independent review of our practices and processes following the incident and are considering the recommendations to enhance our network resilience which we are building into our processes.

Internet of Things

The Smart Metering Implementation Programme (SMIP), led by Smart Data Communications Company (DCC) and Department for Business, Energy and Industrial Strategy (BEIS), is a key part of the UK's drive towards a low carbon economy and supports the goal of being carbon neutral as a country by 2050.

STRATEGIC REPORT (CONTINUED)

5. Our Technology (continued)

Internet of Things (continued)

O2 are the Communications Service Provider for two of the three national regions (Central and South) which aims to offer every home across the UK a gas and electricity smart meter by 1st January 2021. We have the responsibility for the supply of network connectivity and Communications Hubs which link Smart Meters and in-home displays across a home area network to the Data Communications Company (DCC) and onwards to the numerous Energy Providers who serve UK citizens.

We are reviewed against 32 key operational service measures for each of the two regions we support on a monthly basis. Telefonica UK has successfully met 31 of these throughout 2019. The one measure that was challenging was "Over the Air firmware updates to Meters" and the speed within which these were carried out. A remedial plan was implemented, a number of improvements delivered in November 2019.

Our strong performance was recognised by the DCC and we were awarded the Excellence award at their Supplier Day. We also achieved "Satisfactory", the highest rating, for the fourth year in a row, in their Annual Service Report. We also won the Glotel Award for Consumer IoT initiative of the year.

O2 Information Technology

Our Technology strategy is to better inform investment choices on our IT which will deliver strategic business capabilities and performance. It supports our business focus on the customer, operational efficiency, corporate responsibility and on supporting revenue growth opportunities from our investments in 5G, and the Internet of Things. In order to increase the scope of technology innovation in O2, we have set up innovation partnerships with both commercial and academic organisations and we are working with them on strategic areas for O2 including 5G.

Technology & Automation strategies will deliver key supporting capabilities which change the way we service our customers. Customers benefit from a more proactive and effortless experience, with real-time data usage allowing resolution of issues before experience is impacted. AI & ChatBots will become more prevalent, with cognitive intelligence that will resolve many queries, with seamless connectivity to assisted channels where necessary, without the need to re-authenticate.

Business Intelligence Evolve

This is our programme to enhance our data capabilities and in line with Telefonica Group strategy. The primary focus is the protection of our Customers' data ensuring compliance whilst also improving accuracy and quality of our data. We expanded our capacity and capability to deal with growth in data use by our Customers and to right size it for our Transformation and for 5G. We consolidated data centres, bringing key data services physically back to the UK. Finally, we launched O2 Motion in the Smart Cities market for transport management and a growing variety of other Enterprise customer use cases.

Data

Our Data strategy is continuously evolving to ensure it stays relevant for our customer's experience and right for our business. Specific focus is on increasing the controls we have in place to manage our customer's data, ensuring we continue to retain and gain customer trust.

Delivering our data strategy will ensure:

- Insight by Design – where the advanced use of data and the insight it creates, is embedded into everything we do;
- Intelligent Orchestration – providing customer interactions which are joined up across channels.

STRATEGIC REPORT (CONTINUED)

5. Our Technology (continued)

Data (continued)

The data strategy describes progressive alignment to O2's wider business strategy and investment priorities. We continue to improve how we use data to help support our teams and to deliver one to one personalisation in real time for our customers. Also, we are developing AI capabilities to enhance 5G and Internet of Things customer propositions.

We've introduced Machine learning that provides predictive help to minimise potential high bill usage or fraudulent transactions when using Charge-to-Mobile to make purchases. We created Marketing campaigns through Priority, which were designed and promoted with the help of our data analytics capability, ensuring that what we provide and how we communicate, connects with our customers.

6. Corporate responsibility

As a responsible business, our approach centres on doing the right thing for our customers, our people society. Reducing our environmental impact (including our customers), supplier influence, or business principles and anti bribery and corruption activities are discussed below.

Our Customers

Working with stakeholders and customers will enable us to have a greater impact than we can achieve on our own.

We work with handset manufacturers to assess its sustainability credentials, providing an overall rating between 0 and 5. The higher the rating the more sustainable the phone is. This enables customers to help them make informed product decisions. We've also removed single use plastics from our own branded accessories.

We extended our partnership with the NSPCC and have helped families keep kids safe online through our award-winning multi-media campaigns: Parents vs Kids and Net Aware, which encourage parents to have regular conversations with their kids about the online world. In 2019 we had over 1.5 million actions taken by parents to keep kids safe online.

We extended our support for children at risk for from the online world by supporting the Anti Bullying week, developing research and resources to inform and help children, teachers, parents and carers to help tackle bullying online and offline. We supplied 150,000 school packs with material to help with advice and support to tackle bullying.

We have continued to help young people kick start their careers through offering inspiring and informative content and access to work experience and skills opportunities with O2 and other partners through Go Think Big. You can find out more here - <https://gothinkbig.co.uk/>

Further details on what we delivered on our commitment to the society can be on the Non -Financial Report and Blueprint Report published on www.o2.co.uk website.

Our People

One of our greatest assets are our people. To help drive employee awareness and engagement around corporate responsibility we enable them to take time off (paid) to get involved with volunteering and fundraising opportunities. This year our people have helped to raise over £400,000 for the NSPCC partnership.

We also offer flexible working arrangements so that our people are able to benefit from a better work/life balance. This helps to make it easier for our teams to collaborate and work together on cross-functional projects. Flexible working also contributes to our environmental commitments by helping to reduce our carbon footprint. For the first time this year we recovered the old uniforms from stores and recycled them back into usable materials. In addition, we have reduced the use of single use plastics in our offices and stores.

STRATEGIC REPORT (CONTINUED)

6. Corporate responsibility (continued)

Society

Our Blueprint 2 initiative launched in 2016 with one ambition: to help 20 million people live better with tech by 2020. This helps to give people confidence to enjoy and the opportunities thrive in the digital world. The initiative also aims to help people reduce their impact on the planet and allows O2 to operate and manage our business responsibly. We helped more than 23.7 million people live better with technology through our products, programmes and services. We will be updating our Blueprint commitments in 2020.

Reducing impact on the environment

As part of our sustainability strategy, Blueprint 2, we had the following commitments:

- Reducing the carbon emissions from our network by 40%, relative to data traffic
- buying 100% renewable energy for all sites where we control the energy bill
- using 16% less water per person in our corporate sites
- maintaining zero waste to landfill where operationally possible

As part of our environmental management system we undertake both internal and external audits throughout the business. Progress against the energy/waste and water targets are measured monthly using data from internal and external stakeholders. Data is independently verified before being used for reporting purposes.

Carbon Footprint associated with Operations

- The annual quantity of energy consumed from activities for which the company is responsible involving the combustion of gas or the consumption of fuel for the purposes of transport; and
- The annual quantity of energy consumed resulting from the purchase of electricity by the company for its own use, including for the purposes of transport.
- Greenhouse emissions

Scope 1: Fuel used. This is low impact and fuel used is primarily for space heating (Gas) and Fuel used in standby generators (Diesel).

Scope 2: Electricity Consumed across the following site types (Cells/Switch Sites/Offices and Retail).

Scope 3: Refrigerants used in cooling systems and business travel (business mileage, flights etc.)

The energy efficiency measures taken are primarily around:

- The procurement and deployment of more efficient network transmission equipment.
- Upgrades to cooling systems (and their controls).
- Self-Optimising Networks (SON) which ensures that the network is operating efficiently (turning itself down during periods of low network traffic).

STRATEGIC REPORT (CONTINUED)

6. Corporate responsibility (continued)

Carbon Footprint associated with Operations (continued)

The primary source of data collection is a combination of Utility Bills and Smart Meter Data which is collected, verified and reported by an independent third-party expert.

- UK Water Target: Maintain water consumption and do not increase per FTE by 2020, on track to meet and exceed this target. The UK target was to maintain water consumption at the current level (2015 bslN); We have exceeded this target at 25% less water per person, mainly achieved through users consuming less and using more water efficient equipment in kitchens/washrooms.
- UK waste Target: Ensure that no General Waste that can otherwise be diverted to recycling is sent to landfill. We have not sent waste to landfill where we have operational control.
- TEF Energy Efficiency: reduce company emissions relative to data traffic by 85% by 2025. On track to meet this commitment. Our target was to reduce company emissions relative to data traffic by 40% (2015 bslN). We have exceeded this target and achieved a 78% reduction.
- Material and resource efficiency - to support a circular economy we refurbish and then reuse traded-in handsets. Where they are beyond recovery they are fully recycled – We are pleased to report that no waste was sent to landfill.
- Biodiversity and ecosystem service –While biodiversity and our ecosystem is important to us all, we focus on issues with the greatest materiality to our organisation, where we have the greatest impact. These include energy, waste and water
- Emission to land, water and air – While emissions to land, water and air are important to us all, we focus on issues with the greatest materiality to our organisation, – where we have the greatest impact which include energy, waste and water.

We comply with Energy Saving Opportunity Scheme (ESOS) and have conducted all mandatory audits as per the requirements of the scheme and actively followed up on recommendations made within the report.

Climate Change

The key non-financial risks for O2 associated with climate change are the continued availability of renewable energy and the potential for floods to impact delivery of our services. The biggest impact on the Climate from an Operations perspective is Carbon Emissions associated with electricity consumption. Over 80% of our carbon emissions can be attributed to electricity consumption in our Network, Retail Stores and offices.

Also, the provision of products and services by O2 help enable our customers to reduce their impact on the environment for example teleconferencing services and telematics.

The Responsible Business Taskforce has delegated responsibility over the environmental management system standard (ISO14001:2015) to help our business become more environmentally friendly, manage compliance obligations and reduce waste.

O2 Recycle

We have a number of opportunities provided through O2's campaigns, products, services and programmes that enable customers to take positive social or environmental action.

O2 Recycle lets people exchange old phones and other gadgets for cash. Devices are processed for re-use or, recycling or stripped down. In 2019, the business had reached 10 years of O2 Recycle announcing that three million devices being diverted from landfill.

We were awarded Carbon Trust Triple Standard (for waste, water and energy) and Carbon Trust Supply Chain Standard (level 3) by The Carbon Trust Standard, an independent recognition of real reductions in waste.

STRATEGIC REPORT (CONTINUED)

6. Corporate responsibility (continued)

Supplier influence

When a new phone is produced, we work with the manufacturers to assess its sustainability credentials, providing an overall rating between 0 and 5. The higher the rating the more sustainable the phone is. Participating manufacturers complete a questionnaire, answering more than 100 questions on product development, phone functionality and the manufacturer's processes and policies, including:

what the phone's made of, the environmental impacts caused during the manufacturing process, the amount of resources used in the phone's packaging, the efficiency of the device, how easy it is to recycle after use.

Business Principles

Our Business Principles are the behaviour and standards underpinning our ethical and responsible approach to business. We are committed to acting with integrity, commitment and transparency. Principles that are essential in promoting the relationship of trust we wish to sustain both internally and externally. Our Business Principles framework underpins our commitment to acting in a responsible, ethical and lawful manner. These principles include ethical and responsible management, our customer and employee commitments, corporate governance and internal controls, responsible communication and our commitment to the environment and societies in which we operate.

Sustainability and good Ethics are a key part of our approach to doing business and was a key focus at our 2019 employee conference. As part of our commitment of being a responsible business, every employee must complete the mandatory Business Principles training and the completion rate at year end was 98%. In addition, employees have a personal objective to support a responsible business commitment and demonstrate our Company values in their day to day activities.

To test adherence our practices and processes, key processes are audited on a periodic basis and Management information is provided to the Leadership Team on a monthly basis to monitor key trends.

Speak Up

Speak Up is our whistleblowing channel and is part of our continued commitment of being a responsible business and to encourage a Bold, Open and Trusted culture. It gives our people the chance to speak up against behavior inconsistent with our Business Principles. In 2019, 89 concerns were received which is expected level for a company of our size. All concerned received are investigated where possible.

To support Speak Up several controls are in place such as a monthly survey of a sample of our people to assess the awareness of Speak Up. There is an Executive Sponsor at Leadership level. Speak Up awareness across the Business was 59% in 2019 and our ambition is to improve on this with a number of communication initiatives.

STRATEGIC REPORT (CONTINUED)

6. Corporate responsibility (continued)

Anti-bribery and corruption

O2 has a zero-tolerance approach to Bribery & Corruption and in recent years has significantly improved compliance process in place. These improvements have been based on Ministry of Justice best practice and have resulted in changes to policies, procedures and training.

The improvements have also been independently verified through an independent third party assessment. Our updated measures in relation to Anti-Bribery & Corruption controls are as per below:

| Category | 2017 | 2019 |
|--------------------------|-------------|---------------|
| Communications | Established | Comprehensive |
| Due Diligence | Developing | Established |
| Monitoring | Developing | Established |
| Proportionate Procedures | Developing | Established |
| Risk Assessment | Basic | Established |
| Top Level Commitment | Established | Comprehensive |

As previously reported we are addressing a request for disclosure made by governmental authorities which is related to possible violations of anti-bribery laws and regulations in the past.

GIFFGAFF

The purpose of our giffgaff brand is to harness the power of people, to challenge the established way and improve it. giffgaff is an online MVNO which runs on the O2 network providing telecommunication services to the consumer mobile segment. giffgaff does not have any call centres or shops instead giffgaff works with its members (customers) to: source ideas and feedback; to provide frontline service support through its community and; be a source of growth through the giffgaff member get member scheme. We call it 'Run by you'. As a result giffgaff has market leading levels of recommendation (NPS) and a low cost operating model that helps giffgaff give its members great value tariffs.

In 2019 we achieved this through:

- **Our members and community:** developing a core community of 'pioneers', who are members choosing to help us identify new opportunities and providing feedback on experiences, to create more engagement with our members. To help engagement prosper we replaced our legacy community hosting platform with one we built ourselves in collaboration with our members who helped us prioritise and test new features.
- **Our propositions:** we never lock our members into airtime contracts and have refreshed our range of tariffs (we call goodybags) to include more data and minutes. We have also evolved our mobile phone proposition to include refurbished phones responding to an emerging need for better value and more sustainable upgrade options when people choose their next phone.
- **Our people:** we believe engagement drives performance and we measure it through Gallup's Q12 survey methodology. Our latest engagement scores are our best yet placing us amongst the most engaged companies in the UK.
- **Our technology:** as a digital platform business, technology underpins our performance. In 2019 we built a game changing new capability to improve the speed at which we can build and deploy new code to enhance our software and crucially the experience of our members.
- **Our corporate responsibility approach:** our belief in the value of Community is demonstrated at scale through charity contributions of over £800,000 through our Member Payback scheme over the last 10 years. We also commit time and money to local good community causes through our internal 'Ministry of Good Deeds' from hosting events for the local elderly to transforming local community venues.

STRATEGIC REPORT (CONTINUED)

Performance and Development

We measure our performance against our strategy through Key Performance Indicators (KPIs). While there are a number used across the business to ensure each operational element of the business is delivering against their objectives, our key indicators at the end of 2019 are as follows:

| KPI | Definition | Measure | Commentary |
|--|--|---|--|
| Total accesses | Total accesses are the number of connections on the O2 network, including giffgaff, Tesco Mobile, Sky Mobile and Lycamobile. | Total accesses, including customers who use the O2 network through giffgaff, Tesco Mobile, Sky Mobile and Lycamobile, reached 34.5 million. The UK Group's mobile base stood at 25.8 million. Contract net additions stood at 1,731,000 (190,000 excluding M2M) in 2019. Active Prepay net additions for the year were 155,000. At the end of 2019, contract customers represented 68.1% of the base (+3.0 percentage points year-on-year). | In 2019, focus on our mobile-first, Customer-Led strategy resulted in a growing base of users. Custom plans gave customers the flexibility to choose which airtime tariff suits them best proving our customer champion approach as the only UK mobile network operator to offer this level of flexibility and transparency. |
| Revenue | This is the total amount of revenue earned for the period. | The Group's revenue for the year ended 31 December 2019 grew to £6,235 million (2018: £6,007 million). | Revenue growth was driven by the continued success of innovative Custom Plans tariffs, higher hardware revenues, progress in the Smart Metering Implementation Programme (SMIP) and increased MVNO revenues. |
| Mobile service revenue | This measures the revenue being generated by the airtime usage on our mobile network. | The Group's mobile service revenue for the year was £4,214 million (2018: £4,279 million). | This reflects competition, regulation, lower year-on-year RPI increases and the impact of IFRS 15 and Custom Plans. |
| Average Revenue Per User (ARPU) | This measures average revenue per user. | The Group's total ARPU for the year was £12.70 (2018: £13.30). | We have stable subscription revenues as the continuing success of Custom Plans mitigates the market driven pressures on bundle prices. Customers are choosing larger bundles being offset by lower out of bundle revenue. |

STRATEGIC REPORT (CONTINUED)

Performance and Development (continued)

| KPI | Definition | Measure | Commentary |
|---------------|--|---|--|
| OIBDA* | This measures operating income before depreciation and amortisation. | <p>The UK Groups's OIBDA (excluding management fees of £40 million (2018: £43 million)) for the year ended 31 December 2019 was **£1,613 million (2018: £1,605 million). The Group's OIBDA margin excluding management fees was 25.9% (2018: 26.7%).</p> <p>OIBDA upon adoption of IFRS 16 for the year ended 31 December 2019 was £1,805 million as a result of lease rental payments being replaced with depreciation and interest costs. OIBDA margin was 28.9%.</p> | Healthy profit and margin ensures that the business remains financially viable for the long term. We support ongoing investment as well as providing a suitable return for our shareholder. |
| CapEx | This measure capital expenditure in the period. | The Group's capex for the year ended 31 December 2019 was £803 million (2018: £1,335 million) as the Group continued to invest in its network for customers. Capex during 2018 included £523.6 million of Spectrum acquisition. | Ongoing investment in infrastructure, new services and innovation enables our business to optimise its capabilities while providing the service customers want. A balance is made between levels of ongoing investment to support the long term health of the business and cash returns for our shareholder. |

* OIBDA is reconciled to operating profit in note 6.

** Financial KPIs have been assessed on a like for like basis applying the IAS 17 leases standard to 2019 numbers. The financial statements for the year ended 31 December 2019 have been prepared under the new leases standard IFRS 16. See note 2 for further information.

STRATEGIC REPORT (CONTINUED)

Performance and Development (continued)

Financial performance highlights

The Group's profit for the year ended 31 December 2019 was £641 million (2018: £629 million).

The net assets of the Group as at 31 December 2019 were £5,117 million compared to £5,079 million at 31 December 2018, the movement of which is due to £641 million of profit for the year, £53 million actuarial loss after tax impacts on the defined benefit pension scheme and a dividend payment of £550 million.

The cash and cash equivalents of the Group at 31 December 2019 were £305 million compared to £315 million at 31 December 2018. The decrease of £10 million is driven by £1,678 million net cash flow from operating activities, £939 million net cash flow used in investing activities and £749 million cash flow used in financing activities. The significant cash flows within these areas are: £904 million for purchase of property, plant and equipment and intangible assets; £550 million dividend payment to the Company's immediate parent, Telefonica O2 Holdings Limited (formerly Telefonica Europe plc); and £164 million principal payments on leases.

The cash and cash equivalents of the Group at 31 December 2018 were £315 million compared to £172 million at 31 December 2017. The increase of £143 million was driven by £1,359 million net cash flow from operating activities, £1,337 million net cash flow used in investing activities and £121 million cash flow from financing activities. The significant cash flows within these areas are: £1,277 million for purchase of property, plant and equipment and intangible assets, including £524m for purchase of spectrum; £524 million proceeds for a new loan with Telfin Ireland for purchase of spectrum; £265 million repayment of borrowings including £150 million of an existing loan with Telfin Ireland DAC and a £115 million Telfisa Global B.V. overdraft; and £110 million dividends paid to Telefonica O2 Holdings Limited (formerly Telefonica Europe plc).

See note 2 for further information on the impacts of adoption of IFRS 16.

Principal risks and uncertainties

The principal risks and uncertainties of the UK Group are the aggregate significant risks of the principle subsidiaries, O2 and giffgaff.

At UK Group we operate 4 x principle risk categories and related sub-categories, through which all risks are identified, linked and managed.

Our approach is aligned to Telefonica Group and its other operating businesses (OBs). This ensures we collectively undertake aligned micro and macro analysis of our OBs, the external environments and the markets in which we operate to determine and manage applicable risks to our strategy.

We have updated the categories shown here to align to the current principle risks used within the UK Group and the Telefonica Group. As we drive continual improvement to our risk management practices and culture, these new categories better reflect the interconnections between our managed risks.

STRATEGIC REPORT (CONTINUED)

Principal risks and uncertainties (continued)

| Principle Risk Categories | Sub-categories of Risk |
|---|---|
| Global risk: Possible loss of value or results derived from events that affect in a global way the entire Group in terms of its corporate reputation and sustainability, communication, corporate public relations, marketing strategy, brand, sponsorship and innovation. | Sustainability Compliance Reputation |
| Business risk: Possible loss of value or results derived from changes in the business, competition and market scenario, changes in the regulatory framework or strategic uncertainty. | Strategy (including Market, Economic & Political Environment, Business Model & Adaptation) Regulation |
| Financial risk: Possible loss of value or results derived from adverse movements in financial variables and the inability of the Company to meet its obligations or convert its assets into cash, as well as commercial credit and fiscal risks. | Finance Fiscal |
| Operational risk: Possible loss of value or results derived from events caused by inadequacies or failures in customer service, processes, human resources, business teams and IT systems, security, enforcing contracts, laws and regulations, or due to external factors. | Customer Systems & Network Security Supply Chain Operational Management Legal Human Resources |

Perceived most significant and emerging risks to our strategy:

| Risk category | Risk | Why this is important | How we manage it | Trend |
|------------------------|-----------------------------|---|---|--------------|
| Global: Sustainability | Reputation & Sustainability | <p>At O2 our Blueprint plan underpins our ambition to help people live better with technology and to deliver our long-term commitment of delivering responsibility leadership.</p> <p>We believe in operating our business in a sustainable way and putting our customers at the heart of everything we do.</p> | We operate an ethical approach to all aspects of our business, underpinned by Our Blueprint and our core business principles. | Stable |

STRATEGIC REPORT (CONTINUED)

Principal risks and uncertainties (continued)

Perceived most significant and emerging risks to our strategy: (continued)

| Risk category | Risk | Why this is important | How we manage it | Trend |
|---|----------------------------------|--|---|--|
| Global: Compliance and Business: Regulation | Compliance & Regulation | As a customer centric company that operates in a market subject to many different regulations and laws, it is important that O2 operates within the regulatory obligations and delivers positive customer journeys and outcomes. | We continually monitor the legal and regulatory requirements applicable to O2 and apply these requirements to our operations and change activities. | Increased: Due to increased complexity of regulations and intervention from regulators |
| Business: Strategy | Market & Competition | The market continues to evolve at pace in relation to multiple factors e.g. technology, customer demands, product offerings, new sub-markets, new competitors, and it is important to O2 to remain relevant and attractive. | In 2019 we rolled out our 5G network to 21 towns and cities. O2 also released Unlimited Data tariffs on its Custom Plans | New: This new category has been created to recognise previous risks which are interconnected. |
| Business: Strategy | Economic & Political Environment | Economic and political factors present a dynamic set of challenges and risks for O2 to consider, relating to market, strategy and operations factors. | 2019 has been an uncertain time in the UK both politically and economically, predominantly due to Brexit. Early indications in 2020 are that this uncertainty only increases due to the Covid-19 pandemic and the next phase of the UK leaving the EU. O2 has and continues to plan for different political and economic scenarios, which include Brexit and the Covid-19 pandemic. This planning is to ensure we continue to be successful in executing our strategy and operations as planned and to minimise negative impact to our customers and stakeholders. | Increased: Due to the increased and extended uncertainty caused by Brexit. |

STRATEGIC REPORT (CONTINUED)

Principal risks and uncertainties (continued)

Perceived most significant and emerging risks to our strategy: (continued)

| Risk category | Risk | Why this is important | How we manage it | Trend |
|--|-------------------------|---|--|--|
| Business: Strategy | Transformation | Constant change at pace is an inherent requirement due to the technological evolution in the markets we operate and the healthy competition. It is therefore vital that we deliver constant change and transformational activities. | O2 is currently delivering a transformation programme which is delivering substantial technology evolution and ensuring we are well placed for the future. | New |
| Financial: Finance & Fiscal | Finance & Fiscal | The financial performance, liquidity and financial going concern of the company are inherent risks to the organisation, including continued access to lending markets in the UK. | We maintain strong banking relationships across a number of key banks, also leveraging our relationship at a Group level. 2019 has seen a strong financial performance by the organisation, as reflected in our financial results. We operate continuous monitoring of credit risks through our financial and procurement processes. | Stable |
| Operational: Systems & Network, and Security | Cyber & System Security | As a company who facilitates the communication of data and whose customers are enthused by our services and increasingly dependent on connectivity, we recognise this as one of our greatest areas of risk. Cyber-crime is increasing in both frequency and sophistication, and presents potential impacts to service, data loss, data integrity, data accessibility, and fraud. | We work collaboratively with our regulators to understand our cyber threat landscape and we are proactive in creating security standards that will help protect us and the industry in the future. | Increased: In recognition that the implications of this risk materialising has increased, for example costs to address sophisticated cyber-crime. |

STRATEGIC REPORT (CONTINUED)

Principal risks and uncertainties (continued)

Perceived most significant and emerging risks to our strategy: (continued)

| Risk category | Risk | Why this is important | How we manage it | Trend |
|--------------------------------|---|---|---|--|
| Operational: Systems & Network | System availability & capacity | Customers have an ever increasing demand for our services and products. In order to continually deliver excellent customer experiences across our network and products it is key that our systems keep pace with demand and service expectations. | At O2 our Strategy and Business Plans anticipate and plan for future market direction and demand. Our operational teams then work tirelessly to deliver the functionality needed. | Stable |
| Operational: Supply Chain | Suppliers, partnerships & Third Parties | O2 is a highly collaborative organisation that has many important relationships with third parties, in order to deliver its products and services. | We employ strong contractual requirements to ensure the quality of procured products and services and adopt a sustainable procurement strategy that drives our suppliers to greater social contribution, environmental protection and compliance to a clear and detailed supplier code of conduct. In addition we use risk based due diligence to assess and develop our supply chain aligning their capability to our business needs. This is managed via mature procurement, supply chain management processes, and a considered third party governance framework. We are certified to operate ISO44001-compliant Collaborative Working Relationships with certain key partners | New This new category has been created to recognise previous risks which are interconnected. |

STRATEGIC REPORT (CONTINUED)

Principal risks and uncertainties (continued)

Perceived most significant and emerging risks to our strategy: (continued)

| Risk category | Risk | Why this is important | How we manage it | Trend |
|--|------------------------|--|---|--------------|
| Operational: Operational Management | Operational Management | This broad area of risk is of significance to O2 given it covers factors such as; customer service, processes, human resources, fraud, laws and intellectual property. | At O2 we operate an internal control framework which places responsibilities across the business to execute effective management of the Company. These internal controls and responsibilities are integrated into our daily activities to deliver assurance across all the areas of operational risk mentioned here, and more. | Stable |

Changes year on year:

As we continue to ever evolve and enhance our risk management practices, the following shows where risks from our last report have moved under new categories due to them being related/interconnected:

| Risks From Last Report | Movements |
|--|---|
| Network Spectrum/Capacity | Moved under 'System availability & capacity' |
| 5G deployment plan | Now considered under 'Market & Competition', 'System availability & capacity' and 'Transformation'. |
| Legacy Systems architecture | Moved under 'System availability & capacity' |
| Breach of Data Security | Moved under 'Compliance & Regulation' |
| Data Privacy | Moved under 'Compliance & Regulation' |
| Loss of FCA Authorisation to sell FCA Regulated products | Moved under 'Compliance & Regulation' |
| Child Protection | Moved under 'Reputation & Sustainability' |
| Smart Metering | Considered under 'System availability & capacity' and 'Compliance & Regulation'. |
| Economic/Political Instability | Renamed to Economic & Political Environment |

STRATEGIC REPORT (CONTINUED)

Main trend and factors likely to affect company

Network

A key future event for the company is the next Spectrum Auction in 2020. This auction will open further spectrum to the UK mobile industry and allow for the further deployment of 5G services.

In 2020 we plan to deliver further 5G network and capability and drive the infrastructure strategy to enable future capability resulting in an enhanced network experience for our customers. There are risks and opportunities. We anticipate a high number of customers moving to 'unlimited' tariffs and average bundle utilisation increasing, causing higher growth than forecast. There is also a risk of not acquiring further spectrum. Our Network team carries out regular risk management across all of the identified network risks to ensure these are adequately mitigated.

Non-Financial Statement

Under our integrated approach to reporting, we report certain matters relating to employees, social, environmental, anti-bribery and corruption and human rights. The reporting obligation to include a non-financial statement under the Non-Financial Reporting Regulations are addressed throughout the Strategic Report. For ease of reference, each of the matters addressed by the regulations can be found in the following pages Employees (pages 11 to 13), Social (page 17), Environmental (pages 17 to 18), Human rights (page 12), and Anti-bribery and corruption (page 20). Additional non-financial matters on how we operate are embedded in our Business Principles (page 19). Further information is detailed in the Non-Financial Report published on the Company's website.

172(1) Statement

The Directors in the performance of their statutory duties detailed in Section 172(1) of the Companies Act 2006, have a responsibility to act in a way they consider, in good faith would most likely promote the success of the Company, for the benefit of the shareholders as a whole. In doing the Directors have had regard to:

1. The likely consequences of any decisions in the long term;
2. The interests of Company's employees;
3. The need to foster the Company's business relationship with suppliers, customers and others;
4. The impact of the Company's operation on the community and environment;
5. The desire of the Company maintaining a reputation of high standard of business conduct; and
6. The need to act fairly between shareholders of the Company (*there are no minority shareholders*).

The directors are of the opinion that they have fulfilled their obligation through the governance framework detailed in the Corporate Governance Statement on Page 36. The directors and members of the main committees are aware and have been reminded of their statutory duties. In addition, the Directors have established a formal process to ensure adequate considerations of these matters for significant arrangements.

Each year the Directors prepare an annual strategic plan that is approved by the shareholders of the Company, confirming the Company's objectives and commitments in the near and longer term and intended to promote the success of the Company. In preparing the strategic plan, due consideration is given to key stakeholders and s172(1) considerations, including the Company's customers, employees and the environment. The Company's operational plan was built to deliver against its strategic plan. In 2019, there were a number of events and activities that delivered against the strategic plan and which impact and involve some key stakeholders. This included the Shared Rural Network (SRN) which was based on collaboration and partnership between the Government, Ofcom and MNOs to invest by delivering increased coverage for remote areas, helping the community and delivering improved connectivity. In 2019, we also reviewed our Operating Model to ensure our people and ways of working are set up to be the best they can be. We are focused on delivering a great service for our customers in an extremely competitive environment. We decided to make some changes to our employee resources, having due regard to the likely consequences in the long term and the interests of the Company's employees. These changes were made in consultation with our union partners, employee representatives and our people.

STRATEGIC REPORT (CONTINUED)

Post Balance Sheet Events

Regulatory intervention

Under Ofcom rules, we introduced End of Contract Notification and will introduce Annual Best Tariff Notification (ABTN) by February 2021. The ECN obligation is to send a notification within 10 to 40 days before the customer's contract end date and for ABTN to send another notification at least every 12 months from the date the customer received the ECN if the customer has not acted, or if out of contract, one notification in every 12 month period. We will comply with the regulation for when it comes into force and change tone of narrative.

Annual Licence Fees

In 2015, by way of regulations (2015 Regulations), Ofcom reset the existing regulations (2011 Regulations) for Annual Licence Fees (ALFs) for the 900 & 1800 MHz bands from approximately £65m to £200m per annum for all mobile network operators (MNOs): Telefonica UK's fees were set at £49.8m pa. The 2015 Regulations were quashed in 2017 pursuant to a Court of Appeal judgment which held that they had been determined unlawfully by Ofcom. The fees regime reverted to the pre-existing 2011 Regulations and the lower fees set in these Regulations. O2 and the other MNOs brought a claim against Ofcom for repayment of the difference between the amounts paid under the unlawful 2015 Regulations and the lawful 2011 Regulations. O2's claim was initially £52.8m plus interest. This figure increased to £54.4m plus interest in 2019 due to a payment being incorrectly characterised when the claim was first formulated.

Ofcom disputed that the MNOs were entitled to claim the difference in this way, instead asserting that the MNOs were only entitled to the difference between the amount paid under the unlawful 2015 Regulations and a notional amount that would have been paid had Ofcom put in place lawful regulations at the relevant time (which Ofcom noted would have been of a similar level to the 2015 Regulation fees based on a new consultation and subsequent 2018 Regulations that came into force which set ALFs at a broadly similar level as they had been set by the 2015 Regulations). The MNOs won their claim in the High Court in 2019 and the appeal in the Court of Appeal in 2020. Ofcom is not appealing the Court of Appeal decision to the Supreme Court.

O2 and Virgin Media Joint Venture

On 7 May 2020, Telefonica SA and Liberty Global announced that both companies had entered into an agreement together to create a 50:50 joint venture in the UK, bringing together the Telefonica UK (O2) and Virgin Media businesses. The arrangement is still subject to regulatory clearance has been agreed in order to create a national connectivity champion capable of competing at the highest level with the combined mobile and home connections. It is anticipated that closing of the transaction, subject to regulatory clearance is expected to take place around the middle of 2021.

COVID 19

Worldwide or national health-related events, including the outbreak of contagious diseases, epidemics or pandemics, such as COVID-19 (coronavirus), could significantly affect our operations. Such events could cause, among others, delays in the supply chain due to problems in factories or logistic services; impact on employees or third parties due to quarantine periods or infection, and also affecting global and therefore national economic growth. The latter stemming from a variety of adverse impacts on supply (paralysis of integrated production chains, freezing of productive resources) and demand (deterioration of confidence and expectations, negative income and wealth effects) caused by a substantial deterioration in financial markets, unprecedented falls in commodity prices, sharp slowdown in commercial activity or heavy restrictions on transport. Like every other business we are not immune to the consequences of the pandemic and are committed to ensuring that the Business can navigate through the unprecedented uncertain times, supporting our customers and employees as well as contributing to the recovery of the economy which we operate in by keeping Britain connected. As Britain works through this national crisis, mobile is playing a more critical role than ever to keep people connected. We are doubling some elements of our network capacity, enabling essential connectivity, supporting Britain's productivity and donating directly to those who need it - all in the pursuit of keeping Britain connected.

STRATEGIC REPORT (CONTINUED)

Post Balance Sheet Events (continued)

COVID 19 (continued)

As a responsible business we followed government advice to help protect our people and our customers. We implemented our business continuity plans to allow office-based employees to work from home and took a decision to close our stores after trading on 23 March 2020 ahead of the national lockdown announcement by the government. During the lockdown period we implemented a work from home policy where it is possible to do so ensuring the safety and welfare of our people and the ability to continue to meet the needs of our customers. In addition, we brought in a range of temporary people measures, including the protection of base pay for all employees including paid leave for vulnerable employees and for those in self-isolation, or with caring responsibilities who are unable to work from home, including retail employees. We worked closely with the government to provide assistance to NHS workers, charities and our customers by providing 25% discount on tariffs and free data for NHS workers, unlimited free calls for Pay Monthly customers, suspended roaming charges, support for vulnerable customers and zero-rating access to support and charity websites. We were instrumental to supporting the NHS and keeping Britain connected by providing connectivity to the Nightingale hospitals across the country and donated The O2 as a training facility as well as a drive through testing facility for the NHS. We also partnered with the BBC's Big Night In to galvanize the nation to respond to the challenges that lie ahead.

Following the ease of the lockdown restrictions in phases we are committed to ensuring the continuing safety of our employees and customers and have re-engineered our retail estate, practices and procedures to align with the government guidelines for social distancing. We are mindful of the economic pressure and impact on our profitability growth and are committed to helping Britain get back to normal by supporting our customers and businesses.

The Group has shown resilience throughout this turbulent period and the need for connectivity by our customers has been just as strong, albeit their specific demands have changed. The below table outlines the main impacts to the business as a result of COVID-19 and what the business has done to address them.

| Matter to consider | Impacts/Risks | Mitigations | Conclusion |
|---------------------------|---|---|--|
| Revenue | <p>Store closures have resulted in a slow down of hardware revenue.</p> <p>Smart metering revenues have slowed down due to physical restrictions during lockdown.</p> <p>The travel ban in the UK and across many parts of Europe has resulted in reduced roaming revenues.</p> | <p>Improved online sales capabilities by enabling telesales teams to operate from home and adapting physical estate in order to manage the sales process under social distancing guidelines.</p> | <p>We have seen an increase in online channel sales and we expect other channels to pick up again as lockdown restrictions start to ease from mid-June.</p> <p>The reduction in roaming revenues is partially offset by a reduction in associated costs.</p> |
| Liquidity | <p>Financing becomes more expensive and unavailable in the current climate.</p> | <p>Key debt facility has been renewed for an additional term and the introduction of a new funding partner has enabled the Company to grow the facility whilst keeping the total cost of funding the facility flat.</p> | <p>No significant liquidity concerns, the risk of a loss of available funding has been mitigated through the introduction of a third funding partner.</p> |

STRATEGIC REPORT (CONTINUED)

Post Balance Sheet Events (continued)

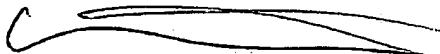
COVID 19 (continued)

| Matter to consider | Impacts/Risks | Mitigations | Conclusion |
|---------------------------|--|---|--|
| Collections | Customers struggle to pay their bills and increased bad debt. | Following emergency changes to government regulations on Consumer Credit Agreements we initially introduced an emergency payment option for any customers finding it difficult to pay their bill as a direct result of COVID-19. Appropriate provisions have been made for the anticipated increase in bad debt as a result of the pandemic. | The volumes of customers taking the emergency payment option has been within expected levels, the impact has been considered in forward looking financial forecasts. |
| Costs/Capital allocation | Spend is not reviewed in light of COVID-19. | The board has reviewed discretionary expenditure and investments in view of COVID-19 and continue to execute smart spending principles to focus on core service and targeted cost management throughout the business. | Appropriate measures are now in place to review cost control and capital expenditure in light of the pandemic. |
| Forecasting | Forecasts are not reflective of performance during COVID-19 crisis. | We have processes in place to review the appropriateness of our financial outlooks regularly and monitor market activity on an ongoing basis. Rate and volume assumptions have been stress tested and triangulated with market insight and trading updates. | Current forecasts take account of risks associated with trading during the COVID-19 crisis. |
| Network Resilience | Network overload and possible degradation of services from the growth of voice / data traffic. | We proactively managed the expected voice traffic increase through increased network capacity. Data usage patterns changed as people connected from their homes rather than work locations and commuting routes with no negative impact on the network. | Network capacity planning reflects an expected impact of changes in future usage patterns as a result of COVID-19. |

STRATEGIC REPORT (CONTINUED)

The Strategic Report was approved by the Board on 24 June 2020

By Order of the Board



Vivienne Aziba
For and on behalf of O2 Secretaries Limited
Company Secretary

DIRECTORS' REPORT

The Directors of the Company present their audited consolidated report for the Company and its subsidiaries (the UK Group), which has been prepared in accordance with the Large and Medium-sized Companies and Group (Accounts and Reports) Regulations 2008.

In accordance with Section 414C (11) of the Companies Act 2006 the Directors have chosen to set out in the Strategic Report certain information which fulfils the requirement of the Directors' report.

Directors and Secretary

The Directors who held office during the year and at the date of this report are as follows:

Mark Evans
Patricia Cobian

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

Directors' liability insurance and indemnities

Telefonica O2 Holdings Limited (formerly Telefonica Europe plc), the Company's ultimate UK parent company, has granted an indemnity in the form permitted by UK Company Law to Directors appointed to subsidiary companies. This indemnity was in force during the financial year and at the date of approval of the financial statements.

Corporate Governance Statement

Details of the Company's governance arrangement is set on on pages 36 to 46 the Annual Report.

Stakeholder Statement

Details of how the ELT have had regard to the need to foster the Company's business relationships with suppliers, customers, and other and the effect of that regard in principal decisions taken by the Company can be found throughout the integrated report. For ease of reference the key stakeholders are detailed on page 19 of the Strategic Report and pages 41 to 46 of the Corporate Governance Statement.

UK Employee Engagement Statement

The Company has a small number of employees and adopts the same employee related policies and processes as Telefonica UK Limited, the principal subsidiary in the UK Group.

Details of how the directors have engaged with UK employees and how the directors have had regard to the UK employee interest, and the effect of that regard on decisions taken by the Group as applicable to the Company can be found on pages 11 to 12 of the Strategic Report and pages 43 of the Corporate Governance Statement.

Dividends

During the year ended 31 December 2019 the Company paid interim dividends totalling £550 million (2018: £110 million).

Political donations

In accordance with the Group policy, no political donations were made or political expenditures incurred in accordance with the Companies Act 2006, in respect of political parties during the financial year ended 31 December 2019.

DIRECTORS' REPORT (continued)

Financial risk management objectives, policies and exposure

Details of the UK Group's approach to financial risk management objectives and policies are set out in the financial statements in note 34 "Financial instruments and capital management".

Important events since the end of the financial year

The Strategic report sets out on page 30 details of the important events affecting the Group which have occurred since the financial year end.

Going concern

The Company's business activity is that of a mobile cellular telephone system provider and operator. The financial position of the Company is described on page 22 of the strategic report. In addition, note 34 to the financial statements includes the Company's objectives, policies and processes for managing its capital; its financial risk management objectives; and its exposures to credit risk, liquidity risk and interest rate risk. The Directors believe that the Company is well placed to manage its business risk successfully. The Directors have reviewed the business plan for the period to 31 December 2021, and together with the commitment received from the ultimate parent company to continue providing financial support because of the net current liabilities position have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future and thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

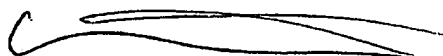
The impact to the Company from COVID-19 is described in detail on pages 30 to 32. The Company has shown resilience throughout this turbulent period and the need for connectivity by our customers has been just as strong. The impact to the Company has been modest considering the challenges faced across the global economy. In light of this, the Directors believe that the Company is well placed to continue to mitigate the impacts of COVID-19 during 2020 and beyond.

Statement as to disclosure to auditors

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.

The Directors' Report was approved by the Board on 24 June 2020

By Order of the Board



Vivienne Aziba
For and on behalf of O2 Secretaries Limited
Company Secretary

CORPORATE GOVERNANCE STATEMENT

Group Corporate Governance Structure

Each operating business operates within the framework of the Telefónica Group Operating Model and Delegated Authorities whilst maintaining objectivity in managing the affairs of the respective business.

The UK Group's principal trading subsidiary is Telefonica UK Limited (O2), which is the focal point for corporate governance arrangements relating to the UK Group as a whole as explained below.

The Group's governance statement is based on Telefonica UK Limited's governance arrangements and reported against the Wates Principles detailed below. Reference to the Board in this statement refers to the board of Telefonica UK Limited.

Principle One: Purpose and leadership

The Board, supported by the Executive Leadership Team, are responsible for promoting our Company's purpose of making every day better through personal experiences that count supported by our Customer Led Mobile First strategy. This is underpinned by our company values of being Bold, Open and Trusted which is demonstrated in our commitment in being a responsible business, our business principles and our company policies. Our policies and procedures are updated regularly and continually reviewed against desired behaviours and culture as well as values.

Culture

Our company values, are embedded in our performance management processes. Our leadership development programmes bring the values to life and provide leaders in the business with greater detail about what great values leadership looks like.

The 'Ourstars' site, hosted on Workplace, allows our people to recognise colleagues for demonstrating our values and to share these examples with the whole business, highlighting and celebrating our desired behaviours. The Executive Leadership Team regularly reference and demonstrate the values as well as giving awards throughout the year to those living the values across the organisation. Events through the year such as 'O2s Got Talent', and National Inclusion Week regularly encourage our people to be Bold and Open outside of their day to day roles.

Principle Two: Board composition

The Board (which is comprised of the Chief Executive Officer and the Chief Financial Officer) with the support of the Executive Leadership Team (ELT) (comprised of the two principle committees) has overall accountability and oversight responsibilities which forms part of the governance framework to deliver the Company's purpose.

Principle committees (ELT)

The ELT are members of the two principle committees; the Operating Committee and Strategy Committee (Principle Committee). The Principle Committee members are; the Chief Executive Officer, Chief Financial Officer, the General Counsel, the Chief HR Officer and Chief of Staff, the Chief Marketing Officer, the Chief Operating Officer, the Sales Director, Director of Business and Directorate of Corporate Affairs. Full details of the Committee structure and the Leadership Team bios can be found on the Company's website <https://www.o2.co.uk/abouto2/our-leadership-team>

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Two: Board composition (continued)

Delegation of authority

The Board has a number of other committees to consider specific matters within the framework of the Telefónica Group Operating Model and Delegated Authorities whilst maintaining objectivity in managing the affairs of the Company. The ELT has the necessary skills and experience to make valuable contributions in promoting the success of the Company and is committed to ensuring that the Company is managed according to the highest standards of corporate governance. The Board regularly reviews the composition of the ELT and consequently appointed the Director of Corporate Affairs to the ELT in 2019, recognising the value that those skills and experience would add to the ELT. The ELT has a 55/45 split of female vs male representatives.

Effectiveness

The ELT and the Board are committed to ongoing professional development. During the period the ELT (which include the members of the Board) participated in regular leadership and personal development sessions to ensure they have the right skills to discharge their duties and work effectively as the leadership team. In addition, the Board increased the number of meetings to distinguish its oversight and accountability responsibilities from the day today operational responsibilities of the ELT. Also, we conduct annual Committee Effectiveness reviews for all committees to ensure they operate effectively. As a result we enhanced the governance process, in particular the flow of information to the Board and Committees to ensure that the decision makers have timely and sufficient information to discharge their duties.

Principle Three: Responsibilities

Committees

The Board has established two principal committees: namely

- The Operating Committee who monitor the operating and financial performance of the UK businesses as a whole and assesses risk; and
- The Strategy Committee which monitors the external market and competitive forces in the UK, develops strategy and monitors key strategic projects. The main focus during the year included a review of the medium to long term strategic plan.

Other committees reporting directly to the Board are:

- The Assurance Forum which considers the internal control framework and assists the ELT in fulfilling certain oversight responsibilities in the areas of governance, risk management and compliance framework.
- The National Security Committee which considers policy and issues in respect of the company's specific legal obligation as a communication provider.
- The Pensions Committee which considers matters relating to the Telefonica UK Pension Plan of which the Company is the Principal Employer and liaises with the Trustee of the Plan.
- The Responsible Business Taskforce which considers matters related to the delivery of the Company's sustainability and responsibility strategy. It also considers the Company's disclosure of non-financial reporting matters. Full details of our approach to being a responsible business is published on the Company's website.

There are other forums that assist with operational matters such as the Incentives Forum which oversees all of the sale related incentive schemes, including those sponsored by a third party supplier.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Three: Responsibilities (continued)

Accountability

The Board and its committees have a defined charter of roles and responsibilities and terms of reference detailing their responsibilities and delegated authority. The Board has delegated authority to the Operating Committee to establish the policies and practices that govern the internal affairs of the Company. They retain oversight of the policies including the review of the policy management framework. The Board regularly receives reports from the direct committees with delegated responsibilities and deals with board reserved matters.

Information integrity

The ELT receive regular updates on all key aspects of the business including financial performance, and on strategy and operational matters. In addition, Board information on non-financial matters are monitored with KPIs for all business areas which are reviewed by at least one member of the Senior Leadership Team to ensure information integrity in order to assist the ELT with the effective monitoring of the Company's performance and inform decision making.

Principle Four: Opportunity and Risk

Opportunity

We have an agreed 3-year planning process that engages and collaborates with the relevant stakeholders across all business units to develop our Strategic ambitions. This identifies new market and product opportunities and the relevant actions that need to be taken in order to create a suitable case for investment if appropriate to do so.

How we manage our risks

We recognise that risks are inherent in all business and company activities, and that effective risk management contributes to the development of the business through an appropriate balance between growth, return and risk.

We have a comprehensive Enterprise-wide Risk Management Framework in place, which is aligned with ISO31000:2009 Principles and Guidelines for Risk Management. This is supported by our Risk Management Policy and detailed process which have been independently assessed by the BSI against the ISO31000:2009 Standard. The risk management framework forms part of the internal control framework, which is aligned to COSO (Committee of Sponsoring Organisations) standards as discussed on page 37.

Risk Appetite

Telefonica Group has established the acceptable risk level (Risk Appetite) each year for O2. This defined level enables O2 to deliver value creation, growth and performance whilst managing risk exposure in a measured accountable way. When applied to our strategy decision making, this helps the Company's management to select appropriate strategies within its acceptable risk level.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Four: Opportunity and Risk (continued)

Risk Framework & Process Summary

The framework is designed to identify, assess, manage, monitor and treat significant risks that could adversely affect the future success of the organisation.

- The risk management process takes, as a starting reference, the strategy and objectives of the Company, as a basis for the identification of the main risks that may affect their achievement. Then, more broadly, our model considers three complementary perspectives: overall (top-down), local (bottom-up) and cross-functional (projects and processes). This approach includes the consideration of the external environment.
- The identified risks are assessed in a qualitative and/or quantitative way in order to prioritise the follow-up and response to these risks, usually through mitigation plans, or strategies to avoid or transfer these risks.
- Regular reporting gives management awareness of key risks and the capacity to assign the most effective resources at the optimal moment to control and respond to the risks and opportunities identified.
- Risk insight allows Internal Audit to prioritise its activities for the supervision of the internal control structures.

Risk Management Execution & Oversight

The activities that underpin these risk management processes are facilitated across the business by individuals who execute their respective risk management roles and responsibilities in their team. They are supported by a dedicated Central Risk Management team and network of Risk Champions.

The most significant risks to the Business are presented to the ELT at regular intervals each year for discussion, validation and direction. This takes place via the Operating Committee and Statutory Board, with the support of the Assurance Forum. These structures drive accountability and direction for O2's risk exposures.

Details of the Principal Risks and Uncertainties facing the Business are disclosed in pages 23 to 28 of the Strategic Report.

Internal Control

The Company's internal control framework is configured as a process that is integrated into our daily activities. The Internal Control Framework incorporates preventive and verifying functions structured in an integrated way: Preventative - Company Policies, Risk Management, Monitoring and Operational Controls. The control framework has been designed to meet the requirements of the Sarbanes Oxley Act 2002.

Internal Audit

Internal Audit is responsible for confirming the adequate function and operation of the internal control and risk management structures. It will also help to identify possible inefficiencies or non-compliance of the control system.

Each month Internal Audit reports to the ELT on the Governance, Risk and Control key performance indicators, which is based on a set of metrics covering the management of risks, the implementation of any control and/or internal audit actions identified. The status of the KPI and actions required are reported to each Business area on a monthly basis.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Five: Remuneration

The focus of the Group's Remuneration Policy is to ensure that the business can attract, reward and retain the best leadership talent, enabling it to meet our strategic targets within a highly competitive and globalised setting.

The pay principles and the approach outlined below is for employees including the ELT.

A significant portion of the remuneration is delivered in variable pay, which is designed to incentivise the achievement of the Company's short- and long-term goals. The short-term variable remuneration is linked to achieving specific financial, business, customer satisfaction and sustainability objectives. The long-term variable remuneration is linked to the value creation in the Group by measuring the shareholders' return on investment and key economic financial objectives.

The positioning of base pay is based on

- the external benchmark data applicable to an individual's role
- the internal pay range or the pay points for an individual's grade and individual's performance
- the Company's overall pay budget which is determined by financial position and company performance.

There are formal negotiations with Trade Unions and consultation with employee representatives on pay and benchmarking. The pay ranges of each of our grades are set competitively using robust external market data which is reviewed at least annually.

There are two ways in which an individual's salary can be reviewed:

- Annual pay review – awards are made on an annual basis based on budget, position against external market data and individual performance.
- Exceptional pay review – requests can be submitted for out of cycle pay reviews on the basis of a retention risk and/or misalignment to the internal or external market.

Both of these processes are managed centrally by a Reward team with detailed governance and approvals in place and clear/consistent guidance being given to line managers. In delivering pay reviews in this way, it is possible to monitor all awards from a cost, equity, fairness and diversity perspective.

There is an additional level of governance for ELT pay which is strictly determined and assessed by Group Remuneration Committee. The ELT remuneration details are disclosed in notes 7 and 8 of the Financial Statements.

Details of the gender pay gap report is published on the Company's website [here](#).

All our people on a permanent contract are eligible for our Flexible Benefits programme to help improve their lifestyle. This includes an employee share scheme which is called Share in Success Share where they can choose to invest up to £1,800 or 10% of their salary (whichever is the lower) in Telefónica, S.A. (our parent company) shares per tax year.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement

Our stakeholders are classified as any group that may be affected by our business in a significant manner such as customers, people, suppliers, strategic partners, the regulator, government, our shareholders, society and the environment. The ELT continues to promote the long-term aspirations for the company and considers the wider interest of the stakeholders. The CEO, as the chair of the ELT holds a monthly meeting with the sole Shareholder to understand the shareholders views and regularly updates the ELT to ensure alignment between the Company and the shareholder.

External impact

The ELT is committed to working with people to help them live better with tech through our Blueprint ambition to help 20 million people live better with tech by 2020. This brings our purpose to our communities and invites everyone to come together for the good and to help bring positive change. We aim to help society as a whole, not just our customers, and to improve people's lives, now and in the future. Full details of our Blueprint can be found on the Company <https://www.o2.co.uk/our-blueprint>

Stakeholders

The ELT promotes the Company values, Bold, Open and Trusted in dealings with all external stakeholders. Each Stakeholder Group has at least one member of the ELT as an Executive Sponsor to help manage the day to day relationship. The ELT receive regular updates on stakeholder matters.

Customer

We build relationships and listen to our customers through a number of channels.

Customer closeness – We engage our customers via online video focus groups, video interviews and broader online discussion rooms. Insight from the sessions was delivered face to face across 10 driver workshops and reports, which fed directly into our NPS plans for 2020 with clear leadership accountability. We have monthly open discussion forums with the consumer and SMB communities. We also actively listen to conversations on social networks and consider the feedback.

Our Enterprise customers have dedicated account and service management teams. This allow us to maintain an ongoing relationship with these customers. Our customer facing teams can be present within the Enterprise customer's own environment. Our partnership approach allows us to understand their ongoing and evolving business needs and priorities, and how we can help them to achieve these. Additionally, members of our ELT are sponsors for some of our Enterprise accounts to help further with customer engagement. We also actively promote and interact with our customers through industry events for example, Blue Door Events for our Enterprise Customers and Innovation Workshops.

In 2019 we introduced the 'Voice of the Customer Mission Team' – a working group made up of subject matter experts from across the business and our partner, Capita. Our role is to be the single voice of the customer across our channels. Shared ideas remove duplication of effort and seek out improvement opportunities, utilising cross directorate expertise and influence.

Customer Experience measurement programme (FanBASE) – Over 1 million customers responded to our text surveys to share their views of O2 products, services and experiences. The feedback is shared across the business including front line teams so they can learn from our customer's experience.

NPS Relationship survey – We supplement our text surveys, We use a representative sample from the fanbase and other customers from an online panel, who have opted into complete surveys to help the business to understand where we can improve and what we are doing right.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement (continued)

Closing the loop - As a customer led organisation, we offer all dissatisfied customers (from our text or NPS survey) the option to talk to us. Over 27,000 customers have been offered the real time URL to book an appointment, 90% of customers who have spoken to the team consider their issue resolved after this contact.

Mystery shopping - O2 employ a 3rd party agency to carry out monthly mystery shopping visits to stores throughout the UK. They are designed to monitor the compliancy of store staff during the sales experience (e.g. contract explanation, credit check process, RPI explanation). Monthly reports are issued which highlight any areas and opportunities to make improvements for our customers.

Customer Advisory Forum - 2019 saw the introduction of our new Customer Advisory Forum, chaired by the COO. This is a strategic forum for our most significant customers, who have access to our unique insights and relationships and collaborate to explore how we can create greater value. The group meets at least twice a year to share ideas and experiences around common business challenges and provide input and advice on O2's strategies and direction.

Vulnerable customers

Through our regulators, extensive research and cross industry best practice we understand the areas of our business where there is a higher likelihood of interacting with customers in vulnerable situations. In response to this, as well as training all front line colleagues, we have a number of specialist teams who focus on meeting the needs of our most vulnerable customers; this includes Customer Relations who support customers who have experienced a bereavement and those diagnosed with long-term illness; Payment Management supporting customers in financial difficulties and Access For You for customers who struggle with our conventional channels due to their personal circumstances.

We continue our work with Ombudsman Services, our Regulators and Citizens Advice and have visited a number of "Centres of Excellence" in supporting vulnerable customers, to understand other areas of vulnerability which may impact our customers; this helps us to continually develop strategies to support customers appropriately through our various service channels, new technology and self-service options.

Both Ofcom and the FCA have recently produced guidance on treating vulnerable customers fairly and there is a lot of emphasis on gathering feedback from vulnerable customers to ensure they are getting the support they need and we will continue to work with them to find the best way to do this.

Business Partners

We have focused on delivering support that would enable O2 to be "easier to do business with". We have launched a new Partner Hub which is a central area where all Partners receive their O2 communications.

We have a regular programme of engagement with each partnership segment such as weekly meetings to discuss trading performance, any day to day issues and opportunities. We have quarterly briefing sessions to cascade key messages from O2 and to discuss strategic opportunities/issues. There are feedback opportunities through Forums, informal group discussions and conferences. In addition we use Webex sessions to promote marketing campaigns and new products and Partners are encouraged to give feedback. O2 conduct an Annual Partner Survey which allows Partners to feedback on all aspects of the support they receive which in turn drives a priority action list enabling us to provide updates on the actions. The ELT engages at key Partner events.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement (continued)

Our People

We have various means to engage with our employees and to act upon their feedback:

Conference: We held our annual conference over three days in London for our people. The audience got to hear about our key objectives for 2019. All members of the ELT presented plans for each area with the theme of #weareo2.

Wider Leadership Team/Senior Leadership Team events: Each quarter, through face to face or livestream events, The ELT share important updates against company objectives with all leaders in our business. They will focus on key messages and initiatives so ensure that our performance continues to centre around our strategy.

Listening Tour: We run regular Listening Tours where a co-ordinated programme of the ELT and senior members of the business visit company-owned stores to engage with, obtain feedback from the ground and motivate our people on the shop-floor.

Workplace: Our internal social media platform where we can cascade key messages to our people and provide a forum for them to share feedback, ideas and news from around the Business.

Global Engagement Survey: every year we encourage our people to provide their views on working in the business. They can also share feedback which can help identify areas for improvement within the business which we aim to address.

Quarterly update: Each quarter, members of the ELT share our business financial results and strategy updates with our people which includes our financial and economic factors. These are held face to face across all our sites and supported with information on Workplace.

Employee representatives: On a regular basis, we engage with the trade unions and employee representatives on a broad range of employee related matters to maintain a positive and collaborative industrial climate within the business. The CEO and HR Director meets with the trade unions annually to communicate the Company's strategy and direction. In addition, there are regular meetings between the trade unions, functional leaders and HR to listen the concerns and views of the employee representatives, and act on those concerns where appropriate. We undertake collective consultation for all formal transformation activities such as change to roles, changes to terms & conditions, restructure and redundancy programmes, TUPE, compensation changes.

Telefonica UK Pension Plan ("the Plan")

The Company's Pension Plan is held and managed under trust. The fiduciary responsibility for operating the Plan is with an independent set of Pension Trustees. The Company engages with the Pension Trustees through regular communication, meetings and information sharing. The Pension Trustees consult with the Company on all their principal decisions around the operation of the Plan. Examples of decisions taken during the year include:

- Company and Trustee agreement to change the investment strategy in the Defined Contribution Section of the Plan. The changes will incorporate a greater weighting to Environmental, Social and Governance factors in the investments held by members.
- Joint agreement around a framework to monitor the long-term funding progression of the Defined Benefit (DB) Section of the Plan. This framework is a joint strategy to manage the investment and other risks associated with the DB Section pension liabilities.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement (continued)

Regulators

Ofcom

We are subject to sectoral regulation administered by Ofcom, the Communications Regulator. The UK regulatory regime is wide ranging and includes regulation designed to: protect consumers; provide universal services; ensure the availability of electronic networks and services; and address enduring competition problems. Ofcom is also responsible for policy relating to spectrum, including setting Annual Licence Fees and administering spectrum awards. It is essential that we have a full, constructive working relationship with the regulator.

In 2019 Ofcom implemented the following initiatives.

- **Bill spend caps:** Delivers the capability for our customers to set a usage cap to their account. The customer's account will be barred once the agreed usage limit is reached.
- **Text to Switch:** The new text functionality to help improve the customer experience when they want to switch providers.

In our relationship with Ofcom, we seek to further the interests of the Company so we can always deliver great experiences for our customers. We have a regulatory team responsible for managing the relationship with Ofcom, including developing regulatory policy; responding to consultation documents and requests for information; and managing enforcement investigations. The team provides updates to the ELT on a regular basis. Our CEO meets with Ofcom's CEO on a quarterly basis and there are regular meetings between members of our ELT and senior officials in Ofcom.

We responded to Ofcom consultations relating to the proposed forthcoming award for 700 MHz and 3.6 - 3.8 GHz spectrum. That spectrum is expected to be auctioned in spring 2020. Also we engaged in Ofcom's reviews of the Business Connectivity market and Physical Infrastructure market, which culminated, in July 2019, in a regulatory duty on Openreach to provide unconstrained access to its ducts and poles and charge controls on ethernet circuits (used in the provision of mobile backhaul services).

In 2019, Ofcom conducted several enforcement investigations into the company. In November 2019, Ofcom found that we had not breached our statutory duty to take appropriate measures to protect our network, in relation to the December 2018 network outage.

FCA

O2 continues to maintain a strong relationship with the FCA. We report on various metrics such as finance and complaints which are shared on a quarterly basis. The complaints is published on our website [here](#). We engaged with the FCA on the implementation of the Senior Managers Review Framework which came into force on 9 December 2019. There were no FCA determinations against us.

ICO

The ICO is the UK's independent body set up to uphold information rights. The Executive Leadership Team monitors regulatory complaints, personal data breaches and any regulatory sanctions. We seek a constructive engagement with the regulator in all areas and take appropriate remediation actions to drive continuous improvement in support of our customer led strategy.

We engage with ICO to foster a constructive relationship with the regulator in support of our business strategy. We engage in a range of ways including consultations, industry initiatives and day to day contact. In 2019 we responded to ICO's Consultation on "Age appropriate design: a code of practice for online services" and on "The accountability toolkit".

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement (continued)

Government

We work with the Government to help secure a more progressive and favourable policy environment for our business priorities. We have regular meetings and written correspondence, either through the Public Affairs team, or directly with the CEO and issues that matter to the Business and our Customers. An example negotiating and securing the Single Rural Network.. Give a description of how we influenced the government decision – with Paul James.

Analysts and Media

We engage with analysts and the media to increase understanding and perceptions of our business externally. Launching our 5G service in October generated over 500 pieces of coverage across all types of media outlets including broadcast. We also secured extensive press coverage when we announced we had increased paternity leave to 14 weeks for all permanent employees, acknowledging the importance of sharing and caring responsibilities and flexible working as part of our employee benefits. Many pieces highlighted that the policy is one of the best available in the retail sector.

Suppliers

Every year O2 spends a significant amount with its supply base in order to meet our bought in requirements for goods and services. It's important that we purchase the correct quality and the best price from those suppliers to meet our requirements.

Our default position is to purchase through competitive Request For Proposals wherever possible and in-line with our Group's model. This ensures interaction with potential vendor base that is larger than just existing suppliers.

The Supplier relationship management covers Service Level Agreement compliance, continuous improvement, risk management, innovation, and commercials. All suppliers are managed within a governance framework, according to their tiering. For example, we have monthly service reviews, quarterly relationship meetings and bi-annual executive strategic discussions.

As a business certified to ISO 44001 Collaborative Business Relationships Management, we have identified specific supply areas where we want a collaborative relationship and we work with such suppliers. Within a formal relationship management model design to maximise the value of the relationship to both parties and optimise our collective performance in support of the end customers. As part of the Telefonica group we routinely survey our Suppliers to understand their experience of doing business with Telefonica. Additionally we carry out local relationship reviews where we review and optimise our working relationship.

We share our sustainability requirements with suppliers and, via contractual terms, commit our suppliers and their extended supply chain to align to them. For example, our procurement goal is to manage and minimise emissions in our supply chain. To this end we contractually require suppliers to have active carbon reduction programmes and we have contractually agreed programmes (as independently assessed by the Carbon Trust) with 20% of our supply chain emission sources.

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Principle Six: Stakeholder Relationship and Engagement (continued)

Suppliers (continued)

Additionally we also collaborate via the Joint Audit Cooperation (JAC) an Memorandum of Understanding between other mobile operators to assess suppliers in our common supply chains against a synthesis of our collective ethical codes. It's an initiative that we have participated in for many years. Each year we collectively assess approximately 100 suppliers in our common supply chains. In the 2019 campaign we have:

- driven 20 x JAC Academy audits by our suppliers to our audit standard
- conducted 20 x surveys of workers in our collective supply chains
- driven 93 x JAC audits collectively

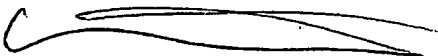
We prohibit all forms of forced labour by our suppliers. Following government guidelines, we identify 'at risk' areas of our supply chain and engage with those suppliers to assess how they manage Modern slavery risk. This happens as part of our general management of human rights in the supply chain. A full explanation of

our approach to managing Modern slavery risks can be found in the our Modern Slavery Statement published annually on the Company's website.

During 2019 we strengthened our management of suppliers involved in work that falls under the Construction Design Management (CDM) Regulations and other safety critical activities. Such suppliers must now have Safe Contractor Safety Scheme in Procurement accreditation. You can see the suppliers involved in different activities in our non-financial report.

The Corporate Governance Statement was approved by the Board on 24 June 2020

By Order of the Board



Vivienne Aziba
For and on behalf of O2 Secretaries Limited
Company Secretary

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare such financial statements for each financial year. Under that law the directors have elected to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing the financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements;
- make judgements and accounting estimates that are reasonable and prudent; 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 adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006.

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.

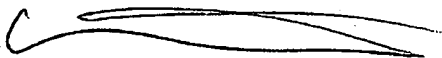
The directors are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

In the case of each director in office at the date the Directors' Report is approved:

- so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
- they have taken all the steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

The Statement of Directors' responsibilities was approved by the Board on 24 June 2020

By Order of the Board



Vivienne Aziba
For and on behalf of O2 Secretaries Limited
Company Secretary

Independent auditors' report to the members of O2 Holdings Limited

Report on the audit of the financial statements

Opinion

In our opinion, O2 Holdings Limited's group financial statements and company financial statements (the "financial statements"):

- give a true and fair view of the state of the group's and of the company's affairs as at 31 December 2019 and of the group's profit and the group's and the company's cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies 2006.

We have audited the financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), which comprise: the group and parent company statement of financial position as at 31 December 2019; the group statement of comprehensive income, the group and company statement of cash flows, and the group and company statement of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the group's and company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the group's and company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

Independent auditors' report to the members of O2 Holdings Limited

Reporting on other information (continued)

With respect to the Strategic Report and Directors' Report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2019 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the group and company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of Directors' responsibilities set out on page 47, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the group's and the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Independent auditors' report to the members of O2 Holdings Limited

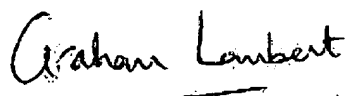
Other required reporting

Companies Act 2006 exception reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.



Graham Lambert (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Uxbridge
26 June 2020

Group statement of comprehensive income
For the year ended 31 December 2019

| | Note | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|------|--------------------------------------|--------------------------------------|
| Revenue | 6 | 6,235 | 6,007 |
| Operating costs | 6 | (5,262) | (5,134) |
| Net impairment losses on financial and contract assets | 6 | (149) | (89) |
| Operating profit | 6 | 824 | 784 |
| Share of profit of joint ventures | 19 | 1 | 1 |
| Financial income | 10 | 18 | 7 |
| Financial costs | 10 | (34) | (26) |
| Profit before taxation | | 809 | 766 |
| Taxation expense | 11 | (168) | (137) |
| Profit for the year | | 641 | 629 |
| Other comprehensive loss | | | |
| <i>Items that will not be reclassified to profit or loss:</i> | | | |
| Actuarial loss on retirement benefit obligations | 33 | (59) | - |
| Income tax related to other comprehensive loss | 25 | 6 | - |
| Other comprehensive loss for the year | | (53) | - |
| Total comprehensive income for the year attributable to equity holders | | 588 | 629 |

The accompanying notes on pages 55 to 109 are an integral part of these financial statements.

Group and Company statement of financial position
As at 31 December 2019

| | | Group | | Company | |
|--|------|---------------------|---------------------|---------------------|---------------------|
| | | 31 December 2019 | 31 December 2018 | 31 December 2019 | 31 December 2018 |
| | Note | £m | £m | £m | £m |
| Non-current assets | | | | | |
| Property, plant and equipment | 13 | 2,828 | 2,678 | - | - |
| Right of use assets | 14 | 612 | - | - | - |
| Intangible assets | 15 | 1,367 | 1,518 | - | - |
| Goodwill | 16 | 2,377 | 2,377 | - | - |
| Investment in subsidiary undertakings | 18 | - | - | 9,181 | 9,181 |
| Trade and other receivables | 21 | 341 | 237 | - | - |
| Other financial assets | 22 | 57 | 12 | - | - |
| Retirement benefit asset | 33 | - | 19 | - | - |
| Investment in joint venture | 19 | 8 | 7 | - | - |
| Deferred tax assets | 25 | 7 | - | 1 | 1 |
| | | 7,597 | 6,848 | 9,182 | 9,182 |
| Current assets | | | | | |
| Inventories | 20 | 125 | 98 | - | - |
| Trade and other receivables | 21 | 1,714 | 1,885 | 30 | 44 |
| Other financial assets | 22 | 61 | 71 | 2 | 72 |
| Cash and cash equivalents | 30 | 305 | 315 | 27 | 25 |
| | | 2,205 | 2,369 | 59 | 141 |
| Current liabilities | | | | | |
| Lease liabilities | 24 | (186) | - | - | - |
| Trade and other payables | 26 | (2,634) | (2,712) | (83) | (95) |
| Current tax liabilities | | (73) | (139) | - | - |
| Provisions | 27 | (37) | (15) | - | - |
| | | (2,930) | (2,866) | (83) | (95) |
| Net current (liabilities)/assets | | (725) | (497) | (24) | 46 |
| Total assets less current liabilities | | 6,872 | 6,351 | 9,158 | 9,228 |
| Non-current liabilities | | | | | |
| Borrowings | 23 | (964) | (964) | - | - |
| Lease liabilities | 24 | (417) | - | - | - |
| Trade and other payables | 26 | (233) | (206) | - | - |
| Retirement benefit obligations | 33 | (16) | - | (4) | (4) |
| Deferred tax liabilities | 25 | (52) | (37) | - | - |
| Provisions | 27 | (73) | (65) | - | - |
| | | (1,755) | (1,272) | (4) | (4) |
| Net assets | | 5,117 | 5,079 | 9,154 | 9,224 |
| Equity | | | | | |
| Share capital | 29 | 12 | 12 | 12 | 12 |
| Capital reserve | 29 | 23 | 23 | - | - |
| Retained earnings | | 5,082 | 5,044 | 9,142 | 9,212 |
| Total equity attributable to equity holders | | 5,117 | 5,079 | 9,154 | 9,224 |

The Company reported a profit for the year ended 31 December 2019 of £480 million (2018: £Nil).

The accompanying notes on pages 55 to 109 are an integral part of these financial statements. The financial statements on pages 51 to 109 were approved by the Board of Directors and authorised for issue on 24 June 2020. They were signed on its behalf by:



Mark Evans
 Director

Group and Company statement of changes in equity
For the year ended 31 December 2019

| | Share capital (Note 29) £m | Group Capital reserve (Note 29) £m | Retained earnings £m | Total equity £m | Share capital (Note 29) £m | Company Retained earnings £m | Total equity £m |
|--|-------------------------------------|--|----------------------------|-----------------------|-------------------------------------|---------------------------------------|-----------------------|
| At 1 January 2018 | 12 | - | 4,525 | 4,537 | 12 | 9,322 | 9,334 |
| Profit for the year | - | - | 629 | 629 | - | - | - |
| Total comprehensive income for the year | - | - | 629 | 629 | - | - | - |
| Capital contribution | - | 23 | - | 23 | - | - | - |
| Dividends paid (Note 12) | - | - | (110) | (110) | - | (110) | (110) |
| At 31 December 2018 | 12 | 23 | 5,044 | 5,079 | 12 | 9,212 | 9,224 |
| Profit for the year | - | - | 641 | 641 | - | 480 | 480 |
| Other comprehensive loss | - | - | (53) | (53) | - | - | - |
| Total comprehensive income for the year | - | - | 588 | 588 | - | 480 | 480 |
| Dividends paid (Note 12) | - | - | (550) | (550) | - | (550) | (550) |
| At 31 December 2019 | 12 | 23 | 5,082 | 5,117 | 12 | 9,142 | 9,154 |

The accompanying notes on pages 55 to 109 are an integral part of these financial statements.

Group and Company statement of cash flows
For the year ended 31 December 2019

| | | Group | | Company | |
|---|------|---|---|---|---|
| | | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
| | Note | | | | |
| Net cash inflow/(outflow) from operating activities | 30 | 1,678 | 1,359 | 2 | (54) |
| Purchase of property, plant and equipment & intangible assets | | (904) | (1,277) | - | - |
| Increase in other financial assets | | (35) | (60) | - | - |
| Proceeds from settlement of other financial assets | | - | - | 70 | 170 |
| Share subscription in subsidiary entity | | - | - | - | (10) |
| Dividends received | | - | - | 480 | - |
| Net cash (outflow)/inflow from investing activities | | (939) | (1,337) | 550 | 160 |
| Repayment of borrowings | | - | (265) | - | - |
| Proceeds from borrowings | | - | 524 | - | - |
| Principal elements of lease payments | | (164) | - | - | - |
| Lease interest paid | | (14) | - | - | - |
| Other interest paid | | (21) | (28) | - | (7) |
| Dividends paid | 12 | (550) | (110) | (550) | (110) |
| Net cash (outflow)/inflow from financing activities | | (749) | 121 | (550) | (117) |
| Net (decrease)/increase in cash and cash equivalents | | (10) | 143 | 2 | (11) |
| Cash and cash equivalents at beginning of period | | 315 | 172 | 25 | 36 |
| Cash and cash equivalents at end of period | | 305 | 315 | 27 | 25 |

The accompanying notes on pages 55 to 109 are an integral part of these financial statements.

**Notes to the financial statements
For the year ended 31 December 2019****1. General information**

O2 Holdings Limited and its subsidiaries and investees ("O2 Holdings", "the Company", the "O2 Group" or "the Group") is a private company limited by shares and domiciled in the United Kingdom. It is incorporated under the Companies Act 2006 and registered in England and Wales under the number 02604354. The address of the Company's registered office is 260 Bath Road, Slough, Berkshire SL1 4DX. The principal activity of the Group is the operation of a cellular communications network using spectrum held under licences granted in 1994, 2001, 2013 and 2018 to provide mobile communications services to its customers under the "O2" and "giffgaff" brands.

Telefónica, S.A. and its subsidiaries and investees ("Telefónica Group"), is the ultimate parent company of the Group and is a public limited company incorporated on April 19, 1924. Its registered office is at Gran Vía 28, Madrid, Spain.

The functional currency of O2 Holdings Limited is considered to be pounds sterling because that is the currency of the primary economic environment in which the Group operates. The consolidated financial statements are also presented in pounds sterling.

2. Changes in accounting policies and disclosures**2.1 New and amended standards adopted by the Group**

The Group has applied the following standards and amendments for the first time for the annual reporting period commencing 1 January 2019:

IFRS 16 Leases

On 1 January 2019 the new IFRS 16 Leases accounting standard became effective, resulting in changes in the accounting policies applied in prior periods.

The standard sets out the requirements for recognising right of use assets and lease liabilities. The Group has adopted IFRS 16 using one of two transition methods: the modified retrospective transition method, with the cumulative effect from initial application recognised as an adjustment to the opening balance of retained earnings at the date of initial application, 1 January 2019. Accordingly, the 2018 information presented for comparative purposes has not been restated i.e. it is prepared and presented in accordance with the accounting standards effective during that period: under IAS 17 Leases and related interpretations.

Under the provisions in IFRS 16, it is possible to elect to apply certain practical expedients to reduce complexity in the application of the new requirements. The main practical expedients applied by the Group are:

- Lease assessment: the Group did not reassess whether a contract is or contains a lease on the date of initial application of IFRS 16 for all contracts identified as leases under previous accounting standards.
- Right of use asset measurement: for a vast majority of leases previously classified as an operating lease the Group recognised a right of use asset at the date of initial application measured at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.
- Discount rates: the Group applies a single discount rate to a portfolio of leases with reasonably similar characteristics such as lease term, class of underlying asset, currency and economic environment.
- Initial direct costs: the Group excluded initial direct costs from the measurement of the right of use asset at the date of initial application.

The Group did not need to make any adjustments to the accounting for assets held as lessor under operating leases as a result of the adoption of IFRS 16.

Notes to the financial statements

For the year ended 31 December 2019

2. Changes in accounting policies and disclosures (continued)

2.1 New and amended standards adopted by the Group (continued)

IFRS 16 Leases (continued)

The details of the new significant accounting policies and the nature of the main changes to previous accounting policies in relation to lease accounting under the new model in IFRS 16 are set out in Note 3. The most significant impacts relate to the first-time recognition of right of use assets and lease liabilities; reduction in operating lease rental expenses in profit and loss; increase in lease interest expense and right of use depreciation charges in profit and loss. The most significant impact on cash flows is the reclassification of lease principal and interest payments to financing activities that were previously classified as lease rental payments in operating activities.

The impacts of adopting IFRS 16 on the Group's financial statements for the year ended 31 December 2019 are set out below:

Income statement

| | 31 December 2019 IFRS 16 £m | 31 December 2019 IAS 17 £m | 31 December 2019 IFRS 16 impact £m |
|--|--------------------------------------|-------------------------------------|---|
| Revenue | 6,235 | 6,235 | - |
| Operating costs before right of use depreciation | (5,081) | (5,272) | 191 (a) |
| Right of use depreciation | (181) | - | (181) (b) |
| Total operating costs | (5,262) | (5,272) | 10 |
| Net impairment losses on financial and contract assets | (149) | (149) | - |
| Operating profit | 824 | 814 | 10 |
| Share of profit of joint ventures | 1 | 1 | - |
| Financial income | 18 | 18 | - |
| Financial costs | (34) | (20) | (14) (c) |
| Profit before taxation | 809 | 813 | (4) |
| Taxation | (168) | (168) | - |
| Profit for the year | 641 | 645 | (4) |

(a) The decrease in operating costs is driven by a reduction in lease expenses as these have been replaced by depreciation of right of use assets and interest costs on lease obligations.

(b) The increase in right of use depreciation expense is related to the recognition of new right of use assets that are depreciated over the lease term.

(c) The increase in lease interest expense is related to interest on recognition of lease obligations.

Statement of financial position

| | 31 December 2019 IFRS 16 £m | 31 December 2019 IAS 17 £m | 31 December 2019 IFRS 16 impact £m |
|-------------------------------|-----------------------------------|----------------------------------|--|
| Non-current assets | | | |
| Property, plant and equipment | 2,828 | 2,828 | - |
| Right of use assets | 612 | - | 612 (d) |
| Intangible assets | 1,367 | 1,367 | - |
| Goodwill | 2,377 | 2,377 | - |
| Investments | 8 | 8 | - |
| Trade and other receivables | 341 | 341 | - |
| Other financial assets | 57 | 57 | - |
| Deferred tax assets | 7 | 7 | - |
| | 7,597 | 6,985 | 612 |

Notes to the financial statements
For the year ended 31 December 2019

2. Changes in accounting policies and disclosures (continued)

2.1 New and amended standards adopted by the Group (continued)

IFRS 16 Leases (continued)

Statement of financial position (continued)

| | 31 December 2019 IFRS 16 £m | 31 December 2019 IAS 17 £m | 31 December 2019 IFRS 16 impact £m |
|--|-----------------------------------|----------------------------------|--|
| Current assets | | | |
| Inventories | 125 | 125 | - |
| Trade and other receivables | 1,714 | 1,722 | (8) (e) |
| Other financial assets | 61 | 61 | - |
| Cash and cash equivalents | 305 | 305 | - |
| | 2,205 | 2,213 | (8) |
| Current liabilities | | | |
| Lease liabilities | (186) | - | (186) (f) |
| Trade and other payables | (2,634) | (2,627) | (7) (e) |
| Current tax liabilities | (73) | (73) | - |
| Provisions | (37) | (39) | 2 (g) |
| | (2,930) | (2,739) | (191) |
| Net current liabilities | (725) | (526) | (199) |
| Total assets less current liabilities | 6,872 | 6,459 | 413 |
| Non-current liabilities | | | |
| Borrowings | (964) | (964) | - |
| Lease liabilities | (417) | - | (417) (f) |
| Trade and other payables | (233) | (233) | - |
| Deferred tax liabilities | (52) | (52) | - |
| Retirement benefit obligation | (16) | (16) | - |
| Provisions | (73) | (73) | - |
| | (1,755) | (1,338) | (417) |
| Net assets | 5,117 | 5,121 | (4) |
| Equity | | | |
| Ordinary share capital | 12 | 12 | - |
| Capital reserve | 23 | 23 | - |
| Retained earnings | 5,082 | 5,086 | (4) |
| Total equity | 5,117 | 5,121 | (4) |

(d) The right of use assets reflect the contractual right to use assets over a period of time in exchange for consideration.

(e) The decrease in trade and other receivables and increase in trade and other payables is primarily driven by timing differences between when lease payments are made and interest charges are applied.

(f) The increase in lease liabilities relates to the recognition of the present value of lease payments due on right of use assets held.

(g) The decrease in provisions relates to certain leased properties that would have been recognised as onerous leases under previous accounting standards but under IFRS 16 the liability was already recognised within lease liabilities.

Notes to the financial statements

For the year ended 31 December 2019

2. Changes in accounting policies and disclosures (continued)

2.1 New and amended standards adopted by the Group (continued)

IFRS 16 Leases (continued)

Adjustment on initial application of new reporting standard IFRS 16

The initial application of new reporting standard IFRS 16 Leases had an impact on the Group statement of financial position as follows:

| At 1 January 2019 | £m |
|---------------------------------|--------------|
| Non-current right of use assets | 740 |
| Current prepayments | (33) |
| Total assets | 707 |
| Non-current lease liabilities | (528) |
| Current lease liabilities | (179) |
| Total liabilities | (707) |
| Impact in equity | |

The operating lease commitments disclosed as at 31 December 2018 have been reconciled to the opening lease liabilities recognised as follows:

| At 1 January 2019 | £m |
|---|------------|
| Operating lease commitments disclosed as at 31 December 2018 | 515 |
| Adjustments as a result of a different treatment of extension and termination options | 168 |
| Leases without cancellation cost | 73 |
| Discounting using the incremental rate of borrowing rate at the date of initial application | (49) |
| Lease liability recognised as at 1 January 2019 | 707 |

The weighted average incremental borrowing rate applied to lease liabilities recognised in the statement of financial position at the date of initial application was 2.21% for leases relating to our joint arrangement with Cornerstone Telecommunications Infrastructure Limited and 1.99% for all other leases.

2.2 New standards and interpretations not yet adopted

Certain new accounting standards and interpretations have been published that are not mandatory for 31 December 2019 reporting periods and have not been early adopted by the Group. Those that are expected to have an impact on the Group are set out below.

Definition of Material – amendments to IAS 1 and IAS 8

The IASB has made amendments to IAS 1 Presentation of Financial Statements and IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors which use a consistent definition of materiality throughout International Financial Reporting Standards and the Conceptual Framework for Financial Reporting, clarify when information is material and incorporate some of the guidance in IAS 1 about immaterial information.

In particular, the amendments clarify:

- that the reference to obscuring information addresses situations in which the effect is similar to omitting or misstating that information, and that an entity assesses materiality in the context of the financial statements as a whole, and
- the meaning of 'primary users of general purpose financial statements' to whom those financial statements are directed, by defining them as 'existing and potential investors, lenders and other creditors' that must rely on general purpose financial statements for much of the financial information they need.

The Company does not expect the change in definition of Material to significantly impact the financial statements however the change in definition is relevant to the user of the financial statements.

Notes to the financial statements

For the year ended 31 December 2019

2. Changes in accounting policies and disclosures (continued)

2.2 New standards and interpretations not yet adopted (continued)

Definition of a Business – amendments to IFRS 3

The amended definition of a business requires an acquisition to include an input and a substantive process that together significantly contribute to the ability to create outputs. The definition of the term 'outputs' is amended to focus on goods and services provided to customers, generating investment income and other income, and it excludes returns in the form of lower costs and other economic benefits. The amendments will likely result in more acquisitions being accounted for as asset acquisitions.

Sale or contribution of assets between an investor and its associate or joint venture - amendments to IFRS 10 and IAS 28

The IASB has made limited scope amendments to IFRS 10 Consolidated financial statements and IAS 28 Investments in associates and joint ventures.

The amendments clarify the accounting treatment for sales or contribution of assets between an investor and its associates or joint ventures. They confirm that the accounting treatment depends on whether the non-monetary assets sold or contributed to an associate or joint venture constitute a 'business' (as defined in IFRS 3 Business Combinations).

Where the non-monetary assets constitute a business, the investor will recognise the full gain or loss on the sale or contribution of assets. If the assets do not meet the definition of a business, the gain or loss is recognised by the investor only to the extent of the other investor's interests in the associate or joint venture. The amendments apply prospectively.

3. Significant accounting policies

3.1 Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and International Financial Reporting Standards Interpretations Committee ("IFRS IC") 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 2006 applicable to companies reporting under IFRS.

The financial statements have been prepared using historical cost principles, except for the following:

- Certain trade receivables held to sell – measured at fair value through profit or loss
- Defined benefit pension plan – measured at fair value of plan assets

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

The Company has elected to take the exemption under section 408 of the Companies Act 2006 not to present an individual Company statement of comprehensive income.

The Directors have reviewed the business plan for the period to 31 December 2021, and together with the commitment received from the ultimate parent company to continue providing financial support and on this basis have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future and thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

The impact to the Company from COVID-19 is described in detail on pages 30 to 32. The Company has shown resilience throughout this turbulent period and the need for connectivity by our customers has been just as strong. The impact to the Company has been modest considering the challenges faced across the global economy. In light of this, the Directors believe that the Company is well placed to continue to mitigate the impacts of COVID-19 during 2020 and beyond.

Notes to the financial statements

For the year ended 31 December 2019

3. Significant accounting policies (continued)

3.2 Presentation of financial information

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

3.3 Basis of group accounting

The consolidated financial statements comprise the financial statements of the Company, its subsidiaries and its share of jointly controlled entities as at 31 December 2019.

Subsidiaries

Subsidiaries are all entities over which the Group has control. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- Power over the investee (i.e., existing rights that give it the current ability to direct the relevant activities of the investee);
- Exposure, or rights, to variable returns from its involvement with the investee; and
- The ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting right result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including:

- The contractual arrangement with the other vote holders of the investee;
- Rights arising from other contractual arrangements; or
- The Group's voting rights and potential voting rights

The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control. Consolidation of a subsidiary begins when the Group obtains control over the subsidiary and ceases when the Group loses control of the subsidiary. Assets, liabilities, income and expenses of a subsidiary acquired or disposed of during the year are included in the consolidated financial statements from the date the Group gains control until the date the Group ceases to control of the subsidiary.

The financial statements of all subsidiaries are included in the consolidated financial statements from the date when control commences until control ceases. All principal subsidiary undertakings' financial years are co-terminus with those of O2 Holdings Limited.

3.4 Joint arrangements

IFRS 11 establishes principles for the financial reporting of parties to joint arrangements. It defines joint control as the contractually agreed sharing of control of an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control. Joint arrangements that meet the definition of a joint venture are accounted for using the equity method, while joint arrangements that meet the definition of joint operations are accounted for by integrating assets and liabilities, and the related revenues and expenses, in proportion to the joint operator's interest in the arrangement.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.4 Joint arrangements (continued)*****Joint operations***

Upon adoption of IFRS 11 in 2014, the Group determined its interests in Cornerstone Telecommunications Infrastructure Limited, which is engaged in maintaining and managing the non-radio (passive) assets supporting the mobile wireless network of Vodafone Limited and Telefonica UK Limited, and in Digital Mobile Spectrum Limited, which is engaged in the provision of services in relation to spectrum auction obligations, to be classified as joint operations. These are accounted for as joint operations by recognising the assets and liabilities and the related revenues, expenses and share of commitments in proportion to the Group's contribution to and participation in the joint operations.

Joint venture

The Group determined its interests in Tesco Mobile Limited to be classified as a joint venture. Under the equity method, the investment in an associate or a joint venture is initially recognised at cost. The carrying amount of the investment is adjusted to recognise changes in the Group's share of net assets of the associate or joint venture since the acquisition date. The statement of comprehensive income reflects the Group's share of the results of operations of the associate or joint venture. Note 19 includes details of the Group's joint ventures.

3.5 Transactions eliminated on consolidation

Intra-group balances and transactions are eliminated in preparing the consolidated financial statements.

3.6 Foreign currencies

The individual financial statements of each Group company are presented in the currency of the primary economic environment in which it operates (its functional currency). For the purpose of the consolidated financial statements, the results and financial position of each group company are expressed in pounds sterling, which is the functional currency of the Company, and the presentation currency for the consolidated financial statements.

In preparing the financial statements, transactions in currencies other than the functional currency are recorded at the rates of exchange prevailing on the dates of the transactions. At each reporting date, the monetary assets and liabilities that are denominated in foreign currencies are retranslated at rates prevailing at each reporting date. Non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences arising on the settlement of monetary items, and on the retranslation of monetary items, are included in the profit or loss for the period. Exchange differences arising on the retranslation of non-monetary items carried at fair value are included in profit or loss of the period except for differences arising on the retranslation of non-monetary items in respect of which gains and losses are recognised directly in equity.

On consolidation, the assets and liabilities of the Group's overseas operations are translated at the closing exchange rates on the balance sheet date. Income and expense items are translated at the average rates for the period. Exchange differences arising from the average or actual exchange rates used at the period end date, if any, are classified as equity and transferred to the Group's translation reserve. Such translation differences are recognised as income or as expenses in the period in which the operation is disposed of.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.7 Revenue from contracts with customers**

Revenue, which excludes value added tax and other sales taxes, comprises mobile service revenue and hardware and other revenue (each as described in more detail below).

Mobile service revenue includes revenue earned for usage of the Group's wireless network for voice, text message and data transmission by the Group's customers, subscription fees (including those earned from the Group's MVNO partners), inbound roaming (earned from foreign mobile operators whose customers roam onto the Group's network), outbound roaming (earned from the Group's customers roaming outside their domestic coverage area) and interconnect revenue (earned from other telecommunication operators whose customers terminate calls on the Group's network).

Hardware revenue principally consists of revenue from the sale of mobile devices, including smartphones and other mobile handsets sold through the Group's direct distribution channels under the Refresh proposition, where hardware is recognised as a separate performance obligation, as well as the sale of tablets, smart-tech (e.g. smart watches and fitness devices) and accessories (e.g. mobile phone cases, screen protectors, chargers, cables, portable batteries, headphones and speakers). Hardware revenue is recognised when the products are delivered to the customer. Hardware billing will typically include an upfront amount and the remaining payments are spread over the contract term. Where the implied financing element of these payments is significant when compared with the other performance obligations in the contract, a portion of the revenue is allocated to significant financing and is charged to the profit and loss as interest costs over the term of the contract.

Other revenue principally consists of revenue from the Group's integrated mobile, Wi-Fi and fixed-line offerings to business customers and related business offerings and insurance sales. These revenues are recognised on the provision of both goods and services, with revenue recognition on delivery of each separate performance obligation.

Under IFRS 15, for bundled packages that combine mobile service, hardware and other revenue, the total revenue is allocated to each performance obligation based on their standalone selling prices in relation to the total consideration of the package and is recognised when (or as) the obligation is satisfied, regardless of whether there are undelivered items. Consequently, when bundles include a price difference on equipment, the adoption of these new requirements results in an increase of revenues recognised from the sale of handsets and other equipment, generally recognised upon delivery to the end customer, offset by a reduction of ongoing service revenue over subsequent periods. To the extent that the packages are marketed at a price difference, the difference between the revenue from the sale of equipment and the consideration received from the customer upfront is recognised as a contract asset on the statement of financial position and amortised over the term of the contract.

Under IAS 18 Revenue, which was the revenue standard adopted in the year ended 31 December 2017 prior to the adoption of IFRS 15, the portion of the total consideration that was contingent upon delivery of undelivered elements was not allocated to delivered elements.

IFRS 15 requires the recognition of an asset for those incremental costs (sales commissions and other third party acquisition costs) directly related to obtaining a contract and that are expected to be recovered. These are subsequently amortised over the same period as the revenue associated with such asset. Costs to obtain a contract are expensed when incurred if the Group estimates that their amortisation period is one year or less.

3.8 Operating costs

Operating costs principally include costs of acquiring, retaining and servicing customers, network and non-network accommodation costs in relation to the Group's properties, network maintenance costs, IT and system support costs and marketing costs. Marketing costs comprising advertising, promotion, sponsorship and communication are also expensed as incurred.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.9 Staff costs**

Staff costs comprise wages and salaries and related direct employment costs for permanent employees.

3.10 Employee benefits**Retirement benefit obligations**

Telefonica UK Limited, a subsidiary of the Company, operates both defined benefit and defined contribution plans. 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 Telefónica UK Pension Plan ("Plan"), which provides benefits for the majority of UK employees in the UK Group. During the period presented, the Plan had the following defined benefit and defined contribution schemes:

- The defined benefit scheme of the Telefónica UK Pension Plan;
- The defined contribution scheme of the Telefónica UK Pension Plan; and
- The UK defined benefit Unfunded Plan.

On 28 February 2013 the defined benefit scheme of the Plan closed to further benefit accrual. Member benefits of the defined benefit scheme of the Plan will continue to be increased in deferment by reference to the Consumer Prices Index (see Note 33), but will not retain the link to any future increases in salary. Upon closure, members of the defined benefit scheme of the Plan were given the option to become members of the defined contribution scheme of the Plan. The defined contribution scheme of the Plan remains open to new entrants and further accrual. The assets of the Plan are held independently of the Company's finances.

In its capacity as a participating employer in the defined contribution scheme of the Plan, the Group pays contributions into the Plan on behalf of the employees. The Group has no further obligations once the contributions have been paid. The contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) (the Company's ultimate UK parent company) acted as Sponsor and Principal Employer of the Plan up to 14 December 2018. On this date a deed was signed by the trustees to transfer the plan into the Company as the majority of employees participating in the plan are employees of the Company. The transfer was made via a capital contribution from Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) for £23.1 million, being the net asset position of the plan on the transfer date. The corresponding net asset was recorded on the Group statement of financial position. The Company recognises only the unfunded defined benefit liability on its statement of financial position, as the unfunded scheme is exclusively related to the Company.

The asset or liability recognised in the statement of financial position in respect of defined benefit pension plan is the present value of the defined benefit obligation at the statement of financial position date less the fair value of the plan assets. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

Accordingly all actuarial gains and losses are recognised in the statement of comprehensive income and expense in the period in which they arise.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.10 Employee benefits (continued)****Share-based payments**

The Group recognises an expense for share awards and share options, which are equity settled, based on the fair value of the share awards or share options granted as compensation for the services rendered by employees. The fair value is calculated at the grant date using an adjusted statistical model and excludes the impact of non-market conditions. Instead, the expense is adjusted for the effect of non-market conditions at each reporting date through the number of share awards or share options expected to be exercisable.

The effect of market and non-vesting conditions is included in the fair value at the date of grant and is recognised as an expense in employee costs irrespective of whether the market or non-vesting condition is satisfied. Telefónica S.A. recharges the Group for the cost of share schemes and therefore the share-based transaction is not settled in the Group's equity instruments.

3.11 Financial income and expense

Financial income principally consists of interest income on Group deposits and gains arising from foreign exchange rate hedging instruments. Financial expense principally consists of interest expense on Group borrowings and losses arising from foreign exchange rate hedging instruments. The Group utilises foreign exchange rate hedging instruments to hedge foreign exchange rate exposure principally in respect of Euro and US dollar payments with regard to roaming agreements and not for speculative purposes.

3.12 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 statement of financial position liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated 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, except where the timing of the reversal of the temporary difference is controlled by the Group 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 substantively enacted 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 in other comprehensive income or in equity is also recognised directly in other comprehensive income or in equity respectively.

3.13 Dividends

Interim dividend distributions are recognised in the period in which they are paid. Final dividend distributions to the Company's shareholders are recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's Board. Income is recognised when the company's rights to receive the payment is established. Dividends received from subsidiary companies are recognised as finance income in the Company's financial statements in the period in which the dividends are received.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.14 Leases**

The Group adopted the following IFRS 16 Leases accounting policies from 1 January 2019.

Adoption of IFRS 16 has resulted in almost all leases being recognised in the statement of financial position, since the distinction between operating and finance leases is removed for lessee accounting. Under the new standard, an asset (that is, the right to use the leased item) and a financial liability to pay rentals are recognised. The Group has elected not to apply the general requirements to short-term leases and leases of low-value assets. The Group has also elected not to recognise non-lease components separately from lease components for those classes of assets in which non-lease components are not significant with respect to the total value of the arrangement.

The Group acts as a lessee on a large number of lease agreements. These include leases of third party mobile masts (towers), circuits, office buildings and stores and land where towers are located. These contracts were generally accounted for as operating leases under previous accounting standards, with lease payments being recognised on a straight-line basis as an expense in the income statement over the contract term.

Right of use assets are initially recognised at the initial measurement of lease liabilities plus any lease payments made at or before the commencement date; less any lease incentives received; plus any initial direct costs incurred and an estimate of costs to be incurred in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease.

Right of use assets are subsequently measured using the cost model by charging depreciation to profit and loss over the term of the lease and adjusting for any remeasurement of the lease liability or impairment of the asset.

Lease liabilities are initially measured at the present value of the lease payments that are not paid at the commencement date, discounted by interest rate implicit in the lease if it can be readily determined, or the incremental borrowing rate of interest required to finance the expected payments during the lease term. Lease payments included in initial measurement comprise fixed payments, less any incentives receivable; variable lease payments that depend on an index or rate; amounts expected to be paid under residual value guarantees; the exercise price of a purchase option if the Group is reasonably certain to exercise that option and payments for penalties for terminating the lease, if the lease term reflects the Group exercising an option to terminate the lease.

The Group determines the lease term as the non-cancellable term of the contract, together with any period covered by an extension (or termination) option whose exercise is discretionary for the Group, if there is reasonable certainty that it will be exercised (or it will not be exercised). In its assessment, the Group considers all available information by asset class in the industry and evaluates all relevant factors (technology, regulation, competition, business model) that create an economic incentive to exercise or not a renewal/cancellation option. In particular, the Group takes into consideration the time horizon of the strategic planning of its operations. After the commencement date, the Group reassesses the lease term if there is a significant event or change in circumstances that is within its control that may affect its ability to exercise (or not to exercise) an option to extend or terminate (for example, a change in business strategy).

Lease liabilities are subsequently measured by increasing the carrying amount to reflect interest on the lease liability; reducing the carrying amount to reflect the lease payments made; and remeasuring the carrying amount to reflect any reassessment or lease modifications. Interest will be charged to profit and loss.

Information on the impact of initial application of IFRS 16 is disclosed in Note 2.

Notes to the financial statements

For the year ended 31 December 2019

3. Significant accounting policies (continued)

3.15 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 Group and the cost of the item can be measured reliably.

Depreciation is provided on property, plant and equipment from the date they are available for use over their estimated useful lives on a straight-line basis.

The lives assigned to property, plant and equipment are:

| | |
|--------------------------------|---|
| Land and buildings | |
| Freehold Buildings | 40 years |
| Leasehold buildings | Unexpired portion of lease or 40 years whichever is the shorter |
| Plant and equipment | |
| Network assets | 5 to 20 years |
| Computers and office equipment | 2 to 5 years |

The assets' useful lives and residual values are reviewed, and adjusted if appropriate, at each statement of financial position date. No depreciation is provided on freehold land or assets in the course of construction.

An item of property, plant and equipment and any significant part initially recognised is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on de-recognition of the asset (calculated as the difference between net disposal proceeds and the carrying amount of the asset) is included in the statement of comprehensive income when the asset is derecognised.

Property, plant and equipment not in use are classified as assets in the course of construction and will not be depreciated. Once they are available for use they will be reclassified to the relevant category of property, plant and equipment and will be depreciated in line with the above accounting policy.

3.16 Intangible assets

Goodwill

Goodwill, arising from the purchase of subsidiaries, represents the excess of the cost of acquisition over the fair value of the Group's share of the net identifiable assets, liabilities and contingent liabilities acquired at the date of acquisition.

After initial recognition, goodwill is carried at cost, less any accumulated impairment losses. Goodwill is recognised as an asset denominated in the currency of the Group acquired and is tested for impairment annually, or more frequently if there are certain events or changes indicating the possibility that the carrying amount may not be fully recoverable. The potential impairment loss is determined by assessing the recoverable amount of the cash generating unit (or group of cash generating units) to which the goodwill is allocated from the acquisition date.

Notes to the financial statements

For the year ended 31 December 2019

3. Significant accounting policies (continued)

3.16 Intangible assets (continued)

Radiocommunications Licences

Licence fees paid to the Government, 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 over the initial 20 year term of the licence on a straight line basis. The remaining useful lives of the licences are as follows:

| Licence | Remaining useful life |
|------------------------------|-----------------------|
| 3G – 1,800 MHz and 2,100 MHz | 2 years |
| 4G – 800 MHz | 13 years |
| 4G – 2.3 GHz | 18 years |
| 5G – 3.4 GHz | 18 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 the estimated useful lives of the software 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 Group, 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 the estimated useful lives of the software not exceeding 6 years on a straight line basis.

Development costs are only capitalised if the Group can demonstrate all of the following: the technical feasibility of completing the asset so that it will be available for use or sale; an intention to complete the asset and use or sell it; an ability to use or sell the asset; future economic benefit is expected; adequate technical, financial and other resources are available; and an ability to reliably measure expenditure.

Intangible assets not in use are classified as assets in the course of construction and will not be amortised. Once they are available for use they will be reclassified to the relevant category of intangible assets and will be amortised in line with the above accounting policy.

3.17 Impairment of non-financial assets

Non-financial assets 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 its 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").

3.18 Investments

Investments are stated at cost less provision for impairment. An impairment loss is recognised for the amount by which the investment's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an investment's fair value less costs to sell and value in use.

3.19 Inventories

Inventories comprise mainly handsets and are stated at the lower of cost and net realisable value 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.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.20 Financial assets***(i) Classification*

The Group classifies its financial assets in the following measurement categories:

- those to be measured subsequently at fair value (either through other comprehensive income or through profit or loss); and
- those to be measured at amortised cost.

(ii) Recognition and derecognition

Financial assets are recognised on the date the Group becomes a party to the contractual provisions of the instrument. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or have been transferred and the Group has transferred substantially all the risks and rewards of ownership.

Trade receivables that are sold without recourse are derecognised at the point they are factored. Any fee incurred to effect factoring is netted against cash received and expensed in the income statement.

(iii) Measurement

At initial recognition, the group measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss (FVPL), transaction costs that are directly attributable to the acquisition of the financial asset. Transaction costs of financial assets carried at FVPL are expensed in profit or loss.

(iv) Impairment

The Group assesses on a forward looking basis the expected credit losses associated with its financial assets carried at amortised cost. The impairment methodology applied depends on whether there has been a significant increase in credit risk.

The Group provides services to individuals and business customers on credit terms. The Group expects that some debts due will not be paid as a result of the default of a small number of customers. The Group uses estimates based on historical results and future expectations, the economic and competitive environment and other relevant factors to determine the provision for credit losses. A significant, unanticipated downturn in the major economies that the Group 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. The carrying amount of credit losses provision for each reporting period is set out in Note 34.1.

3.21 Cash and cash equivalents

Cash and cash equivalents are carried in the statement of financial position at cost. Cash and cash equivalents includes cash on hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and short term deposits repayable on demand with Telefónica Finanzas S.A and Telfisa Global B.V., both of which are related parties. Bank overdrafts are shown within borrowings in current liabilities in the statement of financial position.

**Notes to the financial statements
For the year ended 31 December 2019****3. Significant accounting policies (continued)****3.22 Borrowings**

Borrowings are recognised initially at fair value. Subsequent to initial recognition, borrowings are stated at amortised cost with any difference between the cost and the redemption value being recognised in the statement of comprehensive income over the period of the borrowings on an effective interest basis. Accrued interest on borrowings is included within the carrying value.

3.23 Trade and other payables

Trade payables and other payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. They are classified as current liabilities if payment is due within one year or less (or in the normal operating cycle of the business, if longer). If not, they are presented as non-current liabilities.

Trade payables and other payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

3.24 Provisions

Provisions are recognised when the Group 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.

Restructuring provisions could comprise, amongst other items, employee termination payments, and these are recognised in the period in which the Group 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.

4. Accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires management to make judgements (other than those involving estimations) in the process of applying the Group's accounting policies. It also requires the use of certain accounting estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates and a reasonably possible change in the facts and circumstances on which these estimates are based could have a material impact on the Group's earnings and financial position.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Significant accounting judgements

The Group has the following significant accounting judgement where making a different judgment may result in a material adjustment to the income and expenses reported for the period and to the carrying amounts of assets and liabilities at the end of the period.

**Notes to the financial statements
For the year ended 31 December 2019****4. Accounting estimates and judgements (continued)****Significant accounting judgements (continued)*****Joint arrangements***

The Group participates in a number of joint arrangements where control of the arrangement is shared with one or more other parties. Judgement is required to classify joint arrangements in a separate legal entity as either a joint operation or as a joint venture which depends on management's assessment of the legal form and substance of the arrangement taking into account relevant facts and circumstances such as whether the owners have rights to substantially all the economic outputs and, in substance, settle the liabilities of the entity.

The classification can have a material impact on the consolidated financial statements. The Group accounts for its interest in its joint operation by recognising the assets and liabilities and the related revenues, expenses and share of commitments in proportion to the Group's contribution to and participation in the joint operation.

The Group's investment and share of results of joint ventures are accounted for under the equity method where the share of results of joint ventures are shown within single line items in the consolidated statement of financial position and consolidated income statement respectively.

Critical accounting estimates

The critical assumptions concerning the future and key sources of estimation uncertainty at the reporting period that may cause a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below.

4.1 *Group pension benefits*

The cost of the defined benefit pension plan and the present value of the pension obligation are determined using an actuarial valuation. An actuarial valuation involves making various assumptions. These include the discount rate, future salary increases, mortality rates and future pension increases. Due to the complexity of the valuation, the underlying assumptions and its long term nature, a defined benefit obligation is highly sensitive to changes in these assumptions. All assumptions are reviewed at each reporting date.

In determining the appropriate discount rate, management considers the interest rates of corporate bonds with at least an AA rating, with extrapolated maturities corresponding to the expected duration of the defined benefit obligation. The mortality rate is based on publically available mortality tables. Future salary increases and pension increases are based in expected future inflation rates.

Further details about the assumptions and sensitivities are given in note 33.

4.2 *Company impairment of investments*

An impairment exists when the carrying value of an investment exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The value in use calculation is based on a discounted cash flow model. The cash flows are derived from forecasts. The recoverable amount is most sensitive to the discount rate used in the discounted cash flow model as well as the expected cash inflows and the growth rate used for extrapolation purposes. Further details about the assumptions and sensitivities are given in note 18.

**Notes to the financial statements
For the year ended 31 December 2019****4. Accounting estimates and judgements (continued)****Other key sources of estimation uncertainty**

Other key sources of estimation uncertainty which are not expected to give rise to a material adjustment in the reporting period are discussed below.

4.3 Group property, plant and equipment and licences

Accounting for property, plant and equipment and 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 licences are depreciated or amortised on a straight line basis over their estimated useful lives and taking into account their expected residual values. When the Group 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 impact 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 is a significant number of assets in use. The impact of any change would vary significantly depending on the individual changes in assets and the classes of assets impacted.

The Group assesses the impairment of property, plant and equipment and 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 is 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 Group 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 impairment and may have a material adverse impact on the operating results and financial condition of the Group. The carrying amount of property, plant and equipment and licences for each reporting period is set out in Notes 13 and 15 respectively.

4.4 Group provisions

Provisions are recognised when the Group 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. 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 Group 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.

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.

The asset retirement provision is based on assumptions covering the discount rate, expected lease renewals and the expected cost of restoring the sites. The payment dates of these asset retirement costs are uncertain but are currently anticipated to be over the next 17 years.

The carrying amount of provisions for each reporting period is set out in Note 27.

Notes to the financial statements

For the year ended 31 December 2019

4. Accounting estimates and judgements (continued)

Other key sources of estimation uncertainty (continued)

4.5 *Group right of use assets and lease liabilities – lease terms*

The lease term used in the calculation of right of use assets and lease liabilities is estimated. Lease term estimates are based on the non-cancellable period; plus periods covered by options to extend the lease, where such options depend only on the Group and where exercise is assessed to be reasonably certain, taking into account the specific situation of the lease. In addition certain assumptions have been required to calculate the discount rate, based principally on the incremental borrowing rate of interest required to finance the expected payments during the lease term.

5. Operating segments

As at 31 December 2019 and 31 December 2018, the Group had only one reportable segment, which is the mobile telecommunications business in the UK.

The mobile telecommunications segment derives revenue from the operation of a cellular communications network, and the sale of mobile and data services to the Group's customer base.

6. Revenue and operating profit

The total revenue and significant revenue streams for the period are detailed below:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|--------------------------------------|--------------------------------------|
| Mobile service revenue | 4,214 | 4,279 |
| Hardware and other revenue | 2,021 | 1,728 |
| Total revenue | 6,235 | 6,007 |
| Operating costs (excluding depreciation, amortisation and management fees) | (4,241) | (4,270) |
| Impairment losses on financial and contract assets | (159) | (99) |
| Reversal of impairment losses on financial and contract assets | 10 | 10 |
| Operating profit before depreciation and management fees | 1,845 | 1,648 |
| Management fees* | (40) | (43) |
| Operating profit before depreciation and amortisation (OIBDA) | 1,805 | 1,605 |
| Property, plant and equipment depreciation | (536) | (523) |
| Right of use asset depreciation | (181) | - |
| Intangible asset amortisation | (264) | (298) |
| Operating profit | 824 | 784 |

*Management fees include payables to other Telefónica Group companies outside of the UK Group.

Notes to the financial statements

For the year ended 31 December 2019

6. Revenue and operating profit (continued)

| Group operating costs included: | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|---|---|
| Cost of inventories recognised as an expense | 1,463 | 1,365 |
| Net write down of inventories recognised in the year | - | 6 |
| Staff costs (Note 7) | 412 | 391 |
| Auditors' remuneration | 1 | 1 |
| Capitalised development costs - permanent staff | (53) | (48) |
| Capitalised development costs - third party labour | (80) | (65) |
| Operating lease rental payments | - | 167 |
| Restructuring costs (Note 27) | 27 | 5 |
| Gain on disposal of property, plant and equipment | (6) | - |
| Other operating expenditure | 2,477 | 2,448 |

7. Employees

The costs incurred in respect of employees were:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|-------------------------------|---|---|
| Wages and salaries | 333 | 319 |
| Social security costs | 39 | 36 |
| Other pension costs (Note 33) | 38 | 35 |
| Share based payments | 2 | 1 |
| Total staff costs | 412 | 391 |

The monthly average number of employees within the Group (including executive directors) were:

| | People in post | | Full time equivalent | |
|--|----------------|--------------|----------------------|--------------|
| | 2019 No. | 2018 No. | 2019 No. | 2018 No. |
| Sales and marketing | 4,577 | 3,864 | 3,985 | 3,305 |
| Operations | 1,611 | 2,035 | 1,591 | 1,953 |
| Administration | 849 | 887 | 829 | 863 |
| Total monthly average employees | 7,037 | 6,786 | 6,405 | 6,121 |

During the year ended 31 December 2019 customer service employees were reclassified from operations to sales and marketing.

8. Key management and Directors' compensation

The Group's employees and directors participated in a number of employee incentive share schemes operated by Telefonica S.A. (see Note 32 for further details).

No directors are members of the Company's defined benefit pension scheme (2018: one). One director is a member of the defined contribution scheme (2018: two). One of the directors participated in long term incentive-schemes in the year (year ended 31 December 2018: One).

Notes to the financial statements

For the year ended 31 December 2019

8. Key management and Directors' compensation (continued)

Directors of the Company are part of the key management of the Group. Key management compensation for their services to the Group for the period were as follows:

| | Year ended 31 December 2019 £000 | Year ended 31 December 2018 £000 |
|---|---|---|
| Salaries and short-term employee benefits | 6,370 | 6,707 |
| Post-employment benefits | 50 | 79 |
| Share-based payments | 2 | 1 |
| Total key management compensation | 6,422 | 6,787 |

The emoluments of the Directors of the Company for the year ended 31 December 2019 were as follows:

| | Year ended 31 December 2019 £000 | Year ended 31 December 2018 £000 |
|--|---|---|
| Aggregate emoluments in respect of qualifying services | 2,560 | 2,836 |
| Aggregate amount of company contributions paid to a pension scheme | 11 | 37 |
| Total directors' compensation | 2,571 | 2,873 |

In respect of the highest-paid director during the period:

| | Year ended 31 December 2019 £000 | Year ended 31 December 2018 £000 |
|--|---|---|
| Aggregate emoluments in respect of qualifying services | 1,796 | 1,549 |
| Aggregate amount of company contributions paid to a pension scheme | - | - |
| Total highest-paid director compensation | 1,796 | 1,549 |

9. Auditors' remuneration

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

| | Year ended 31 December 2019 £000 | Year ended 31 December 2018 £000 |
|---|---|---|
| Fees payable to the Company's auditors for the audit of the Group and Company's annual financial statements | 55 | 55 |
| Other fees: | | |
| Local statutory audits of subsidiaries | 830 | 844 |
| Audit-related assurance services | 100 | - |
| Total audit and audit-related fees | 985 | 899 |

Notes to the financial statements
For the year ended 31 December 2019

10. Financial income and financial costs

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|---|---|
| Interest income on cash, cash equivalent and other financial assets | 2 | - |
| Interest income on financial assets measured at amortised cost | 13 | 4 |
| Exchange gains | 3 | 3 |
| Financial income | 18 | 7 |
| Interest payable to related parties | (17) | (20) |
| Lease interest | (14) | - |
| Exchange losses | (3) | (1) |
| Other financial costs | - | (5) |
| Financial costs | (34) | (26) |
| Net financial costs | (16) | (19) |

11. Taxation

The analysis of the tax charge for the period is as follows:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|---|---|
| Current tax – current year | 159 | 154 |
| Current tax – adjustment in respect of prior periods | (5) | (31) |
| Current tax | 154 | 123 |
| Deferred tax – origination and reversal of temporary differences | 14 | 15 |
| Deferred tax – adjustments in respect of prior periods | - | (1) |
| Deferred tax (Note 25) | 14 | 14 |
| Taxation – charge for the year from continuing operations | 168 | 137 |

The tax assessed for the period varied from the amount computed by applying the UK statutory tax rate to profit or loss on ordinary activities before taxation. The difference was attributable to the following factors:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|---|---|
| Profit before taxation | 809 | 766 |
| Profit before taxation multiplied by the rate of UK corporation tax of 19% (2018: 19%) | 154 | 146 |
| Adjustments to tax in respect of prior period | (5) | (33) |
| Expenses not deductible for tax purposes | 21 | 21 |
| Tax losses not recognised | - | 4 |
| Effect of change in tax rate | (2) | (1) |
| Taxation – total charge for the year | 168 | 137 |

The corporation tax main rate was set at 19% from 1 April 2017.

Notes to the financial statements
For the year ended 31 December 2019

12. Dividends paid

| Group and Company | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|---|---|
| Interim dividend for the year of £45.83 (2018: £9.17) per share | 550 | 110 |
| Total dividend paid | 550 | 110 |

13. Property, plant and equipment

| Group | Land and Buildings £m | Plant and equipment £m | Assets in course of construction £m | Total £m |
|---------------------------------|-----------------------------|------------------------------|---|--------------|
| Cost | | | | |
| At 1 January 2018 | 359 | 7,105 | 257 | 7,721 |
| Additions | - | - | 712 | 712 |
| Reclassifications | 28 | 512 | (599) | (59) |
| Disposals | (2) | (330) | - | (332) |
| At 31 December 2018 | 385 | 7,287 | 370 | 8,042 |
| Additions | - | - | 686 | 686 |
| Reclassifications | 25 | 686 | (711) | - |
| Disposals | (85) | (1,870) | - | (1,955) |
| At 31 December 2019 | 325 | 6,103 | 345 | 6,773 |
| Accumulated depreciation | | | | |
| At 1 January 2018 | 266 | 4,914 | - | 5,180 |
| Charge for the period | 20 | 503 | - | 523 |
| Reclassifications | - | (25) | - | (25) |
| Disposals | - | (314) | - | (314) |
| At 31 December 2018 | 286 | 5,078 | - | 5,364 |
| Charge for the period | 25 | 511 | - | 536 |
| Disposals | (85) | (1,870) | - | (1,955) |
| At 31 December 2019 | 226 | 3,719 | - | 3,945 |
| Net book amount | | | | |
| At 31 December 2019 | 99 | 2,384 | 345 | 2,828 |
| At 31 December 2018 | 99 | 2,209 | 370 | 2,678 |

During the year ended 31 December 2019 amounts of £1,503 million cost and £1,503 million accumulated depreciation were disposed of relating to legacy assets no longer in use. The disposal had £Nil impact on the net book amount of property, plant and equipment.

Notes to the financial statements
For the year ended 31 December 2019

14. Right of use assets

| Group | Land and buildings £m | Plant and equipment £m | Total £m |
|---------------------------------|--------------------------------------|---------------------------------------|---------------------|
| Cost | | | |
| At 31 December 2018 | - | - | - |
| Initial application of IFRS 16 | 547 | 193 | 740 |
| At 1 January 2019 | 547 | 193 | 740 |
| Additions | 101 | 41 | 142 |
| Disposals | (67) | (32) | (99) |
| At 31 December 2019 | 581 | 202 | 783 |
| Accumulated depreciation | | | |
| At 31 December 2018 | - | - | - |
| Initial application of IFRS 16 | - | - | - |
| At 1 January 2019 | - | - | - |
| Charge for the period | 122 | 59 | 181 |
| Disposals | (7) | (3) | (10) |
| At 31 December 2019 | 115 | 56 | 171 |
| Net book amount | | | |
| At 31 December 2019 | 466 | 146 | 612 |
| At 31 December 2018 | - | - | - |

Right of use assets have been recognised from 1 January 2019. See note 2 for further information on first time adoption of IFRS 16 Leases.

Notes to the financial statements
For the year ended 31 December 2019

15. Intangible assets

| Group | Licences | Software | Assets in course of construction | Total |
|---------------------------------|-----------------|-----------------|---|--------------|
| Cost | £m | £m | £m | £m |
| At 1 January 2018 | 4,641 | 1,680 | 21 | 6,342 |
| Additions | 206 | - | 417 | 623 |
| Reclassifications | - | 159 | (100) | 59 |
| Disposals | - | (49) | - | (49) |
| At 31 December 2018 | 4,847 | 1,790 | 338 | 6,975 |
| Additions | - | - | 117 | 117 |
| Reclassifications | 318 | 129 | (447) | - |
| Disposals | - | (427) | - | (427) |
| At 31 December 2019 | 5,165 | 1,492 | 8 | 6,665 |
| Accumulated amortisation | | | | |
| At 1 January 2018 | 3,711 | 1,472 | - | 5,183 |
| Charge for the period | 152 | 146 | - | 298 |
| Reclassifications | - | 25 | - | 25 |
| Disposals | - | (49) | - | (49) |
| At 31 December 2018 | 3,863 | 1,594 | - | 5,457 |
| Charge for the period | 158 | 106 | - | 264 |
| Disposals | - | (423) | - | (423) |
| At 31 December 2019 | 4,021 | 1,277 | - | 5,298 |
| Net book amount | | | | |
| At 31 December 2019 | 1,144 | 215 | 8 | 1,367 |
| At 31 December 2018 | 984 | 196 | 338 | 1,518 |

The licences are assets permitting the Group to operate its "3G", "4G" and "5G" networks in the UK.

During the prior year the Group secured 80 MHz of spectrum in an Ofcom auction, at a cost of £523.6 million. This included 40MHz of immediately useable (2.3GHz) spectrum, which was all of the spectrum available in this band, as well as 40MHz of 3.4 GHz spectrum, earmarked for 5G. The 3.4GHz spectrum was reclassified from assets in the course of construction to licenses during the year ended 31 December 2019 and amortisation commenced as the licence was in use from October 2019.

During the year ended 31 December 2019 amounts of £392 million cost and £392 million accumulated amortisation were disposed of relating to legacy assets no longer in use. The disposal had £Nil impact on the net book amount of intangible assets.

During the year ended 31 December 2018 a transfer was made from property, plant and equipment to software amounting to £59 million to better present certain assets. Additional amortisation of £29 million was charged in the year relating to the population of assets affected to record amortisation at the rate appropriate for the assets.

Notes to the financial statements

For the year ended 31 December 2019

16. Goodwill

| Net book amount | £m |
|---------------------|-------|
| At 31 December 2019 | 2,377 |
| At 31 December 2018 | 2,377 |

Impairment testing

Goodwill arises in relation to the Telefonica UK cash-generating unit ("CGU"), being Telefonica UK Limited. There has been no impairment during the year and there are no accumulated impairment losses at the beginning or end of the reporting period.

Goodwill is tested for impairment annually, or more frequently if there are certain events or changes indicating the possibility that the carrying amount may not be fully recoverable. The potential impairment loss is determined by assessing the recoverable amount of the cash-generating unit (or group of cash-generating units) to which the goodwill is allocated from the acquisition date. If this recoverable amount is less than the carrying amount, an irreversible impairment loss is recognised.

The Group evaluates its cash-generating unit performance regularly to identify potential goodwill impairments. The strategic plan of the CGU to which the goodwill is allocated has been used to perform the impairment test at year-end. The process of preparing the CGU strategic plan takes into consideration the current condition of the CGU market, analysing the macroeconomic, competitive, regulatory and technological climate together with the CGU position in this context and the growth opportunities given the market projections and their competitive positioning.

The recoverable amount of the CGU has been determined based on a value in use calculation using cash flow projections from financial budgets covering a five-year period.

Main assumptions used in calculating value in use

Value in use is calculated based on the approved business plan reflecting the Group's view of its prospects at 31 December 2019 taking into account certain variables such as operating income before depreciation and amortisation (OIBDA) margin, capital expenditure (CAPEX) ratio for non-current assets, expressed as a percentage of revenue, and discount and perpetuity growth rates.

OIBDA margin and long-term CAPEX

The OIBDA margin and long-term CAPEX ratio used to calculate terminal value, are based on the business plan approved for the CGU, as well as external estimates of trends in operating indicators, and the outlook for the various businesses and markets. The rates applied to the cash flow projections were as follows:

| | Year ended 31 December 2019 % | Year ended 31 December 2018 % |
|------------------------------------|--|--|
| Terminal OIBDA Margin | 32.6 | 27.2 |
| Terminal ratio of CAPEX / Revenues | 12.5 | 13.0 |

Notes to the financial statements

For the year ended 31 December 2019

16. Goodwill (continued)

Discount rate

The discount rate used by management, applied to measure free cash flow, is the weighted average cost of capital (WACC), determined by the weighted average cost of equity and debt according to the finance structure established for each CGU.

The pre-tax discount rate, applied to the cash flow projections was as follows:

| | Year ended 31 December 2019 % | Year ended 31 December 2018 % |
|----------------|--|--|
| United Kingdom | 7.7 | 7.6 |

Perpetuity growth rate

Cash flow projections to the end of the asset's useful life are estimated using a rate of growth for the future years.

Terminal value is calculated from the projected cash flows in the period, taking as the perpetuity growth rate consensus estimates among analysts for the business and the country based on the maturity of the industry depending on technology and the degree of development. Each indicator is compared to the forecast long-term GDP growth adjusted for any specific characteristics of the business.

The perpetuity growth rate applied to the cash flow projections was as follows:

| | Year ended 31 December 2019 % | Year ended 31 December 2018 % |
|----------------|--|--|
| United Kingdom | 0.8 | 0.8 |

Sensitivity to changes in assumptions

The Group carries out a sensitivity analysis of the impairment test by considering reasonable possible changes in the main assumptions used in calculating value in use. The sensitivities to changes in these assumptions are included in Note 18.

Management believes that no reasonable possible change in any of the above key assumptions would cause the carrying amount to materially exceed the recoverable amount of the cash-generating unit.

Notes to the financial statements

For the year ended 31 December 2019

17. Subsidiary undertakings and joint arrangements

The subsidiary undertakings as at 31 December 2019 are detailed below, all of which are included in the Group financial statements.

| Name / (Registered number) | Registered office | Country of incorporation and operation | Activity | Portion of ordinary shares held % |
|--|---|--|--|---|
| Telefonica UK Limited ^{1, 2} (01743099) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Mobile cellular telephone system provider and operator | 100 |
| Weve Limited (08178832) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Mobile marketing and commerce services | 100 |
| Statiq Limited (08702435) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Audience data solutions | 100 |
| Cellular Radio Limited (01612599) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Active non trading | 100 |
| giffgaff Limited (04196996) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Mobile communications services | 100 |
| O2 Networks Limited ¹ (02604351) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Active non trading | 100 |
| Telefónica Europe People Services Limited ¹ (10486438) | Hanover Court Erne Street Lower Dublin 2 | Republic of Ireland | HR Services | 100 |
| DX Communications Limited (SC133682) | The Ca'D'Ore, 45 Gordon Street, Glasgow, United Kingdom, G1 3PE | Scotland | Dormant | 100 |
| The Mobile Phone Store Limited (02837875) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Active non trading | 100 |
| O2 Cedar Limited ¹ (04678681) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Active non trading | 100 |
| O2 Communications Limited ¹ (04271548) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Intermediate holding company | 100 |
| Telefonica UK Pension Trustee Limited ¹ (04267552) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Corporate trustee of the Telefonica UK Pension Plan | 100 |
| O2 Unify Limited (07999361) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Information Communication Technology Solution | 100 |
| O2 Secretaries Limited ¹ (04272689) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Dormant | 100 |
| O2 Redwood Limited (02383186) | 260 Bath Road Slough Berkshire SL1 4DX | England and Wales | Dormant | 100 |
| Cornerstone Telecommunications Infrastructure Limited (08087551) | Hive 2, 1530 Arlington Business Park. Theale Reading Berkshire RG7 4SA | England and Wales | Mobile infrastructure network joint operation with Vodafone | 50 |
| Tesco Mobile Limited (04780736) | Shire Park, Welwyn Garden City, AL7 1GA | England and Wales | Mobile cellular telephone distributor joint venture with Tesco | 50 |
| Digital Mobile Spectrum Limited (08247385) | 24/25 the Shard, 32 London Bridge Street, London, SE1 9SG | England and Wales | Services in relation to the spectrum auction obligation | 25 |

Notes to the financial statements

For the year ended 31 December 2019

17. Subsidiary undertakings and joint arrangements (continued)

¹ The shares are held directly by the Company. The shares in all other companies are held indirectly through wholly owned subsidiaries within the Group.

² Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) holds a direct investment in Telefonica UK Limited of £23 million as a result of the transfer of the pension scheme from Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) into Telefonica UK Limited on 14 December 2018 (see note 33).

On 30 April 2019, the Company acquired 100% of the shares of Statiq Limited for a cash consideration of £715,000, from Telefonica Digital Limited, a fellow subsidiary within the Telefónica Group.

All share holding portions remain the same as at 31 December 2018, with the exception of the acquisition of Statiq Limited.

18. Investments in subsidiary undertakings

| Company Cost | Total £m |
|--|-------------|
| At 1 January 2019 and 31 December 2019 | 16,897 |
| Provision for impairment | |
| At 1 January 2019 and 31 December 2019 | (7,716) |
| Net book amount | |
| At 1 January 2019 and 31 December 2019 | 9,181 |

Investments in subsidiary undertakings are tested for impairment annually or more frequently if there are certain events or changes indicating the possibility that the carrying amount may not be fully recoverable. The potential impairment loss is determined by assessing the recoverable amount of the investments in subsidiary undertakings. If this recoverable amount is less than the carrying amount, an impairment loss is recognised.

In the years ended 31 December 2019 and 31 December 2018 the impairment review identified that no additional impairment was required to be recognised in relation to the Company's investments. The recoverable amount, being the value in use of the investments in Telefonica UK Limited, O2 Cedar Limited and O2 Networks Limited, was concluded to be not less than the net book amount. Refer to note 16 for key assumptions used in the impairment test performed during the year.

The recoverable amount of the investments in the other subsidiary undertakings have been assessed based on the net assets of those entities at 31 December 2019 and was concluded to be not less than the net book amount.

Sensitivity to changes in assumptions

The Company carries out its sensitivity analysis of the impairment test by considering reasonable changes in the main assumptions used in calculating value in use. The changes in assumptions if applied individually to the value in use calculation would have the following impacts for the year ended 31 December 2019, expressed in percentage points:

| Assumption | Change | Valuation impact | Change | Valuation impact |
|------------------------------------|-----------|------------------|-----------|------------------|
| Discount rate | -0.50p.p. | £1,614 million | +0.50p.p. | -£1,341 million |
| Perpetuity growth rates | -0.50p.p. | -£1,119 million | +0.50p.p. | £1,347 million |
| Terminal OIBDA Margin | -0.50p.p. | -£381 million | +0.50p.p. | £381 million |
| Terminal ratio of CAPEX / Revenues | -0.50p.p. | £471 million | +0.50p.p. | -£471 million |

Notes to the financial statements

For the year ended 31 December 2019

18. Investments in subsidiary undertakings (continued)

Management believes that no reasonable possible change in any of the above key assumptions would cause the carrying value of the cash-generating unit to materially exceed its recoverable amount, with significant headroom remaining after performing sensitivity analysis. Details of the Company's subsidiaries are provided in Note 17.

19. Investment in joint venture

The Group holds a 50% interest in Tesco Mobile Limited, a mobile virtual network operator, which is accounted for using the equity method in the consolidated financial statements.

Summarised financial information of the joint venture, based on IFRS financial statements, and reconciliation with the carrying amount of the investment in these consolidated financial statements, are set out below:

| Group | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|------------------------------|---|---|
| Revenue | 835 | 834 |
| Operating costs | (834) | (832) |
| Profit before tax | 1 | 2 |
| Income tax | - | - |
| Profit for the period | 1 | 2 |

| Group | 31 December 2019 £m | 31 December 2018 £m |
|-------------------------|---------------------------|---------------------------|
| Current assets | 477 | 518 |
| Non-current assets | 17 | 13 |
| Current liabilities | (254) | (326) |
| Non-current liabilities | (225) | (191) |
| Equity | 15 | 14 |

The financial performance and financial position of Tesco Mobile Limited disclosed above represents 100% of the results of the joint venture.

The Group share of profit and the carrying amount of investment have been calculated after applying the Group percentage interest to the financial statements of the joint venture.

The details of the movement in investments in joint ventures and associates in the year are set out below:

| | £m |
|----------------------------|----------|
| At 1 January 2018 | 6 |
| Group share of profit | 1 |
| At 31 December 2018 | 7 |
| Group share of profit | 1 |
| At 31 December 2019 | 8 |

The Group has no commitments made but not recognised with the joint venture at 31 December 2019 (31 December 2018: None).

Details of the Group's jointly controlled entities are given in Note 17.

Notes to the financial statements

For the year ended 31 December 2019

20. Inventories

Inventory primarily consists of mobile devices and is presented net of provisions for obsolescence:

| Group | 31 December 2019 £m | 31 December 2018 £m |
|------------------------------------|---------------------------|---------------------------|
| Mobile devices and other equipment | 125 | 98 |

In the opinion of the Directors there is no material difference between the balance sheet value of inventories and their replacement cost.

21. Trade and other receivables

| | Group | | Company | |
|--|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Current trade and other receivables | | | | |
| Trade receivables | 866 | 988 | - | - |
| Other receivables | 14 | - | 11 | 25 |
| Amounts owed by ultimate parent company | 1 | - | - | - |
| Amounts owed by immediate parent company | 8 | 28 | - | - |
| Amounts owed by subsidiaries | - | - | 11 | 10 |
| Amounts owed by other related parties | 48 | 47 | 8 | 9 |
| Contract assets (Note 28) | 166 | 137 | - | - |
| Costs of obtaining a contract (Note 28) | 97 | 115 | - | - |
| Prepayments | 360 | 396 | - | - |
| Accrued income | 154 | 174 | - | - |
| Total current trade and other receivables | 1,714 | 1,885 | 30 | 44 |
| Non-current trade and other receivables | | | | |
| Trade receivables | 155 | 48 | - | - |
| Contract assets (Note 28) | 103 | 74 | - | - |
| Costs of obtaining a contract (Note 28) | 25 | 39 | - | - |
| Prepayments | 58 | 76 | - | - |
| Total non-current trade and other receivables | 341 | 237 | - | - |

The Directors consider that the carrying amount of trade and other receivables is approximately equal to their fair value.

Notes to the financial statements
For the year ended 31 December 2019

22. Other financial assets

| | Group | | Company | |
|---------------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Current other financial assets | | | | |
| Other financial assets | 61 | 71 | 2 | 72 |
| | 61 | 71 | 2 | 72 |

| | Group | | Company | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Non-current other financial assets | | | | |
| Other financial assets | 57 | 12 | - | - |
| | 57 | 12 | - | - |

Included within the total Group other financial assets of £118 million (2018: £93 million) is £112 million (2018: £74 million) of loan notes issued upon factoring of trade receivables; £57 million (2018: £63 million) of which is due within one year.

Within Company other financial assets, £2 million (2018: £72 million) relates to a loan issued to a subsidiary entity to fund general trading activities and is unsecured, interest free and repayable on demand. £70 million was repaid during the year ended 31 December 2019.

23. Borrowings

| | Group | | Company | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Non-current unsecured borrowings at amortised cost | | | | |
| Amounts owed to other related parties | 964 | 964 | - | - |
| Total borrowings | 964 | 964 | - | - |

Non-current amounts owed relate to two loans of £440 million (2018: £440 million) and £524 million (2018: £524 million) with Telfin Ireland.

The maturity date of the loan of £440 million is 30 June 2023. The purpose of this loan was to assist with the acquisition of 800MHz 4G spectrum. The loan had an interest rate based on LIBOR plus 272 basis points up until 30 June 2018 and LIBOR plus 105 basis points from 1 July 2018 and is calculated on a quarterly basis. The effective rate of interest on the loan for 2019 was 1.87% (2018: 2.59%).

The loan of £524 million has a maturity date of 30 June 2022. The loan has an interest rate based on LIBOR plus 90 basis points up and is calculated on a quarterly basis. The effective rate of interest on the loan for 2019 was 1.72% (2018: 1.66%). The purpose of this loan was to assist with the acquisition of 2.3GHz 4G and 3.4GHz 5G spectrum.

Notes to the financial statements
For the year ended 31 December 2019

24. Lease liabilities

| | Group | |
|-------------------------------|-------|------|
| | 2019 | 2018 |
| | £m | £m |
| Current lease liabilities | 186 | - |
| | 2019 | 2018 |
| | £m | £m |
| Non-current lease liabilities | 417 | - |

Maturity of lease liabilities

| | 2019 | 2018 |
|---|------------|----------|
| | £m | £m |
| Within one year | 186 | - |
| Later than one year but not later than five years | 331 | - |
| Later than five years | 86 | - |
| Total lease liabilities | 603 | - |

The future minimum lease payments for operating leases for the year ended 31 December 2018 is included in note 31. Upon first time adoption of IFRS 16 Leases these operating leases are recognised as lease liabilities on the statement of financial position. See note 2 for further information on first time adoption of IFRS 16.

25. Deferred tax

The total movement in Group deferred tax assets or liabilities during the period, before taking into consideration the offsetting balances within the same tax jurisdiction, is as follows:

| Group | Assets £m | Liabilities £m | Net asset/(liability) £m |
|--------------------------------------|--------------|-------------------|-----------------------------|
| At 1 January 2018 | 5 | (32) | (27) |
| Charge to comprehensive income | (3) | (11) | (14) |
| Credit to other comprehensive income | 4 | - | 4 |
| At 31 December 2018 | 6 | (43) | (37) |
| Charge to comprehensive income | (5) | (9) | (14) |
| Credit to other comprehensive income | 6 | - | 6 |
| At 31 December 2019 | 7 | (52) | (45) |

Deferred tax assets have been offset against deferred tax liabilities where there is a legally enforceable right of offset and they relate to income taxes levied by the same taxation authority on either the same taxable entity or different entities which intend to settle current tax assets and liabilities on a net basis.

The movement in deferred tax liabilities and assets during the period, without taking into consideration the offsetting balances within the same tax jurisdiction, is as follows:

Group deferred tax liabilities

| | Property, plant and equipment £m | Intangible assets £m | Total £m |
|--------------------------------|--|----------------------------|-------------|
| At 1 January 2018 | (18) | (14) | (32) |
| Credit to comprehensive income | (13) | 2 | (11) |
| At 31 December 2018 | (31) | (12) | (43) |
| Charge to comprehensive income | (6) | (3) | (9) |
| At 31 December 2019 | (37) | (15) | (52) |

Notes to the financial statements
For the year ended 31 December 2019

25. Deferred tax (continued)

Group deferred tax assets

| | Pension £m | Provisions £m | Total £m |
|--------------------------------------|---------------|------------------|-------------|
| At 1 January 2018 | 1 | 4 | 5 |
| Credit to comprehensive income | - | (3) | (3) |
| Credit to other comprehensive income | - | 4 | 4 |
| At 31 December 2018 | 1 | 5 | 6 |
| Charge to comprehensive income | (4) | (1) | (5) |
| Credit to other comprehensive income | 6 | - | 6 |
| At 31 December 2019 | 3 | 4 | 7 |

Company deferred taxation:

| | Total £m |
|---|-------------|
| At 1 January 2018 | 1 |
| Charge to comprehensive income | - |
| At 31 December 2018 | 1 |
| Credit/(charge) to comprehensive income | - |
| At 31 December 2019 | 1 |

There were no unrecognised Company deferred tax assets or liabilities at 31 December 2019 (2018: £nil).

In the Spring Budget 2020, the Government announced that from 1 April 2020 the corporation tax rate would remain at 19% (rather than reducing to 17%, as previously enacted). This new law was substantively enacted on 17 March 2020. As the proposal to keep the rate at 19% had not been substantively enacted at the balance sheet date, its effects are not included in these financial statements. However, it is likely that the overall effect of the change, had it been substantively enacted by the balance sheet date, would be to increase the tax expense for the period by £6 million, and to increase the net deferred tax liability to £50 million.

26. Trade and other payables

| | Group | | Company | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Current trade and other payables | | | | |
| Trade payables | 788 | 732 | - | - |
| Amounts owed to ultimate parent company | 8 | 10 | - | - |
| Amounts owed to immediate parent company | 6 | 31 | - | - |
| Amounts owed to subsidiaries | - | - | - | 10 |
| Amounts owed to other related parties | 279 | 346 | 81 | 87 |
| Other payables | 520 | 430 | - | - |
| Accrued expenses | 736 | 822 | 2 | (1) |
| Contract liabilities (Note 28) | 296 | 339 | - | - |
| Deferred income | 1 | 2 | - | (1) |
| Total current trade and other payables | 2,634 | 2,712 | 83 | 95 |

Notes to the financial statements
For the year ended 31 December 2019

26. Trade and other payables (continued)

| | Group | | Company | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Non-current trade and other payables | | | | |
| Contract liabilities (Note 28) | 229 | 203 | - | - |
| Amounts owed to ultimate parent company | 3 | 1 | - | - |
| Other payables | 1 | 2 | - | - |
| Total non-current trade and other payables | 233 | 206 | - | - |

27. Provisions

| Group | 31 December 2019 £m | 31 December 2018 £m |
|-------------------------------------|---------------------------|---------------------------|
| Current | | |
| Restructuring provisions | 26 | 4 |
| Asset retirement provisions | 3 | 11 |
| Other provisions | 8 | - |
| Total current provisions | 37 | 15 |
| Non-current | | |
| Restructuring provisions | - | 1 |
| Asset retirement provisions | 73 | 64 |
| Total non-current provisions | 73 | 65 |

| | Restructuring £m | Asset retirement £m | Other £m | Total £m |
|--|---------------------|------------------------|-------------|-------------|
| At 1 January 2018 | 4 | 82 | - | 86 |
| Charge for the period | 5 | - | - | 5 |
| Utilised in the period | (4) | (4) | - | (8) |
| Amounts released to the income statement | - | (3) | - | (3) |
| At 31 December 2018 | 5 | 75 | - | 80 |
| Charge for the period | 27 | 10 | 8 | 45 |
| Utilised in the period | (2) | (9) | - | (11) |
| Amounts released to the income statement | (4) | - | - | (4) |
| At 31 December 2019 | 26 | 76 | 8 | 110 |

Restructuring provisions

Restructuring provisions include the full costs of planned business restructuring programmes, entered into during the current and prior years.

Notes to the financial statements

For the year ended 31 December 2019

27. Provisions (continued)

Asset retirement provisions

The Group has certain legal obligations relating to the restoration of leased property to its original condition at the end of the lease term. This obligation relates principally to the Group's share of obligation for assets held in Cornerstone Telecommunications Infrastructure Limited, and to mast sites.

The provision is based on assumptions covering the discount rate, expected lease renewals and the expected cost of restoring the sites. The payment dates of these asset retirement costs are uncertain but are currently anticipated to be over the next 17 years.

The provision recognised represents the best estimate of the expenditure required to settle the present obligation at the current statement of financial position date. Such cost estimates, expressed at current price levels at the date of the estimate are discounted at 31 December 2019 using rates in the range of 1.26% - 1.67% (2018: 1.33% - 2.05%) per annum. The initial discounted cost amount has been capitalised as part of property, plant and equipment and depreciated over the life of the assets.

28. Contract assets and liabilities and capitalised costs

The movement of contract assets and capitalised costs during the year ended 31 December 2019 is as follows:

| | At 1 January 2019 £m | Additions £m | Amortisation £m | Reclassifications £m | At 31 December 2019 £m |
|--|-------------------------------|-----------------|--------------------|-------------------------|---------------------------------|
| Non-current contract assets (Note 21) | 74 | 137 | - | (108) | 103 |
| Contract assets | 79 | 137 | - | (108) | 108 |
| Impairment losses | (5) | - | - | - | (5) |
| Current contract assets (Note 21) | 137 | 329 | (408) | 108 | 166 |
| Contract assets | 144 | 333 | (408) | 108 | 177 |
| Impairment losses | (7) | (4) | - | - | (11) |
| Total | 211 | 466 | (408) | - | 269 |

The balance of the contract assets account represents amounts recognised as revenue but not yet due. The amounts recognised as contract assets are amortised over the contractual period. Included within contract assets is £23 million (2018: £32 million) of right of return assets related stock provided franchise retail stores. A corresponding £23 million (2018: £32 million) right of return obligation is included within contract liabilities.

| | At 1 January 2019 £m | Additions £m | Amortisation £m | Reclassifications £m | At 31 December 2019 £m |
|--|-------------------------------|-----------------|--------------------|-------------------------|---------------------------------|
| Non-current capitalised costs (Note 21) | 39 | 50 | - | (64) | 25 |
| Of obtaining a contract | 39 | 50 | - | (64) | 25 |
| Impairment losses | - | - | - | - | - |
| Current capitalised costs (Note 21) | 115 | 64 | (146) | 64 | 97 |
| Of obtaining a contract | 115 | 64 | (146) | 64 | 97 |
| Impairment losses | - | - | - | - | - |
| Total | 154 | 114 | (146) | - | 122 |

Notes to the financial statements

For the year ended 31 December 2019

28. Contract assets and liabilities and capitalised costs

The movement of contract liabilities of contracts with customers during the year ended 31 December 2019 is as follows:

| | At 1 January 2019 £m | Additions £m | Amortisation £m | Reclassifications £m | At 31 December 2019 £m |
|---|-------------------------------|-----------------|--------------------|-------------------------|---------------------------------|
| Non-current contract liabilities (Note 26) | 203 | 17 | (3) | 12 | 229 |
| Current contract liabilities (Note 26) | 339 | 2,015 | (2,046) | (12) | 296 |
| Total | 542 | 2,032 | (2,049) | - | 525 |

Contract liabilities are unperformed performance obligations mainly related to prepaid airtime, set up fees and other prepaid services.

The maturity schedule of contract liabilities at 31 December 2019 is as follows:

| | 2020 £m | 2021 £m | 2022 £m | Subsequent years £m | Total £m |
|---|------------|------------|------------|---------------------------|-------------|
| Contract liabilities – activation fees | 142 | - | - | - | 142 |
| Contract liabilities – sale of prepay cards | 60 | - | - | - | 60 |
| Other contract liabilities | 94 | 94 | 91 | 44 | 323 |
| Maturity of performance obligations | 296 | 94 | 91 | 44 | 525 |

29. Ordinary share capital and capital reserve

| Group and Company | 31 December 2019 Number of authorised shares | £m | 31 December 2018 Number of authorised shares | £m |
|---|---|----|---|----|
| Called up, allotted and fully paid | | | | |
| Ordinary shares of 100 pence each | 12,000,600 | 12 | 12,000,600 | 12 |

The Company has a single class of shares, comprising of ordinary shares of £1 each. Subject to the Company's articles of association and applicable law, the Company's ordinary shares confer on the holder the right to receive notice and vote at general meetings of the Company, the right to receive any surplus assets on a winding up of the Company and an entitlement to receive any dividend declared on ordinary shares, but not the right of redemption of shares.

Capital reserve

On 14 December 2018 the Telefonica UK Pension Plan ("the Plan") transferred into the Group via a capital contribution from Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) for £23.1 million, being the net asset position of the plan on the transfer date. This transfer created a capital reserve in the Group.

Notes to the financial statements
For the year ended 31 December 2019

30. Notes to the cash flow statement

Group reconciliation of operating profit to net cash flow from operating activities:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|---|---|
| Profit before tax | 809 | 766 |
| Adjustments for: | | |
| Share of profit of jointly controlled entities | (1) | (1) |
| Property, plant and equipment depreciation | 536 | 523 |
| Right of use asset depreciation | 181 | - |
| Intangible asset amortisation | 264 | 298 |
| Increase in bad debt provision | 3 | 25 |
| Increase in other provisions | 40 | 5 |
| Gain on disposal property, plant and equipment and intangible assets | (6) | - |
| Share based payment expense | 2 | - |
| Net foreign exchange gain | - | (3) |
| Loss realised on hedges | - | 1 |
| Net financial expenses | 19 | 20 |
| Other non-cash movements | - | (5) |
| Operating cash flow before movement in working capital | 1,847 | 1,629 |
| (Increase)/decrease in inventory | (27) | 10 |
| Decrease in trade and other receivables | 80 | 140 |
| Decrease in other provisions | (11) | (5) |
| Company contributions to retirement benefit obligation | (25) | - |
| Decrease in trade and other payables | (5) | (281) |
| Cash generated by operations | 1,859 | 1,493 |
| Income taxes paid | (194) | (144) |
| Interest received | 13 | 10 |
| Net cash inflow from operating activities | 1,678 | 1,359 |

Company reconciliation of operating profit to net cash flow from operating activities:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|---|---|
| Operating profit | - | 2 |
| Adjustments for: | | |
| Net financial expenses | - | - |
| Operating cash flow before movement in working capital | - | 2 |
| Decrease in trade and other receivables | 14 | 230 |
| Decrease in trade and other payables | (12) | (286) |
| Net cash inflow/(outflow) from operating activities | 2 | (54) |

Notes to the financial statements

For the year ended 31 December 2019

30. Notes to the cash flow statement (continued)

Group and Company cash and cash equivalents are as follows:

| | Group | | Company | |
|----------------------------------|---------------------|---------------------|---------------------|---------------------|
| | 31 December 2019 | 31 December 2018 | 31 December 2019 | 31 December 2018 |
| | £m | £m | £m | £m |
| Cash and cash equivalents | | | | |
| Short term deposits | 305 | 315 | 27 | 25 |
| | 305 | 315 | 27 | 25 |

The Company's short term deposits are deposited with Telfisa Global B.V., a related party.

31. Financial commitments and contingent liabilities

Operating lease commitments

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

From 1 January 2019 the Group has recognised right of use assets and lease liabilities.

At 31 December 2018 the Group was committed to making the following total future lease payments in respect of operating leases for each of the following periods:

| | Year ended 31 December 2018 £m |
|---|---|
| Future minimum rentals payable under non-cancellable operating leases: | |
| Within one year | 158 |
| Between one and five years | 260 |
| After five years | 97 |
| Total | 515 |

From 1 January 2019 the Company has recognised right of use assets and lease liabilities in respect of these commitments. See notes 2, 14 and 23 for further information.

Capital commitments

Contracts placed for expenditure not provided in the accounts are as follows:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|---|---|
| Contractual commitments placed for expenditure not provided in the accounts: | | |
| Tangible assets | 192 | 244 |
| Intangible assets | 490 | 493 |
| Operating expenditure (excluding operating leases) | 1,579 | 1,807 |
| Total contractual commitments | 2,261 | 2,544 |

The Group has no contingent liabilities or guarantees on which material losses are expected. The Group has insurance cover to certain limits for major risks on property and major claims in connection with legal liabilities arising in the course of its operations.

The Group does not believe there are any pending legal proceedings which would have a material adverse effect on the financial position or results of operations of the Group.

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For the year ended 31 December 2019

32. Share-based payments

Equity-settled share options scheme

The main share-based payment plans in place during the period are as follows:

Telefonica Performance Investment Share Plan 2018-2022

The Telefónica, S.A. General Shareholders' Meeting on 8 June 2018 approved a new instalment of the long-term share-based incentive "Performance and Investment Plan" for certain senior executives and members of the management team of the Telefonica Group.

The term of the plan is a total of five years divided into three phases, each of a three year duration. The first cycle was deemed to have started on 1 January 2018 and will end on 31 December 2020. Under the terms of the Plan, employees will be entitled to receive a certain maximum number of shares of Telefónica S.A., upon fulfillment of certain requirements, namely:

1. The final delivery of shares is conditional upon the employee remaining in the entity's employ during the vesting period.
2. The final number of shares granted is subject to certain performance conditions based on:
 - a. 50% of the total shares shall be delivered upon achievement of a certain Total Shareholder Return ("TSR") target that must be satisfied during the period in which the evolution of the TSR of the Telefónica Group is measured.
 - b. 50% of the total shares shall be delivered if a certain free cash flow ("FCF") target is met.

Thus, if certain performance levels and FCF targets are achieved, the employee is entitled to receive 100% of the maximum number of shares awarded, whereas if only one of the targets is met, the employee shall receive the related shares.

468,234 shares were assigned in the first phase with a fair value of €6.46 per share for the FCF linked shares and €4.52 per share for TSR linked shares.

562,558 shares were assigned in the second phase with a fair value of €6.46 per share for the FCF linked shares and €4.52 per share for TSR linked shares.

Talent for the future Share Plan (TFSP) 2018-2022

The TFSP is a long-term programme aimed to recognise and reward employees with consistent outstanding performance, with high potential and key skills.

At the General Shareholders' Meeting of Telefónica S.A. held on 8 June 2018, a long-term share-based incentive plan called "Talent for the Future Share Plan" was approved for certain Telefonica Group employees.

Under this Plan, a certain number of shares of Telefónica S.A. will be delivered to participants selected by the company who have opted to take part in the scheme and meet the requirements and conditions stipulated to this end.

The term of the plan is a total of five years divided into three phases, each of a three year duration. The first cycle was deemed to have started on 1 January 2018 and will end on 31 December 2020. Under the terms of the Plan, employees will be entitled to receive a certain maximum number of shares of Telefónica S.A., upon fulfillment of certain requirements, namely:

1. The final delivery of shares is conditional upon the employee remaining in the entity's employ during the vesting period.

Notes to the financial statements

For the year ended 31 December 2019

32. Share-based payments (continued)

Talent for the future Share Plan (TFSP) 2018-2022 (continued)

2. The final number of shares granted is subject to certain performance conditions based on:
- 50% of the total shares shall be delivered upon achievement of a certain Total Shareholder Return ("TSR") target that must be satisfied during the period in which the evolution of the TSR of the Telefónica Group is measured.
 - 50% of the total shares shall be delivered if a certain free cash flow ("FCF") target is met.

Thus, if certain performance levels and FCF targets are achieved, the employee is entitled to receive 100% of the maximum number of shares awarded, whereas if only one of the targets is met, the employee shall receive the related shares.

53,000 shares were assigned in the first phase with a fair value of €6.46 per share for the FCF linked shares and €4.52 per share for TSR linked shares.

49,250 shares were assigned in the second phase with a fair value of €6.46 per share for the FCF linked shares and €4.52 per share for TSR-linked shares.

Global Employee Share Plan 2019-2021

The Global Employee Share Plan 2019 was launched on 20 May 2019. Under the plan employees were offered the option to acquire Telefónica S.A. shares during a twelve-month period (the acquisition period), with the company undertaking to deliver a certain number of free shares to participants, subject to certain requirements.

The total term of the plan is two years. Employees joining the plan could acquire Telefónica S.A. shares through maximum monthly instalments of €150 (or the local currency equivalent) up to a maximum of €1,800 over a period of 12 months (acquisition period) and the minimum contribution to be made by each participant would be €25 per month. Those employees who hold the shares for a further twelve months after the end of the acquisition period, are entitled to receive one free share for every two acquired shares, within the Plan conditions.

The acquisition period commenced in July 2019 and will end in June 2020. The plan's shareholding period will come to an end in July 2021. Shares will be delivered in July 2021 at the end of the vesting period.

33. Retirement benefit schemes

Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) acted as Sponsor and Principal Employer of the Plan up to 14 December 2018. On this date a deed was signed by the trustees to transfer the plan into the Company as the majority of employees participating in the plan are employees of the Company. The transfer was made via a capital contribution from Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) for £23.1 million, being the net asset position of the plan on the transfer date.

The Telefónica UK Pension Plan ("the Plan") comprises the following:

- The defined benefit scheme of the Telefónica UK Pension Plan
- The defined contribution scheme of the Telefónica UK Pension Plan
- The UK defined benefit Unfunded Plan

The net defined benefit expense and actuarial valuation impacts of the defined benefit scheme, as assessed in accordance with the advice of a qualified, independent actuary, measuring actuarial liabilities using the projected unit method and taking assets at market value, are recognised in the statement of total comprehensive income of Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) up to the date of transfer to Telefonica UK limited on 14 December 2018.

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For the year ended 31 December 2019

33. Retirement benefit schemes (continued)

The Plan provides the pension benefits for the majority of Telefonica's UK employees, including those of Telefonica UK Limited. Participating companies whose employees are members of the Plan account for the defined benefit sections of the plan as though it were a defined contribution plan as there is no contractual arrangement or stated policy for charging out the net defined benefit cost between participating employers. Telefonica UK Limited therefore expensed any contributions payable to the defined benefit sections of the plan for the period up to 14 December 2018.

With effect from 28 February 2013 the defined benefit scheme of the Plan was closed to new entrants and further benefit accrual. The only funding provided into the defined benefit scheme of the Plan after this date has been the additional deficit funding payments and the section 75 payment. Members' defined benefit pensions will continue to be increased in deferment by reference to the Consumer Prices Index but will not retain the link to any future increases in salary. Upon closure, members of the defined benefit scheme of the Plan were given the option to become members of the defined contribution scheme of the Plan. The defined contribution scheme of the Plan remains open to new entrants and further contributions and the employer contributions are recognised as part of the staff costs in the participating entities. The assets of the Plan are held independently of the Group's finances. The trustee of the Plan acts in accordance with its responsibilities under pension regulations and trust law. They act in the interests of the members and beneficiaries of the Plan and operate independently from the Group.

The liabilities of the UK defined benefit Unfunded plan are recorded within the statement of financial position of O2 Holdings Limited, as it relates to ex-employees of O2 Holdings Limited. The costs arising from the Unfunded plan are borne by O2 Holdings Limited, and are reflected on the statement of comprehensive income of the Company.

The total charge included in the statement of comprehensive income for the Group's entire pension schemes are as follows:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---------------------------------|---|---|
| Telefónica UK Pension Plan cost | 38 | 35 |
| Total operating charge | 38 | 35 |

Actuarial valuation

A full valuation of the defined benefit section of the Plan was undertaken as at 30 September 2017 by a suitably qualified independent actuary. The valuation used the projected unit method.

The initial results of the actuarial valuation of the Plan as at 30 September 2017 have been updated to 31 December 2019 by a third party qualified actuary in accordance with the requirements of IAS 19. The defined benefit liabilities have been measured using the projected unit credit method. Plan assets are stated at fair value.

The Plan's assets are currently invested in a diversified range of credit assets and long-dated inflation linked gilts, which are aligned to the Plan's liability characteristics. A £25 million contribution was paid to the defined benefit scheme by the Group during the year ended 31 December 2019 (2018: £nil).

Notes to the financial statements

For the year ended 31 December 2019

33. Retirement benefit schemes (continued)

The amounts included in the consolidated statement of financial position at 31 December 2019 arising from obligations in respect of the defined benefit scheme of the Plan are as follows:

| | Year ended 31 December 2019 | | Year ended 31 December 2018 | |
|---|-----------------------------|------------|-----------------------------|------------|
| | Funded | Unfunded | Funded | Unfunded |
| | £m | £m | £m | £m |
| Fair value of assets | 1,565 | - | 1,404 | - |
| Present value of defined benefit obligations | (1,577) | (4) | (1,381) | (4) |
| Net (obligation)/asset recognised in statement of financial position | (12) | (4) | 23 | (4) |

Movements in the present value of the various funded and unfunded plans' defined benefit obligations in the current and preceding period were as follows:

| | Year ended 31 December 2019 | | Year ended 31 December 2018 | |
|--|-----------------------------|----------|-----------------------------|----------|
| | Funded | Unfunded | Funded | Unfunded |
| | £m | £m | £m | £m |
| At start of the year | 1,381 | 4 | 1,618 | 4 |
| Past service cost | - | - | (3) | - |
| Interest cost | 39 | - | 39 | - |
| Actuarial loss/(gain) on demographic assumptions | 2 | - | (13) | - |
| Actuarial loss/(gain) on financial assumptions | 199 | - | (186) | - |
| Actuarial gain on expectation adjustments | (4) | - | (30) | - |
| Benefits paid | (40) | - | (44) | - |
| At the end of the year | 1,577 | 4 | 1,381 | 4 |

Movements in fair value of the various funded and unfunded plans' defined benefit scheme assets in the current and preceding period were as follows:

| | Year ended 31 December 2019 | | Year ended 31 December 2018 | |
|--|-----------------------------|----------|-----------------------------|----------|
| | Funded | Unfunded | Funded | Unfunded |
| | £m | £m | £m | £m |
| At start of the year | 1,404 | - | 1,465 | - |
| Interest income | 40 | - | 35 | - |
| Return on plan assets in excess of interest income | 138 | - | (50) | - |
| Company contributions | 25 | - | - | - |
| Scheme expenses paid | (2) | - | (2) | - |
| Benefits paid | (40) | - | (44) | - |
| At the end of the year | 1,565 | - | 1,404 | - |

The Group expects to contribute £25 million to the defined benefit scheme during the year ended 31 December 2020.

Notes to the financial statements

For the year ended 31 December 2019

33. Retirement benefit schemes (continued)

The amounts recognised in the statement of comprehensive income in respect of the defined benefit scheme are as follows:

| | Year ended 31 December 2019 | | Year ended 31 December 2018 | |
|---|-----------------------------|----------|-----------------------------|----------|
| | Funded | Unfunded | Funded | Unfunded |
| | £m | £m | £m | £m |
| Return on plan assets in excess of interest income | (138) | - | 50 | - |
| Actuarial loss/(gain) on demographic assumptions | 2 | - | (13) | - |
| Actuarial loss/(gain) on financial assumptions | 199 | - | (186) | - |
| Actuarial gain on experience adjustments | (4) | - | (30) | - |
| Total loss/(gain) recognised in other comprehensive income | 59 | - | (179) | - |

The main assumptions adopted for the Plan (funded and unfunded) under IAS 19 are as follows:

| | Year ended 31 December 2019 | Year ended 31 December 2018 |
|--|-----------------------------|-----------------------------|
| Life expectancy (male currently age 40 / 60) in years | 88.0/86.8 | 88.2/87.0 |
| Life expectancy (female currently age 40 / 60) in years | 90.2/88.9 | 90.4/89.1 |
| Nominal rate of increase of pensions in payment (RPI max 5%) | 2.90% | 3.05% |
| Discount rate | 2.05% | 2.85% |
| Inflation assumption | | |
| - CPI | 1.95% | 2.20% |
| - RPI | 2.95% | 3.20% |

Plan assets are valued by reference to quoted market prices in active markets.

At 31 December 2019, the weighted average duration of the defined benefit obligation of the funded plan was 22 years (2018: 23 years).

The position and results reported are subject to the accuracy of the assumptions used.

A reduction in the discount rate will increase the assessed value of liabilities as a higher value is placed on benefits paid in the future. A rise in the discount rate will have an opposite effect of similar magnitude.

An increase in the inflation rate will increase the assessed value of liabilities as a higher value is placed on benefits paid in the future. A reduction in the inflation rate will have an opposite effect of similar magnitude.

There is also uncertainty around the future life expectancy of the UK population. The value of current and future pension benefits will depend on how long they are assumed to be in payment.

Notes to the financial statements

For the year ended 31 December 2019

33. Retirement benefit schemes (continued)

The following table summarises the estimated sensitivity of the disclosed liability value to changes in the principal assumptions that have been used in the calculations:

| Charge by assumption | Liabilities increase by: |
|------------------------------------|--------------------------|
| Decrease discount rate by 0.25% | £98 million |
| Increase inflation rate by 0.25% | £94 million |
| Increase life expectancy by 1 year | £41 million |

Investment commentary

As at 31 December 2019, the Plan was fully invested in line with the SIP. The Plan's assets were invested in a diversified range of credit assets and long-dated inflation linked gilts, which are aligned to the Plan's liability characteristics. This strategy is achieved through a mixture of direct investments in the target asset classes and derivatives. This includes the Liability Driven Investment strategy which aims to reduce the Plan's exposure to interest rate and inflation risk.

The Plan's exposure at the end of the reporting period for each category of assets is as follows:

| | 2019 | 2018 |
|---------------------------|-------|-------|
| Equities | | |
| Equity instrument funds | 0% | 0% |
| Credit instruments | | |
| AAA rated | 3% | 7% |
| AA rated | 67% | 65% |
| A rated | 8% | 6% |
| BBB and lower | 28% | 26% |
| Not rated | 25% | 28% |
| Cash/other | 10% | 3% |
| Liabilities | (41%) | (35%) |

The figures above are as at the statement of financial position date. Market values of Plan's assets, which are not intended to be realised in the short-term, may be subject to significant changes before they are realised. All equity securities and credit opportunities have quoted prices in active markets.

Risks

The main risks to which the Group are exposed in relation to the Plan are:

Longevity risk

The assumptions adopted by the Group make allowance for future improvements in life expectancy. However, if life expectancy improves at a faster rate than assumed, this would result in greater payments from the Plan and consequently increases in the Plan's liabilities. The Group and the Plan's Trustee reviews the mortality assumption on a regular basis to minimise the risk of using an inappropriate assumption.

Investment risk

The Plan invests its assets in a portfolio of global corporate bonds, liquid credit and synthetic equity, with a Liability Driven Investment overlay to provide interest and inflation rate hedging. The Plan's liabilities are valued with respect to long dated bond yields, so the value of assets and liabilities may move out of line as investment conditions change. In addition because the duration of the Plan's assets is shorter than the duration of the Plan's liabilities, there is a risk that the Trustee will not be able to reinvest the Plan's assets at assumed rates. The Plan's Trustee reviews the structure of the investment portfolio on a regular basis to minimise these risks.

Notes to the financial statements

For the year ended 31 December 2019

33. Retirement benefit schemes (continued)

Risks (continued)

Yield risk

A fall in bond yields will increase both the value of the Plan's assets and liabilities. At present the value of the Plan's liabilities is greater than the value of its assets, and as a result there is a risk that the value of the liabilities may grow in monetary terms by more than the value of the Plan's assets, increasing the deficit in the Plan.

Inflation risk

The majority of the Plan's liabilities increase in line with inflation and so if inflation is greater than expected, the liabilities will increase. The Plan has hedged some of the inflation risk and will continue to monitor this risk.

Expected benefit payments from the Plan

| Year | 2019 Funded Expected benefit payments (£m) | 2019 Unfunded |
|--------------|---|---------------|
| 2020 | 31 | - |
| 2021 | 33 | - |
| 2022 | 36 | - |
| 2023 | 41 | - |
| 2024 | 44 | - |
| Rest of time | 3,056 | 5 |

Other pension plans

The Group also operates a defined contribution scheme in the UK. The assets of these defined contribution arrangements are held separately from those of the Group in independently administered funds. The expense, in the statement of comprehensive income, relating to the defined contribution section of the Plan is equal to the contributions paid over the period presented, which totaled £38 million for the year ended 31 December 2019 (2018: £35 million).

34. Financial instruments and capital management

34.1 Financial risk factors and management

The Group's principal financial liabilities comprise bank overdrafts, other loans, finance leases and trade and other payables. The purpose of these financial liabilities is to raise finance for the Group's operations. The Group has various financial assets such as trade receivables, cash and short term deposits.

The main sources of risk arising from the Group's financial instruments are currency risk, interest rate risk, credit risk and liquidity risk. Management of the Group's financial risks is achieved mostly through being a part of the larger Telefónica Group, which operates Telefónica Group wide policies in each area and is able to hedge positions on a Group basis.

The Group's operations expose it to a variety of financial risks including currency risk, credit risk and liquidity risk. No detailed sensitivity analysis is presented, as the Group considers that its risk exposure has been appropriately mitigated. The principal financial risks of the Group and how the Group manages these risks are discussed below.

Notes to the financial statements

For the year ended 31 December 2019

34. Financial instruments and capital management (continued)

34.1 Financial risk factors and management (continued)

(a) Market risk

(i) Foreign currency risk

The Group operates mainly in the United Kingdom. The Group is exposed to transactional foreign exchange risks arising from various currency movements, primarily with respect to the Euro and US dollar that can affect its results and financial position. The impact of any reasonable change in foreign exchange rates would not have a significant impact on the result of the Group for the year.

The Group also has a small amount of transactional exposure. Such exposure arises from revenues and purchases by an operating unit that is in currencies other than the unit's functional currency. Significant exposures are managed through the use of foreign exchange contracts and the Telefónica Group managing positions on a Telefónica Group wide basis.

(ii) Cash flow and fair value interest rate risk

Interest rate risk is the risk that fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Group's interest rate risk arises primarily from the effects of movements in interest rates on the value of the Group's long-term borrowings and interest received on cash and cash equivalents. The Group's long term borrowings and other financial assets are at fixed interest rates. The majority of the Group's cash and cash equivalents are deposited with a central Telefonica Group company that pays interest at variable market rates.

The impact of any reasonable change in interest rates would not have a significant impact on the result of the Group for the year.

Effective interest rates and re-pricing analysis

In respect of income-earning financial assets and interest-bearing financial liabilities, the following table indicates the periods in which they re-price or mature (whichever date is earlier). Their effective interest rates at the statement of financial position date are disclosed in Note 23. Accrued interest has been included in the analysis.

| | | Year ended 31 December 2019 | | |
|--|-----------------|-----------------------------|----------------------|--------------|
| | | One year or less | One to five years | Total |
| | | £m | £m | £m |
| Other financial assets | Sterling | 61 | 57 | 118 |
| Cash and cash equivalents | Sterling | 295 | - | 295 |
| | Euro | 9 | - | 9 |
| | USD | 1 | - | 1 |
| Total cash and cash equivalents | | 305 | - | 305 |
| Other loans and borrowings | Sterling | - | (964) | (964) |
| Total | | 366 | (907) | (541) |

| | | Year ended 31 December 2018 | | |
|--|-----------------|-----------------------------|----------------------|--------------|
| | | One year or less | One to five years | Total |
| | | £m | £m | £m |
| Other financial assets | Sterling | 71 | 12 | 83 |
| Cash and cash equivalents | Sterling | 300 | - | 300 |
| | Euro | 14 | - | 14 |
| | USD | 1 | - | 1 |
| Total cash and cash equivalents | | 315 | - | 315 |
| Other loans and borrowings | Sterling | - | (964) | (964) |
| Total | | 386 | (952) | (566) |

Notes to the financial statements

For the year ended 31 December 2019

34. Financial instruments and capital management (continued)

34.1 Financial risk factors and management (continued)

(b) Credit risk

Credit risk is the risk that a counterparty will not meet its obligation under a financial instrument or customer contract, leading to a financial loss.

The Group's principal credit risks are attributable to its trade receivables and contract assets. Trade receivables and contract assets as presented in the statement of financial position are net of provisions for estimated credit losses.

At the statement of financial position 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 in the statement of financial position. The Group does not require collateral in respect of financial assets.

(i) Trade receivables and contract assets

The Group provides services to individuals and business customers on credit terms. The Group expects that some debts due will not be paid as a result of the default of a small number of customers. The expected credit loss rates are based on historical results and future expectations, the economic and competitive environment and other relevant factors to determine the provision for credit losses. A significant, unanticipated downturn in the major economies that the Group 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 exposure to credit risk is monitored on an ongoing basis.

The Group applies the IFRS 9 simplified approach to measuring expected credit losses which uses a lifetime expected loss allowance for all trade receivables and contract assets. The contract assets relate to unbilled revenue and have substantially the same characteristics as the trade receivables for the same types of contracts.

The loss allowance was determined for trade receivables and contract assets at 31 December 2019 and 31 December 2018 as follows:

| | Contract assets | | Trade receivables | |
|----------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 December 2019 £m | 31 December 2018 £m | 31 December 2019 £m | 31 December 2018 £m |
| Current amounts | 285 | 223 | 1,014 | 1,001 |
| Amounts past due: | | | | |
| - Less than 90 days | - | - | 59 | 85 |
| - Between 90 and 180 days | - | - | 23 | 28 |
| - Between 180 and 360 days | - | - | 30 | 26 |
| - Over 360 days | - | - | 55 | 53 |
| Loss allowance | (16) | (12) | (160) | (157) |
| Total | 269 | 211 | 1,021 | 1,036 |

Amounts above are presented including VAT.

For the receivables 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.

Notes to the financial statements
For the year ended 31 December 2019

34. Financial instruments and capital management (continued)

34.1 Financial risk factors and management (continued)

(b) Credit risk (continued)

(i) Trade receivables and contract assets (continued)

The movement in the trade receivables and contract assets loss allowance during the year is as follows:

| | Contract assets £m | Trade receivables £m |
|---|-----------------------------------|-------------------------------------|
| Loss allowance at 1 January 2019 | 12 | 157 |
| Increase in loss allowance recognised in profit or loss during the year | 4 | 157 |
| Receivables written off during the year as uncollectable | - | (144) |
| Unused amount reversed | - | (10) |
| Loss allowance at 31 December 2019 | 16 | 160 |

Trade receivables and contract assets are written off where there is no reasonable expectation of recovery. Impairment losses on trade receivables and contract assets are presented as net impairment losses within operating profit in the statement of comprehensive income. Subsequent recoveries of amounts previously written off are credited against the same line item.

(c) Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities.

Management of the Group's liquidity risk is achieved mostly through being a part of the larger Telefónica Group, which operates Telefónica Group wide policies in this area. The Group 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.

The following tables set out contractual undiscounted cash outflows of financial liabilities, including interest payments:

| | Year ended 31 December 2019 | | |
|------------------------------------|---|------------------------------------|---------------------|
| | Greater than one year £m | One year or less £m | Total £m |
| Borrowings | 997 | 17 | 1,014 |
| Trade and other payables | 4 | 2,337 | 2,341 |
| Total financial liabilities | 1,001 | 2,354 | 3,355 |

| | Year ended 31 December 2018 | | |
|------------------------------------|---|------------------------------------|---------------------|
| | Greater than one year £m | One year or less £m | Total £m |
| Borrowings | 1,018 | 18 | 1,036 |
| Trade and other payables | 2 | 1,546 | 1,548 |
| Total financial liabilities | 1,020 | 1,564 | 2,584 |

Notes to the financial statements
For the year ended 31 December 2019

34. Financial instruments and capital management (continued)

34.1 Financial risk factors and management (continued)

(c) Liquidity risk (continued)

The following tables set out the maturity analysis of financial assets that are held to manage liquidity risk:

| Year ended 31 December 2019 | | | |
|-------------------------------|----------------------------|---------------------------|--------------|
| | One to five years £m | One year or less £m | Total £m |
| Trade and other receivables | 258 | 1,257 | 1,515 |
| Other financial assets | 57 | 61 | 118 |
| Cash and cash equivalents | - | 305 | 305 |
| Total financial assets | 315 | 1,623 | 1,938 |

| Year ended 31 December 2018 | | | |
|-------------------------------|----------------------------|---------------------------|--------------|
| | One to five years £m | One year or less £m | Total £m |
| Trade and other receivables | 122 | 1,374 | 1,496 |
| Other financial assets | 12 | 71 | 83 |
| Cash and cash equivalents | - | 315 | 315 |
| Total financial assets | 134 | 1,760 | 1,894 |

Supplier financing arrangements

The Group operates a supplier financing scheme for certain suppliers that allows them to be paid earlier than the invoice due date. The Group evaluates supplier arrangements against a number of indicators to assess if the payable continues to hold the characteristics of a trade payable or should be classified as borrowings; these indicators include whether the payment terms exceed customary payment terms in the industry. The balances contained within trade payables amounted to £342 million at 31 December 2019 (2018: £302 million). As at 31 December 2019 none of the payables subject to supplier financing arrangements met the criteria to be reclassified as borrowings.

34.2 Capital management

The Group's capital comprises share capital, a capital reserve (see Note 29) and retained earnings.

The Group's objectives when managing capital are to safeguard the Group's ability to continue to operate as a going concern, to maintain optimal capital structure commensurate with risk and return and to reduce the cost of capital.

In order to maintain or adjust the capital structure, the Group may pay dividends to its shareholder, return capital to its shareholder, issue new shares or sell assets to reduce debt or draw down more debt.

The Group's total capital and gearing is as follows:

| | 31 December 2019 £m | 31 December 2018 £m |
|---|---------------------------|---------------------------|
| Total borrowings (note 23) | 964 | 964 |
| Less: cash and cash equivalents (note 30) | (305) | (315) |
| Net debt | 659 | 649 |
| Total equity | 5,117 | 5,079 |
| Total capital | 5,776 | 5,728 |
| Gearing ratio | 11% | 11% |

Notes to the financial statements

For the year ended 31 December 2019

34. Financial instruments and capital management (continued)

34.3 Financial assets

The classification of financial assets for the year ended 31 December 2019 is as follows:

| | Fair value through profit or loss Held to sell £m | Amortised cost £m | Total carrying amount £m |
|-------------------------------------|--|----------------------|--------------------------------|
| Trade receivables | - | 155 | 155 |
| Contract assets | - | 103 | 103 |
| Other financial assets | - | 57 | 57 |
| Non-current financial assets | - | 315 | 315 |
| Trade receivables | 407 | 530 | 937 |
| Contract assets | - | 166 | 166 |
| Other financial assets | - | 61 | 61 |
| Accrued income | - | 154 | 154 |
| Cash and cash equivalents | - | 305 | 305 |
| Current financial assets | 407 | 1,216 | 1,623 |
| Total financial assets | 407 | 1,531 | 1,938 |

For the years ended 31 December 2019 and 31 December 2018 there are no financial assets classified as: fair value through profit or loss using the fair value option; fair value through other comprehensive income (debt or equity instruments); or hedges.

All financial assets held at fair value through profit or loss are classified as level 2 in the measurement hierarchy and are measured using other directly observable market inputs. There are no financial assets classified as level 1 (quoted prices) or level 3 (inputs not based on observable market data).

34.4 Financial liabilities

For the year ended 31 December 2019 all financial liabilities were held at amortised cost.

35. Related party transactions

During the period, the Group entered into transactions with related parties as follows:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|--------------------------------------|--------------------------------------|
| Income from related parties | | |
| Tesco Mobile Limited | 209 | 192 |
| Telefónica Insurance, S.A. | 30 | 22 |
| Telefónica Germany GmbH & Co OHG | 2 | 2 |
| Telefónica S.A. and subsidiaries | 1 | 1 |
| Other related parties | 6 | 5 |
| Total income from related parties | 248 | 222 |

Notes to the financial statements
For the year ended 31 December 2019

35. Related party transactions (continued)

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|--|--------------------------------------|--------------------------------------|
| Expenses to related parties | | |
| Telefónica de España S.A.U | (35) | (39) |
| Telefónica S.A. and subsidiaries | (25) | (22) |
| Telfin Ireland Limited | (17) | (20) |
| Telefónica Global Roaming, GmbH | (8) | (12) |
| Telefónica Móviles España, S.A.U. | (15) | (16) |
| Telefonica Digital Limited | (3) | (3) |
| Other related parties | (14) | (13) |
| Total expenses from related parties | (117) | (125) |

At the dates presented the Group had the following balances arising from transactions with related parties:

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|--------------------------------------|--------------------------------------|
| Receivables from related parties | | |
| Telefónica Móviles España, S.A.U | 8 | 1 |
| Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) | 8 | 28 |
| Tesco Mobile Limited | 21 | 20 |
| Telefónica International Wholesale Services II, S.L. | 3 | 4 |
| Telefónica Germany GmbH & Co OHG | 10 | 9 |
| Telefónica S.A. and subsidiaries | 1 | 1 |
| Telefonica Digital Limited | 1 | 2 |
| Other related parties | 5 | 2 |
| Total receivables from related parties | 57 | 67 |

| | Year ended 31 December 2019 £m | Year ended 31 December 2018 £m |
|---|--------------------------------------|--------------------------------------|
| Payables to related parties | | |
| Telfin Ireland Limited | (964) | (964) |
| Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) | (6) | (31) |
| mm02 plc | (88) | (88) |
| Telefónica Factoring Espana, S.A. | (107) | (163) |
| Telefonica Germany Holdings Limited | (39) | (48) |
| Telefónica International Wholesale Services II, S.L. | (7) | (10) |
| Telefonica Digital Limited | (12) | (16) |
| Telefónica S.A. and subsidiaries | (11) | (10) |
| Telefónica de España, S.A.U. | (6) | (6) |
| Telefónica Móviles España, S.A.U. | (5) | (3) |
| O2 Europe and subsidiaries | (6) | (6) |
| Telefónica Global Roaming, GmbH. | (2) | (3) |
| Telefónica Germany GmbH. | (3) | (2) |
| Other related parties | (1) | (2) |
| Total payables to related parties | (1,257) | (1,352) |

**Notes to the financial statements
For the year ended 31 December 2019****35. Related party transactions (continued)**

Details of receivables and payables to and from the immediate parent company of the Group are contained in Notes 21 and 26.

Included within cash equivalents at 31 December 2019 is £315 million (2018: £305 million) of funds deposited with Telfisa Global B.V., a related party, which are repayable on demand.

Related party transactions with Directors and key management are detailed in Note 8.

36. Contingent Liabilities***Phones 4u***

Legal proceedings have been issued in the High Court against the Group by the Administrators of Phones 4u. The Group has vigorously denied the allegations and filed its defence to this claim in April 2019. No provision has been made in relation to this matter.

37. Other matters

As disclosed in previous years the Group has been addressing a request for disclosure made by governmental authorities which is related to possible violations of anti-bribery laws and regulations. The Group continues to co-operate with the governmental authorities investigating this matter which is still ongoing. Also the Group continues to conduct its own internal investigation on the matter. Whilst it is not possible at this time to predict the full scope or duration of this matter or its eventual outcome, the Group considers it can make a reliable estimate of the outcome and has made an accrual for this amount at 31 December 2019 (31 December 2018 : no accrual was made).

Disclosure of the matters required by IAS 37 has not been provided as permitted by IAS37 para 92 as the directors believe that further disclosure will be seriously prejudicial to future developments on this matter.

38. Subsequent events***Annual Licence Fees***

In 2015, by way of regulations (2015 Regulations), Ofcom reset the existing regulations (2011 Regulations) for Annual Licence Fees (ALFs) for the 900 & 1800 MHz bands from approximately £65m to £200m per annum for all mobile network operators (MNOs). Telefonica UK's fees were set at £49.8m pa. The 2015 Regulations were quashed in 2017 pursuant to a Court of Appeal judgment which held that they had been determined unlawfully by Ofcom. The fees regime reverted to the pre-existing 2011 Regulations and the lower fees set in these Regulations. O2 and the other MNOs brought a claim against Ofcom for repayment of the difference between the amounts paid under the unlawful 2015 Regulations and the lawful 2011 Regulations. O2's claim was initially £52.8m plus interest. This figure increased to £54.4m plus interest in 2019 due to a payment being incorrectly characterised when the claim was first formulated.

Ofcom disputed that the MNOs were entitled to claim the difference in this way, instead asserting that the MNOs were only entitled to the difference between the amount paid under the unlawful 2015 Regulations and a notional amount that would have been paid had Ofcom put in place lawful regulations at the relevant time (which Ofcom noted would have been of a similar level to the 2015 Regulation fees based on a new consultation and subsequent 2018 Regulations that came into force which set ALFs at a broadly similar level as they had been set by the 2015 Regulations). The MNOs won their claim in the High Court in 2019 and the appeal in the Court of Appeal in 2020. Ofcom is not appealing the Court of Appeal decision to the Supreme Court.

Notes to the financial statements

For the year ended 31 December 2019

38. Subsequent events (continued)

O2 and Virgin Media Joint Venture

On 7 May 2020, Telefonica SA and Liberty Global announced that both companies had entered into an agreement together to create a 50:50 joint venture in the UK, bringing together the Telefonica UK (O2) and Virgin Media businesses. The arrangement is still subject to regulatory clearance has been agreed in order to create a national connectivity champion capable of competing at the highest level with the combined mobile and home connections. It is anticipated that closing of the transaction, subject to regulatory clearance is expected to take place around the middle of 2021.

Covid-19

Worldwide or national health-related events, including the outbreak of contagious diseases, epidemics or pandemics, such as COVID-19 (coronavirus), could significantly affect our operations. Such events could cause, among others, delays in the supply chain due to problems in factories or logistic services; impact on employees or third parties due to quarantine periods or infection, and also affecting global and therefore national economic growth. The latter stemming from a variety of adverse impacts on supply (paralysis of integrated production chains, freezing of productive resources) and demand (deterioration of confidence and expectations, negative income and wealth effects) caused by a substantial deterioration in financial markets, unprecedented falls in commodity prices, sharp slowdown in commercial activity or heavy restrictions on transport. Like every other business we are not immune to the consequences of the pandemic and are committed to ensuring that the Business can navigate through the unprecedented uncertain times, supporting our customers and employees as well as contributing to the recovery of the economy which we operate in by keeping Britain connected. As Britain works through this national crisis, mobile is playing a more critical role than ever to keep people connected. We are doubling some elements of our network capacity, enabling essential connectivity, supporting Britain's productivity and donating directly to those who need it - all in the pursuit of keeping Britain connected.

As a responsible business we followed government advice to help protect our people and our customers. We implemented our business continuity plans to allow office-based employees to work from home and took a decision to close our stores after trading on 23 March 2020 ahead of the national lockdown announcement by the government. During the lockdown period we implemented a work from home policy where it is possible to do so ensuring the safety and welfare of our people and the ability to continue to meet the needs of our customers. In addition, we brought in a range of temporary people measures, including the protection of base pay for all employees including paid leave for vulnerable employees and for those in self-isolation, or with caring responsibilities who are unable to work from home, including retail employees. We worked closely with the government to provide assistance to NHS workers, charities and our customers by providing 25% discount on tariffs and free data for NHS workers, unlimited free calls for Pay Monthly customers, suspended roaming charges, support for vulnerable customers and zero-rating access to support and charity websites. We were instrumental to supporting the NHS and keeping Britain connected by providing connectivity to the Nightingale hospitals across the country and donated The O2 as a training facility as well as a drive through testing facility for the NHS. We also partnered with the BBC's Big Night In to galvanize the nation to respond to the challenges that lie ahead.

Following the ease of the lockdown restrictions in phases we are committed to ensuring the continuing safety of our employees and customers and have re-engineered our retail estate, practices and procedures to align with the government guidelines for social distancing. We are mindful of the economic pressure and impact on our profitability growth and are committed to helping Britain get back to normal by supporting our customers and businesses.

The Group has shown resilience throughout this turbulent period and the need for connectivity by our customers has been just as strong, albeit their specific demands have changed. The below table outlines the main impacts to the business as a result of COVID-19 and what the business has done to address them.

Notes to the financial statements
For the year ended 31 December 2019

38. Subsequent events (continued)

Covid-19 (continued)

| Matter to consider | Impacts/Risks | Mitigations | Conclusion |
|---------------------------|---|--|--|
| Revenue | <p>Store closures have resulted in a slow down of hardware revenue.</p> <p>Smart metering revenues have slowed down due to physical restrictions during lockdown.</p> <p>The travel ban in the UK and across many parts of Europe has resulted in reduced roaming revenues.</p> | <p>Improved online sales capabilities by enabling telesales teams to operate from home and adapting physical estate in order to manage the sales process under social distancing guidelines.</p> | <p>We have seen an increase in online channel sales and we expect other channels to pick up again as lockdown restrictions start to ease from mid-June.</p> <p>The reduction in roaming revenues is partially offset by a reduction in associated costs.</p> |
| Liquidity | <p>Financing becomes more expensive and unavailable in the current climate.</p> | <p>Key debt facility has been renewed for an additional term and the introduction of a new funding partner has enabled the Company to grow the facility whilst keeping the total cost of funding the facility flat.</p> | <p>No significant liquidity concerns, the risk of a loss of available funding has been mitigated through the introduction of a third funding partner.</p> |
| Collections | <p>Customers struggle to pay their bills and increased bad debt.</p> | <p>Following emergency changes to government regulations on Consumer Credit Agreements we initially introduced an emergency payment option for any customers finding it difficult to pay their bill as a direct result of COVID-19.</p> <p>Appropriate provisions have been made for the anticipated increase in bad debt as a result of the pandemic.</p> | <p>The volumes of customers taking the emergency payment option has been within expected levels, the impact has been considered in forward looking financial forecasts.</p> |
| Costs/Capital allocation | <p>Spend is not reviewed in light of COVID-19.</p> | <p>The board has reviewed discretionary expenditure and investments in view of COVID-19 and continue to execute smart spending principles to focus on core service and targeted cost management throughout the business.</p> | <p>Appropriate measures are now in place to review cost control and capital expenditure in light of the pandemic.</p> |

Notes to the financial statements
For the year ended 31 December 2019

38. Subsequent events (continued)

Covid-19 (continued)

| Matter to consider | Impacts/Risks | Mitigations | Conclusion |
|---------------------------|--|--|--|
| Forecasting | Forecasts are not reflective of performance during COVID-19 crisis. | We have processes in place to review the appropriateness of our financial outlooks regularly and monitor market activity on an ongoing basis. Rate and volume assumptions have been stress tested and triangulated with market insight and trading updates. | Current forecasts take account of risks associated with trading during the COVID-19 crisis. |
| Network Resilience | Network overload and possible degradation of services from the growth of voice / data traffic. | We proactively managed the expected voice traffic increase through increased network capacity. Data usage patterns changed as people connected from their homes rather than work locations and commuting routes with no negative impact on the network. | Network capacity planning reflects an expected impact of changes in future usage patterns as a result of COVID-19. |

Disposal of legacy assets

During the year ended 31 December 2019 amounts of £1,418 million cost and £1,418 million accumulated depreciation were disposed of relating to legacy assets no longer in use. Subsequent to 31 December 2019 we identified further legacy assets no longer in use of £85 million cost and £85 million accumulated depreciation. Consequently we disposed of a total of £1,503 million cost and £1,503 million accumulated depreciation during the year ended 31 December 2019. The disposals had £Nil impact on the net book amount of property, plant and equipment.

39. Parent company and controlling party

At 31 December 2019, the immediate parent company was Telefonica O2 Holdings Limited (formerly Telefonica Europe plc), a company incorporated in England and Wales. Copies of the financial statements of Telefonica O2 Holdings Limited (formerly Telefonica Europe plc) may be obtained from 260 Bath Road, Slough, Berkshire, SL1 4DX.

The ultimate parent company and controlling party at 31 December 2019 was Telefónica, S.A., a company incorporated in Spain, which prepares consolidated financial statements. Consolidated financial statements of Telefónica, S.A. may be obtained from Gran Via 28, Madrid, Spain.