Operating and financial review and prospects

This commentary discusses, and is based on, the audited consolidated financial statements of the Group prepared in accordance with UK Generally Accepted Accounting Principles (UK GAAP), included on pages 66 to 89. This commentary should be read in conjunction with those financial statements.

Definitions of the non-financial operating metrics (including ARPU, churn, subscriber acquisition costs (SACs), pre-pay customers and post-pay customers) used in this commentary can be found in the non-financial metrics section on page 90 of this document.

Composition of our Group

Throughout the year, we provided voice and data mobile communications services and products in the United Kingdom, Germany and Ireland through our wholly-owned mobile businesses, O2 UK, O2 Germany and O2 Ireland, respectively. We also supplied fixed and mobile communications services in the Isle of Man through our wholly-owned subsidiary, Manx Telecom, and we operate a secure national digital radio service for the police forces of England, Scotland and Wales through our O2 Airwave business.

All our businesses have been included throughout the periods covered by the consolidated financial statements with the exception of O2 Netherlands which was included up to 3 June 2003, the date at which our disposal of this business completed and control passed to the purchaser. O2 Online, our internet portal business, was operated as a separate legal entity until 1 April 2004 when the main business of O2 Online was subsumed into the operations of O2 UK.

Capital reorganisation

Merger accounting

O2 plc was incorporated on 10 December 2004 as part of the capital reorganisation described in note 19 to the financial statements. The purpose of the capital reorganisation was to create distributable reserves in O2 plc to allow the implementation of the Group's distribution policy. These financial statements are O2 plc's first company and consolidated financial statements.

On 14 March 2005, O2 plc was introduced as the new holding company of the mmO2 plc Group pursuant to a Scheme of Arrangement (the Scheme) under section 425 of the Companies Act 1985, whereby O2 plc issued shares in return for the existing shares in mmO2 plc. Shareholders were also offered the opportunity to realise, for cash, their shareholding in mmO2 plc in a cost effective manner.

The Directors consider that in substance the Scheme constituted two distinct transactions being firstly, the insertion of the new holding company, O2 plc, and secondly, a placing of shares on behalf of certain shareholders who elected to receive the consideration for their shares in mmO2 plc in cash. The insertion of a new holding company constitutes a group reconstruction as defined by Financial Reporting Standard (FRS) 6 "Acquisitions and mergers" and has been accounted for using merger accounting principles. The premium paid to shareholders who elected to receive their consideration in cash has been recognised as a deduction from the Group profit and loss account reserve.

The consolidated financial statements for the year ended 31 March 2005 comprise the results of O2 plc from incorporation to 31 March 2005 together with the results of the O2 Group from the 14 March 2005 to the end of the financial year and the results of the mmO2 Group from 1 April 2004 to 13 March 2005. The comparative information presented is as previously published for the mmO2 Group except where otherwise stated.

O2 plc purchased mmO2 plc for share consideration. Certain mmO2 shareholders, holding 299,500,644 ordinary shares of mmO2 plc, elected to receive the consideration for their shares in mmO2 in cash. All other shareholders, holding 8,403,362,095 ordinary shares of 0.1 pence each in mmO2, received the same number of new ordinary shares of 80 pence each in the Company as they previously held in mmO2. In order to fund the cash consideration the Company issued and allotted 299,500,644 ordinary shares in the Company via a placement with investors on the London Stock Exchange's market for listed securities on 17 March 2005. This placement raised £374,375,805. The remaining cash consideration of £14,975,032, representing a premium of five pence per share owing to shareholders electing to receive the cash, was funded by the Group.

The Board of mmO2 also reviewed the US listing and the associated ADR programme which is a legacy of the demerger from BT. As part of the reorganisation, mmO2's ADRs were delisted from the New York Stock Exchange at the time that the Scheme became effective and O2 plc has not established an equivalent ADR programme nor a US listing for the new shares in O2 plc. The Board has also reviewed the consequences of continued SEC registration although the timing of any application to deregister has not yet been determined by the Board.

Factors affecting our business

Certain key factors affecting our results of operations in the three years ended 31 March 2005 are discussed below.

The mobile telecommunications market

The Western European mobile telecommunications market has high penetration rates and is highly competitive. As a consequence we focus on customer retention and on generating increased usage from existing customers through both voice services and data applications. We also focus on acquiring higher spending contract customers, and SACs for certain customers, in particular high value post-pay customers, may increase.

Pre-pay products

Pre-pay customers pay in advance for their usage, and comprise the majority of our customer base across the Group. Our pre-pay customers account for 66 per cent of our customers in the United Kingdom, 45 per cent in Germany and 74 per cent in Ireland.

In each of our mobile telecommunications businesses, on average, pre-pay customers spend less than post-pay customers. Nonetheless, pre-pay services offer us several significant advantages, including lower SAC, higher average per minute charges, reduced credit risk and lower administrative costs. However, lower average outgoing usage minutes for pre-pay customers results in lower ARPU. As our ARPU from pre-pay customers is lower than for post-pay customers, to maintain profitability we give lower handset discounts to pre-pay customers, in line with general industry practice.

Seasonality

Historically, the number of new customer connections to mobile telephone networks in the markets where we are present has been greater during the second half of the financial year than during the first half, primarily owing to increased sales during the Christmas period. Therefore, our revenues from equipment sales and connection charges, and the aggregate costs of customer equipment and dealer commissions and our other related costs of sales, have been greater during the second half of the financial year than during the first half. However, this trend may not continue and it is difficult to predict the seasonality of customer connections in the future.

Impact of regulation

Our businesses operate in highly regulated markets, and governmental regulation frequently limits the revenue we may receive from certain sources. The regulatory climate in the territories in which our businesses operate is discussed in the regulation section of our business review.

Foreign currency translation

The Company publishes its Group financial statements in Sterling (£). The subsidiaries in Germany and Ireland report their results and financial position in Euros (€). Consequently, fluctuations in the value of Sterling against the Euro affect the amount at which these items are reported in the Company's Group financial statements, even if their value has not changed in their original currency.

Critical accounting policies

Our consolidated financial statements are prepared in accordance with accounting principles that are generally accepted in the UK. As part of these reporting guidelines, management are required to identify and disclose the accounting policies relating to all aspects of the results and financial position of our Group used in preparing the financial statements. The preparation of consolidated financial statements requires management to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses, as well as the disclosure of certain contingent assets and liabilities. The accounting policies used in preparing our Group's financial statements for the year ended 31 March 2005 are disclosed in note 1 of those financial statements.

The following accounting policies are considered to be critical to the understanding of the consolidated financial statements. These policies have the potential to have a significant impact on the Group's financial statements, either because of the significance of the financial statement item to which they relate, or because they require a high degree of judgement and estimation owing to the uncertainty involved in measuring, at a specific point in time, events that are continuous in nature.

Tangible and intangible fixed assets

We estimate the useful lives of tangible assets, goodwill and other intangible assets in order to determine the amount of depreciation and amortisation to be charged in any reporting period. These useful lives are estimated at the time the asset is acquired, and are based on historical experience with similar assets as well as taking into account future anticipated events affecting their life. Changes in technology or changes in the Group's intended use of these assets may cause the estimated life or the value of these assets to change.

We perform a review of the estimated useful life, residual value and depreciation method for each category of tangible fixed assets (being land and buildings, plant and equipment and assets in the course of construction), at the end of every reporting period. Our review of these assets may indicate that their lives need to be lengthened or shortened, resulting in a decreased or increased depreciation charge respectively in future periods. Alternatively, our review may indicate a decrease in the value of the asset, recognised by an impairment charge.

Fixed asset impairments

In accordance with UK GAAP, we assess the carrying values of our intangible fixed assets (including goodwill) at the end of the first full financial year following acquisition, and all our fixed assets (tangible, intangible and goodwill) in any accounting period if events or changes in circumstances indicate that the carrying values may not be recoverable. Factors we believe are important and may trigger an impairment review could include the following:

- a significant decline in a fixed asset's market value;
- a significant adverse change in the business or the market in which the fixed asset is involved;
- a significant adverse change in the statutory or other regulatory environment; or
- significant underperformance relative to expected or forecast operating results.

Under UK GAAP, when a triggering event has occurred, we perform an impairment review by comparing the carrying value of the income generating unit (IGU) with its recoverable amount. The recoverable amount is deemed to be the higher of the IGU's value-in-use and its net realisable value. Unless an IGU is to be disposed of, the recoverable amount is deemed to be equal to its value-in-use, which is determined by calculating the net present value of its future estimated cash flows.

We have not identified any events requiring an impairment review to be performed in the current year.

Revenue recognition

In turnover we only recognise transactions that are considered to be part of our principal on-going operations. In particular:

- voice and data service revenue is recognised in the profit and loss account based on minutes of airtime processed over the Group's networks;
- turnover derived from connection fees and subscriptions is recognised evenly over the estimated customer relationship period, or the contracted period to which they relate;
- income received from sales of pre-pay call cards is deferred until the customer uses the value in the card to pay for relevant calls; and
- revenues from handsets are recognised at the point of sale.

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

Debtor recoverability

In connection with recording revenue, we maintain provisions for doubtful debts for estimated losses that result from the inability of a portion of our customers to make required payments. We base our provision on historical results and future expectations, the economic and competitive environment and other relevant factors, and review the provision regularly.

Mast site restoration provisions

We have 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 mast sites. We provide for the expected costs of restoring those sites on which we believe that we will have a material liability. The provision is based on assumptions covering the lease term, the characteristics of the site, the expected cost of restoring the site and the period of time before the obligation is expected to be incurred. There is inherent uncertainty given the long period over which certain leases run and actual restoration costs may differ to those estimated.

Financial performance measurement

We define EBITDA as our earnings before interest, tax, depreciation, amortisation and exceptional items, excluding our share of operating profits and losses of our joint ventures and associates. We use EBITDA, a non-GAAP financial measure, as one of the key performance indicators for evaluating the financial performance of our business units. We believe that EBITDA provides an important measure of the underlying operating performance of our Group because it excludes recurring non-cash items such as depreciation and amortisation. We believe that this measure is also used by readers of this Annual Report in order to assess our performance against other comparable companies. Other measures used include revenues, operating profit or loss and capital expenditure.

We also believe that EBITDA is one of the key indicators of our borrowing potential as indicated by the financial covenants attaching to some of our credit facilities which require compliance with EBITDA targets and EBITDA-based ratios. Further details are provided in the treasury management and policies section on page 37.

As EBITDA is not a measure of financial performance under UK GAAP, it may not be comparable to similarly titled measures of other companies because EBITDA is not uniformly defined. EBITDA should not be considered by investors as an alternative to group operating profit or loss or profit or loss on ordinary activities before taxation as an indication of operating performance, or as an alternative to cash flow from operating activities as an indication of cash flows.

Group operating profit is considered to be the UK GAAP financial measure most directly comparable to EBITDA. The reconciliation of EBITDA to group operating profit/(loss), including O2 Netherlands, for the three years ended 31 March 2005 is as follows:

	2005 £m	2004 £m	2003 £m
EBITDA	**1,768**	1,367	859
Depreciation[1]	**(931)**	(926)	(932)
Goodwill amortisation	**(200)**	(201)	(374)
UMTS licence amortisation	**(169)**	–	–
Other amortisation	**(82)**	(7)	(31)
Operating profit/(loss) before exceptional items	**386**	233	(478)
Exceptional items	**(45)**	(75)	(8,300)
Group operating profit/(loss)	**341**	158	(8,778)

[1] In the years ended 31 March 2005 and 2004, excludes depreciation of £6 million and £2 million respectively charged as exceptional items as part of the reorganisation and restructuring discussed in the exceptional items section on page 28.

Sale of O2 Netherlands

The sale of O2 Netherlands, our wholly-owned Dutch subsidiary, to Greenfield Capital Partners completed on 3 June 2003 for €25 million in cash. The total loss on sale arising on completion was £1,369 million which, after utilisation of the provision recognised in 2003, resulted in a non-operating exceptional loss of £5 million in the year ended 31 March 2004.

In accordance with Financial Reporting Standard 3 (FRS 3) "Reporting financial performance", the results of O2 Netherlands for the two years ended 31 March 2004 and 31 March 2003 have been classified as discontinued.

The summarised results of the Group, excluding O2 Netherlands, for the three years ended 31 March 2005 are:

		Year ended 31 March	
	2005 £m	2004 £m	2003 £m
Group turnover	**6,683**	5,646	4,611
Cost of sales	**(3,799)**	(3,291)	(2,854)
Gross profit	**2,884**	2,355	1,757
Administrative expenses before exceptional items	**(2,498)**	(2,121)	(2,115)
Group operating profit/(loss) before exceptional items	**386**	234	(358)
Exceptional items	**(45)**	(75)	(8,300)
Group operating profit/(loss)	**341**	159	(8,658)

Definition of segments

In the year ended 31 March 2004, we undertook a restructuring of our central functions and rationalisation of our property portfolio. In the year ended 31 March 2005 the activities of O2 Online and Products O2, which were previously reported as the "mobile internet services" segment, are reported within the segments in which they now reside. As the information is not readily available, the comparatives have not been restated and these businesses are reported separately in line with day-to-day managerial and budgetary control at that time.

Operating results

Introduction to results of operations

The main components of turnover, cost of sales and administrative expenses, which form our results of operations, are described below.

Turnover

Our turnover from operations can be analysed into two areas: service and other revenues (including equipment), with service revenue our principal source of income. These income streams are briefly described below:

- service revenue is derived from our customers' use of our mobile networks. This includes both voice-related airtime and data services, such as SMS and GPRS. It also includes interconnection fees from other networks terminating calls on our customers' mobile phones, and roaming fees from other network customers using our networks;
- other revenue includes equipment revenue derived from the sale of handsets and other accessories, income we recognise when acting as a service provider for non-O2 customers, national roaming and wholesale contracts revenue. It also includes connection charges and revenue from other sources such as voice messaging and paging services.

Cost of sales

The principal items within cost of sales are:

- service cost of sales which consists principally of interconnection charges and operation and maintenance costs relating to our networks. Interconnection charges are payments made by us to other fixed line or mobile network operators domestically and abroad when our customers use voice or data services which terminate on other networks. These costs are variable in nature, increasing as the usage of the network increases. Costs relating to the operation and maintenance of our networks mainly comprise core transmission costs, mast site leases, network equipment maintenance and depreciation charges related to our network assets. These costs are more fixed in nature, and depend on the size of the network not the usage of the network, although they will increase as we depreciate our UMTS networks from the date of launch of commercial services;
- other cost of sales includes the cost of purchasing handsets and other hardware items, costs associated with the provision of roaming and wholesale contracts and the network cost of providing voice messaging and paging services.

Administrative expenses before exceptional items

Principal administrative expenses are:

>> promotional and advertising expenses, primarily comprising bonuses and commissions paid to retailers, for the acquisition and retention of customers. They also include expenditure on advertising, marketing and loyalty programmes;

>> overhead expenses including personnel costs relating to functions such as finance, planning, network, regulatory, legal, marketing and customer care. They also include property charges, facilities, training and information technology support;

>> depreciation charges on non-network assets; and

>> amortisation charges on goodwill arising on the acquisition of businesses, on our UMTS telecommunications licences from the date of market launch of UMTS services and on other intangible assets.

Exceptional items

Exceptional items are large non-recurring incomes or expenses that have been disclosed separately to avoid distortion of the underlying trading result.

O2 consolidated results of operations for the three years ended 31 March 2005, 2004 and 2003

The following table presents certain financial data for our Group, including O2 Netherlands, for the years ended 31 March 2005, 2004 and 2003 extracted from our consolidated financial statements:

	2005 £m	2004 £m	2003 £m
Group turnover	**6,683**	5,694	4,874
Cost of sales	**(3,799)**	(3,314)	(3,060)
Gross profit	**2,884**	2,380	1,814
Administrative expenses before exceptional items	**(2,498)**	(2,147)	(2,292)
Exceptional items	**(45)**	(75)	(8,300)
Group operating profit/(loss)	**341**	158	(8,778)
Group's share of operating result of joint ventures and associates	**(3)**	–	5
Total operating profit/(loss)	**338**	158	(8,773)
Costs of capital reorganisation	**(20)**	–	–
Total loss on sale of business	**–**	(5)	(1,364)
Net interest payable and similar charges	**(9)**	(58)	(66)
Profit/(loss) on ordinary activities before taxation	**309**	95	(10,203)
Taxation	**(8)**	71	55
Profit/(loss) for the financial year	**301**	166	(10,148)
Dividends	**(196)**	–	–
Retained profit/(loss) for the year	**105**	166	(10,148)

[1] EBITDA is our earnings before interest, tax, depreciation, amortisation and exceptional items, excluding our share of operating profits and losses of our joint ventures and associates. The use of EBITDA as a financial performance measure is discussed on page 23.

Year ended 31 March 2005 compared to the year ended 31 March 2004

Group turnover

The following table shows contributions of our businesses to Group turnover:

	Year ended 31 March 2005 £m	2004 £m	per cent variation
Continuing operations			
O2 UK	**4,030**	3,451	17
O2 Germany	**1,865**	1,508	24
O2 Ireland	**585**	529	11
O2 Airwave	**169**	89	90
O2 Online	**–**	140	–
Manx Telecom	**53**	50	6
Intragroup eliminations	**(19)**	(121)	(84)
	6,683	5,646	18
Discontinued operations			
O2 Netherlands	**–**	48	(100)
Total	**6,683**	5,694	17

Group turnover from continuing operations increased by 18 per cent from £5,646 million for the year ended 31 March 2004 to £6,683 million for the year ended 31 March 2005. All our businesses contributed to the rise in Group turnover. The principal reasons for the increases in our mobile telecommunications businesses were the overall rise in subscriber numbers in the current year and the increased usage of the Group's services by subscribers.

A description of the significant new products and services offered by the Group during the year, and the development of the O_2 brand, are given in the business review on pages 6 to 19.

O2 UK

O2 UK's overall turnover increased by 17 per cent from £3,451 million for the year ended 31 March 2004 to £4,030 million for the year ended 31 March 2005. O2 UK's total active customer base increased from 13.3 million at 31 March 2004 to 14.4 million at 31 March 2005, an increase of over 8 per cent.

The following table provides an analysis of O2 UK's turnover:

	Year ended 31 March 2005 £m	2004 £m	per cent variation
Service	**3,627**	3,183	14
Equipment and other	**403**	268	50
Total	**4,030**	3,451	17

Service revenues Service revenue is the principal element of O2 UK's turnover, comprising 90 per cent of O2 UK's group turnover for the year ended 31 March 2005. O2 UK's service revenue increased by 14 per cent from £3,183 million for the year ended 31 March 2004 to £3,627 million for the year ended 31 March 2005. Of this, service revenue from post-pay customers remains the principal source of income, accounting for 66 per cent of the total service revenue for the year ended 31 March 2005 (2004: 65 per cent).

O2 UK's service revenue has grown as a result of a combination of an increase in the subscriber base and an increase in ARPU.

At 31 March 2005 our post-pay customer base totalled 4.9 million compared to 4.6 million at 31 March 2004 which represents 335,000 net additions for the year. Our mix of brand, devices and propositions has continued to appeal to new customers. Despite this, post-pay churn for the year ended 31 March 2005 was 31 per cent which is a rise of 5 percentage points from the churn of 26 per cent recorded for the year ended 31 March 2004. This reflects the increasingly competitive market in the UK and the loss of the BT employee corporate account which in itself contributed 2 per cent to churn.

ARPU for both post-pay and pre-pay customers has grown in the year, despite the impact of the termination rate cut imposed by the regulator in September 2004. Post-pay ARPU has increased from £525 for the year ended 31 March 2004 to £542 for the year ended 31 March 2005. Pre-pay ARPU has increased from £141 for the year ended 31 March 2004 to £143 for the year ended 31 March 2005. Voice usage continued to increase and average voice minutes of use per customer increased by 11 per cent to 137 minutes per month during the year ended 31 March 2005. Data ARPU also grew £13 year-on-year, to leave total blended ARPU £9 higher than last year, at £281. Data revenue, as a proportion of total service revenues, was driven by a 34 per cent year-on-year growth in the number of SMS messages handled (from 8.0 billion in the 2004 financial year to 10.7 billion in the 2005 financial year), along with an increasing contribution from non-SMS revenues, which accounted for 3.7 per cent of service revenue in the fourth quarter.

Equipment and other revenues Equipment revenues have increased over the 2004 financial year reflecting the higher level of gross customer connections than in 2004. Other revenues have increased owing to the continued growth in national roaming and wholesale contracts.

O2 Germany

O2 Germany's overall turnover increased by 24 per cent from £1,508 million for the year ended 31 March 2004 to £1,865 million for the year ended 31 March 2005. O2 Germany's total active customer base increased by 33 per cent from 6.0 million at 31 March 2004 to 8.0 million at 31 March 2005.

The following table provides an analysis of O2 Germany's turnover:

	Year ended 31 March 2005 £m	2004 £m	per cent variation
Service	**1,687**	1,347	25
Equipment and other	**178**	161	11
Total	**1,865**	1,508	24

Service Service revenue is the principal element of O2 Germany's turnover, comprising 90 per cent of total turnover for the year ended 31 March 2005. O2 Germany's service revenue increased by 25 per cent from £1,347 million for the year ended 31 March 2004 to £1,687 million for the year ended 31 March 2005. Of this, service revenue from post-pay customers is the principal source of income, with post-pay revenue for the year ended 31 March 2005 accounting for 83 per cent of the total (2004: 84 per cent).

This increase in service revenue is principally the result of a significant increase in the active subscriber base described above. In particular, the net post-pay customer additions in the year ended 31 March 2005 were 890,000, representing 45 per cent of total net additions. The pre-pay customer base increased by 44 per cent from the 2004 financial year to the 2005 financial year, with pre-pay customers totalling 3.6 million at 31 March 2005. Of this, the new Tchibo Mobilfunk channel has contributed in excess of 250,000 pre-pay customers since its launch in October 2004. The growth in service revenue is also affected by foreign exchange, and translating O2 Germany's service revenue in 2005 at the exchange rates prevailing in the prior year would increase the reported growth in turnover by £31 million.

In the post-pay market, O2 Germany's Active bundles were launched in July 2004 and proved very successful with high value customers, with approximately 40 per cent of new contract customers in the second half of the 2005 financial year subscribing to an Active bundle. In the year ended 31 March 2005, the popular O_2 Genion Homezone service, our location based tariffing technology, accounted for 50 per cent of new contract customers. These propositions contributed to the proportion of contract customers in O2 Germany's customer base at 31 March 2005 being nearly 55 per cent.

Post-pay ARPU has decreased from £375 for the year ended 31 March 2004 to £362 for the year ended 31 March 2005. In local currency, the fall is less significant (from €540 in the financial year 2004 to €531 in the financial year 2005) which is a function of the weakening of the Euro during the 2005 financial year. Average customer voice minutes of use remained constant year-on-year, at 118 minutes per month. The fall in blended ARPU can be ascribed to the cut in termination rates suffered in the year and the increasing number of pre-pay customers, as a proportion of the overall customer base, who on average generate lower ARPU than our post-pay customers.

The proportion of data revenues compared to total service revenues rose to 21.8 per cent for the year ended 31 March 2005 compared to 19.5 per cent for the year ended 31 March 2004. The principal element of data revenue is generated by text messages and O2 Germany recorded nearly 2.4 billion text messages in the year ended 31 March 2005, an increase of one third over the previous year. The success of data propositions also drove non-SMS data uptake and usage, and the number of customers at the year-end who had used a non-SMS data service during the previous 90 days was 1.9 million, 24 per cent of the total base.

Equipment and other revenues Within this category, equipment revenues have risen by 9 per cent to £160 million compared to the prior year which is principally owing to the increase in gross additions in the 2005 year compared to the 2004 year.

O2 Ireland

O2 Ireland's revenue has increased by 11 per cent from £529 million for the year ended 31 March 2004 to £585 million for the year ended 31 March 2005. This increase in revenue is attributable to an increase of 142,000 in the customer base. Post-pay customer numbers increased from 381,000 at 31 March 2004 to 403,000 active subscribers at 31 March 2005, and the pre-pay customer base increased from 1,010,000 at 31 March 2004 to 1,130,000 at 31 March 2005.

O2 Airwave

Revenue at our O2 Airwave business has increased by 90 per cent from £89 million for the year ended 31 March 2004 to £169 million for the year ended 31 March 2005. On 1 April 2005, O2 Airwave announced that the roll-out of the secure digital communication network for the police forces of England, Scotland and Wales was complete in all 51 forces across England, Scotland and Wales.

Net operating expenses before exceptional items

Net operating expenses before exceptional items comprises cost of sales and administrative expenses. Net operating expenses from continuing operations (excluding O2 Netherlands) increased by 16 per cent from £5,412 million for the 2004 financial year to £6,297 million for the 2005 financial year. This reflects the increase in the cost of sales arising from the growth in turnover described earlier and the commencement of amortisation of the UMTS licences in our UK and German businesses following commercial launch of UMTS services during the year. Foreign exchange has also had an effect and translating the net operating expenses of our overseas businesses at the exchange rates prevailing in the prior year would increase these costs by £43 million.

Group cost of sales

Group cost of sales from continuing operations increased by 15 per cent from £3,291 million for the year ended 31 March 2004 to £3,799 million for the year ended 31 March 2005. The increase in cost of sales for the 2005 financial year is lower than the increase in Group turnover of 17 per cent owing to the improvement in gross margin percentage in our businesses. The gross profit margin of the Group, excluding O2 Netherlands, increased by one percentage point to 43 per cent.

The gross margin percentage (gross profit divided by turnover) of our newer business in Germany is lower than those of our more established businesses in the UK and Ireland. O2 Germany is still building its customer base and, as revenues grow, additional contribution is made towards the fixed element of cost of sales, which increases the margin. As a consequence, in the year ended 31 March 2005, O2 Germany increased its gross margin by 6 percentage points to 44 per cent. As our O2 Airwave business matures, we expect its gross margin to improve similarly.

Group administrative expenses before exceptional items

Group administrative expenses before exceptional items from continuing operations, which exclude O2 Netherlands, have increased by £377 million from £2,121 million for the year ended 31 March 2004 to £2,498 million for the year ended 31 March 2005. During the year, O2 UK and O2 Germany have launched commercial UMTS services, and in line with Group accounting policy, the UMTS licences held by these businesses have commenced amortisation. The charge for the year ended 31 March 2005 is £169 million. Additionally, amortisation in O2 Germany also includes £78 million in respect of the T-Mobile network sharing agreement.

Administrative expenses have also increased owing to a rise in marketing expenditure reflecting the competitive environment in which our businesses operate and the continued growth in the size of the business. Administrative expenses excluding UMTS licence and other amortisation and marketing expenditure have risen only 4 per cent.

An analysis of the net operating expenses before exceptional items between our operating companies is provided in the table below:

	Year ended 31 March		
	2005 £m	2004 £m	per cent variation
Continuing operations			
O2 UK	**3,464**	2,899	19
O2 Germany	**1,955**	1,579	24
O2 Ireland	**430**	389	11
O2 Online	**–**	224	–
O2 Airwave	**151**	119	27
Other operations and central costs	**97**	1	–
Goodwill amortisation	**200**	201	–
Total	**6,297**	5,412	16

O2 UK

O2 UK's net operating expenses before exceptional items have increased by 19 per cent, from £2,899 million for the year ended 31 March 2004, to £3,464 million for the year ended 31 March 2005.

O2 UK's gross profit margin, being gross profit expressed as a proportion of O2 UK's group turnover, has declined from 44 per cent in the year ended 31 March 2004 to 41 per cent for the year ended 31 March 2005. This is attributable to firstly the integration of the business of O2 Online and Products O2 on 1 April 2004 discussed above and secondly the increasing cost of supplying devices to customers. Handsets are increasingly sophisticated and we have experienced greater demand for more costly devices with additional features such as cameras.

O2 UK's depreciation charge has increased from £488 million in the year ended 31 March 2004 to £558 million in the year ended 31 March 2005, an increase of 14 per cent. This reflects the commencement of depreciation on the UMTS network assets and a larger fixed asset base as well as a review of certain asset lives, mainly software.

Advertising and marketing expenditure for the year ended 31 March 2005 has increased year on year reflecting the general level of competition in the market. Post-pay SACs have increased from £160 to £172 per subscriber and pre-pay SACs have increased from £16 to £19 per subscriber.

O2 Germany

O2 Germany's net operating expenses before exceptional items increased from £1,579 million for the year ended 31 March 2004 to £1,955 million for the year ended 31 March 2005.

Under a long-standing agreement, T-Mobile Deutschland GmbH (T-Mobile) currently provides national roaming capacity to O2 Germany in areas where O2 Germany has not developed its own network. The cost of the contract is determined based on a fixed number of minutes available to O2 Germany and includes certain capital payments to T-Mobile.

In November 2004 O2 Germany announced a strategy to deliver faster customer growth and to step up the level of investment in its UMTS network. To sustain the rapid growth in subscribers experienced in O2 Germany, we aim to deliver UMTS network quality and population coverage competitive with the two market leaders. This will require additional capital expenditure on our UMTS network which we expect to a significant extent to be offset by a reduction in operating costs, including lower national roaming costs, and by faster revenue growth.

The total depreciation charge (for both network and non-network fixed assets) was £241 million for the year ended 31 March 2005, a 18 per cent decrease over the charge for the year ended 31 March 2004 of £295 million.

Blended subscriber acquisition costs have fallen by 8 per cent from £119 per subscriber for the year ended 31 March 2004 to £110 per subscriber for the year ended 31 March 2005. The fall in blended SAC is mainly attributable to the increasing proportion of pre-pay customers in the new connections mix.

O2 Ireland

Net operating expenses before exceptional items for O2 Ireland have increased by 11 per cent from £389 million for the year ended 31 March 2004 to £430 million for the year ended 31 March 2005. The increase is consistent with the growth of this business and reflects the stable margins reported by O2 Ireland.

O2 Airwave

The net operating expenses of our O2 Airwave business have increased by 27 per cent, or £32 million, from 2004 to 2005 as the business has expanded and the roll-out of the network has been completed.

Goodwill amortisation

The Group's goodwill amortisation charge was £200 million for the year ended 31 March 2005 which is consistent year on year and reflects the systematic charge recognised against our Group's goodwill value.

Exceptional items

In the year ended 31 March 2005, we incurred an exceptional operating charge of £45 million and an exceptional non-operating charge of £20 million. The exceptional operating charge related to the redeployment of resources within O2 UK into customer facing areas and away from non-customer facing areas. This is in line with O2 UK's strategy of delivering an enhanced customer experience and increasing customer loyalty. The charge comprises redundancy and property costs. No cash was expended in the year ended 31 March 2005. The exceptional non-operating charge related to the costs of the capital reorganisation described in note 19 to the financial statements. This charge gave rise to a cash outflow of £15 million in the year.

In the year ended 31 March 2004, we incurred an exceptional operating charge of £75 million in respect of the restructuring of central functions and the resultant rationalisation of our property portfolio. This arose on the transfer of O2 Online, Products O2 and certain other central functions to our operating businesses in the UK, Germany and Ireland and included provisions relating to redundancies and the termination of property leases. This charge gave rise to a cash outflow of £17 million in that year.

The sale of O2 Netherlands to Greenfield Capital Partners completed on 3 June 2003 for €25 million in cash. The total loss on sale arising on completion was £1,369 million which, after utilisation of the provision recognised in 2003, resulted in an exceptional non-operating loss of £5 million in the year ended 31 March 2004.

The impairment review performed during the year ended 31 March 2003 resulted in an exceptional non-cash operating charge in respect of our continuing businesses of £8,300 million. This comprised charges relating mainly to the impairment of UMTS licences and goodwill in O2 UK and O2 Germany (totalling

£2,300 million and £4,700 million respectively) and the impairment of goodwill in O2 Ireland of £1,300 million.

EBITDA

EBITDA is our earnings before interest, tax, depreciation, amortisation and exceptional items, excluding our share of operating profits and losses of our joint ventures and associates. All our mobile telecommunications businesses have generated positive EBITDA over the last three financial years.

The reconciliation of EBITDA to Group operating profit/(loss), the closest UK GAAP financial measure, by business is as follows:

	Group operating profit/(loss)		Depreciation		Amortisation		Exceptional items		EBITDA	
	2005 £m	2004 £m	**2005 £m**	2004 £m	**2005 £m**	2004 £m	**2005 £m**	2004 £m	**2005 £m**	2004 £m
Continuing operations										
O2 UK	**371**	346	**558**	488	**209**	150	**45**	57	**1,183**	1,041
O2 Germany	**(90)**	(72)	**241**	295	**190**	–	**–**	2	**341**	225
O2 Ireland	**106**	87	**65**	67	**52**	53	**–**	1	**223**	208
O2 Airwave	**19**	(31)	**53**	31	**–**	–	**–**	1	**72**	1
O2 Online	**–**	(93)	**–**	36	**–**	4	**–**	10	**–**	(43)
Other operations	**(65)**	(78)	**14**	8	**–**	1	**–**	4	**(51)**	(65)
	341	159	**931**	925	**451**	208	**45**	75	**1,768**	1,367
Discontinued operations										
O2 Netherlands	**–**	(1)	**–**	1	**–**	–	**–**	–	**–**	–
	341	158	**931**	926	**451**	208	**45**	75	**1,768**	1,367

The following table shows contributions of our businesses to Group EBITDA:

	Year ended 31 March		
	2005 £m	2004 £m	per cent variation
Continuing operations			
O2 UK	**1,183**	1,041	14
O2 Germany	**341**	225	52
O2 Ireland	**223**	208	7
O2 Airwave	**72**	1	–
O2 Online	**–**	(43)	–
Other operations and central costs	**(51)**	(65)	(22)
	1,768	1,367	29
Discontinued operations			
O2 Netherlands	**–**	–	–
Total	**1,768**	1,367	29

Group EBITDA from continuing operations has increased by 29 per cent from £1,367 million for the year ended 31 March 2004 to £1,768 million for the year ended 31 March 2005. The increased EBITDA contribution has come from all the trading operations of the Group.

Group operating profit

In the year ended 31 March 2004, we recorded our first ever group operating profit of £158 million. This has increased by 116 per cent to £341 million in the year ended 31 March 2005. Excluding exceptional items, our Group's total operating profit has increased by 66 per cent from £233 million in the 2004 financial year to £386 million in the 2005 financial year.

Net interest

Net interest payable relates to the finance charges payable on external debt, net of interest received on amounts invested. In the 2005 financial year we incurred a net interest charge of £9 million, a decrease of 84 per cent over the 2004 financial year which reflects the decrease in net debt over that period. In the 2005 financial year, the principal elements of our interest charge were the interest on our revolving credit facility ("RCF") amounting to £4 million (2004: £8 million) and interest of £57 million (2004: £62 million) accruing on our long-term bonds, which we issued in January 2002. In accordance with UK GAAP, we are amortising the issue costs of our bank facility and our bonds over the lives of the facilities (five and ten years respectively), through the interest line in the profit and loss account. Amortisation of these costs amounted to £8 million in the 2005 financial year (2004: £4 million) with the increase representing an accelerated charge arising from the reduction in our RCF during the year. We also incur interest charges on the O2 UK loan notes and on our finance leases and other borrowings, and have received interest on our short-term investments. Further details are contained in the liquidity and capital resources section on page 35.

Tax on loss on ordinary activities

We recognised a tax charge of £8 million for the year ended 31 March 2005 compared to a credit of £71 million for the year ended 31 March 2004. The overall charge reflects a prudent view of the utilisation of our Group's tax losses in the UK and Germany and the related deferred tax assets. Overall we continue to recognise a net deferred tax liability.

Dividends

We have proposed an inaugural final dividend of 2.25 pence per share for the year ended 31 March 2005. This dividend, totalling £196 million, will be paid on 26 August 2005 to shareholders on the register on 5 August 2005.

Year ended 31 March 2004 compared to the year ended 31 March 2003

Group turnover

The following table shows contributions of our businesses to Group turnover:

	Year ended 31 March 2004 £m	2003 £m	per cent variation
Continuing operations			
O2 UK	**3,451**	3,025	14
O2 Germany	**1,508**	1,060	42
O2 Ireland	**529**	442	20
O2 Online	**140**	93	51
Other operations	**139**	64	117
Intragroup eliminations	**(121)**	(73)	66
	5,646	4,611	22
Discontinued operations			
O2 Netherlands	**48**	263	(82)
Total	**5,694**	4,874	17

Group turnover from continuing operations increased by 22 per cent from £4,611 million for the year ended 31 March 2003 to £5,646 million for the year ended 31 March 2004. All our businesses contributed to the rise in Group turnover. The principal reasons for the increases in our mobile telecommunications businesses were the overall rise in subscriber numbers in the current year and the increased usage of the Group's services by subscribers. The rise in turnover of our other operations is due mainly to our Airwave business which contributed £73 million of the increase.

The strengthening of the Euro during 2004 also improved the growth. Translating the results of our overseas business at the exchange rates prevailing in the prior year would have reduced the reported growth in turnover by £153 million.

O2 UK

O2 UK's overall turnover increased by 14 per cent from £3,025 million for the year ended 31 March 2003 to £3,451 million for the year ended 31 March 2004. O2 UK's total active customer base increased from 12.1 million at 31 March 2003 to 13.3 million at 31 March 2004, an increase of 10 per cent. This included a net increase in post-pay subscribers of over half a million customers.

The following table provides an analysis of O2 UK's turnover:

	Year ended 31 March 2004 £m	2003 £m	per cent variation
Service	**3,183**	2,738	16
Equipment and other	**268**	287	(7)
Total	**3,451**	3,025	14

Service revenues Service revenue is the principal element of O2 UK's turnover, comprising 92 per cent of total turnover for the year ended 31 March 2004. O2 UK's service revenue increased by 16 per cent from £2,738 million for the year ended 31 March 2003 to £3,183 million for the year ended 31 March 2004. Of this, service revenue from post-pay customers remains the principal source of income, accounting for over 65 per cent of the total. This represents a decrease from the 67 per cent recorded for the year ended 31 March 2003 and is a function of the strong growth in pre-pay ARPU in the year ended 31 March 2004.

O2 UK's revenue has grown as a result of a combination of an increase in the subscriber base, partly arising from improving levels of retention of existing post-pay users, and an increase in post-pay ARPU.

Post-pay subscriber gross additions for the year ended 31 March 2004 total 1.7 million, taking our total post-pay customer base to 4.6 million (representing 516,000 net additions for the year). Post-pay churn for the year ended 31 March 2004 was 26 per cent, a fall of two percentage points from the churn of 28 per cent recorded for the year ended 31 March 2003. This reflects our efforts to attract higher-spending customers through innovative products and services as well as targeted and successful campaigns in the business market.

We have also increased our use of ARPU-share incentive arrangements with independent distributors to increase revenue and reduce churn.

ARPU for both post-pay and pre-pay customers grew strongly in the year. Post-pay ARPU increased from £503 for the year ended 31 March 2003 to £525 for the year ended 31 March 2004. Pre-pay ARPU increased from £121 for the year ended 31 March 2003 to £141 for the year ended 31 March 2004.

Data revenues, as a proportion of total service revenues, increased steadily through the year from 17.1 per cent for the year ended 31 March 2003 to 20.4 per cent for the year ended 31 March 2004. Data revenue as a proportion of total service revenue for the final quarter of the year ended 31 March 2004 was 22.3 per cent. Included within these statistics, the popularity of text messages continued to grow, with in excess of 8 billion messages sent during the year ended 31 March 2004, compared with 5.8 billion during the year ended 31 March 2003.

Equipment and other revenues Equipment revenues increased marginally in the 2004 financial year compared to the 2003 financial year. Although the level of gross additions to our subscriber base has remained level in 2004 compared to 2003, handset prices have generally decreased year on year, the effect of which has been offset by the sales mix. Other revenues have fallen by almost one-quarter from 2003 to

2004 reflecting a reduction in service provider and non-mobile retail revenues, which is partially offset by increased revenue from national roaming and wholesale contracts.

O2 Germany

O2 Germany's overall turnover increased by 42 per cent from £1,060 million for the year ended 31 March 2003 to £1,508 million for the year ended 31 March 2004. O2 Germany's total active customer base increased by 24 per cent from 4.8 million at 31 March 2003 to slightly less than 6.0 million at 31 March 2004.

The following table provides an analysis of O2 Germany's turnover:

	Year ended 31 March 2004 £m	2003 £m	per cent variation
Service	**1,347**	944	43
Equipment and other	**161**	116	39
Total	**1,508**	1,060	42

Service Service revenue is the principal element of O2 Germany's turnover, comprising 89 per cent of total turnover for the year ended 31 March 2004. O2 Germany's service revenue increased by 43 per cent from £944 million for the year ended 31 March 2003 to £1,347 million for the year ended 31 March 2004. Of this, service revenue from post-pay customers is the principal source of income, with post-pay revenue accounting for 84 per cent of the total.

This increase in service revenue is principally the result of a significant increase in the active subscriber base described above. In particular, the post-pay customer additions in the year ended 31 March 2004 were 836,000, representing 71 per cent of total net additions. The pre-pay customer base increased by 15 per cent from the 2003 financial year to the 2004 financial year, with pre-pay customers totalling 2.5 million at 31 March 2004. A further contributory factor in the growth in service revenue is the effect of foreign exchange. Translating O2 Germany's service revenue in 2004 at the exchange rates prevailing in the prior year would reduce the reported growth in turnover by £101 million.

A large proportion of the post-pay additions during the year relate to customers who have subscribed to the O_2 Genion Homezone service, our location-based tariffing technology, which allows reduced call rates within a small geographical area, usually at home. O2 Germany also offers an equivalent service to business customers. Both O_2 Genion Home and Business are part of our drive across the Group to attract high-value customers. At 31 March 2004, over 42 per cent of the total customer base subscribed to the O_2 Genion service compared with 30 per cent at 31 March 2003.

Post-pay ARPU has increased from £341 for the year ended 31 March 2003 to £375 for the year ended 31 March 2004. This rise is a function of the continuing drive to win higher spending customers.

O2 Germany have continued to offer advanced data services during the 2004 financial year. This has been reflected in the increase in the proportion of data revenues compared to total service revenues which have risen to 19.5 per cent during the year ended 31 March 2004. The proportion for the three months ended 31 March 2004 reached 20.7 per cent. The principal element of data revenue is generated by text messages and O2 Germany recorded in excess of 1.8 billion text messages in the year ended 31 March 2004, an increase of 466 million messages over last year.

Equipment revenues Equipment revenues have risen by 56 per cent to £147 million compared to the prior year. This is principally owing to the increase of almost 500,000 gross additions in the 2004 year compared to the 2003 year.

O2 Ireland

O2 Ireland's revenue has increased by 20 per cent from £442 million for the year ended 31 March 2003 to £529 million for the year ended 31 March 2004. This increase in revenue is a combination of an increase of 136,000 in the customer base and an 11 per cent rise in blended ARPU. Post-pay customer numbers increased from 366,000 at 31 March 2003 to 381,000 active subscribers at 31 March 2004 and the pre-pay customer base increased from 889,000 at 31 March 2003 to 1,010,000 at 31 March 2004.

A further contributory factor in the growth in revenue is the effect of foreign exchange. Translating O2 Ireland's revenue in 2004 at the exchange rates prevailing in the prior year would reduce the reported growth in turnover by £40 million.

O2 Airwave

Revenue at our Airwave business has increased by over 450 per cent from £16 million for the year ended 31 March 2003 to £89 million for the year ended 31 March 2004. The roll-out of the secure digital communication network for the police forces of England, Scotland and Wales continued during the year and by 31 March 2004 had achieved live status in 35 of the country's 51 forces.

O2 Online

During the year ended 31 March 2004, O2 Online acted as the online sales channel for O2 UK and as the developer of the Group's mobile data capability. Subsequent to the year end, the operations of O2 Online and Products O2 have been transferred to O2 UK as part of the reorganisation undertaken in the year ended 31 March 2004.

O2 Online generated internal revenue mainly from connection fees, airtime voucher sales and the provision of WAP gateway and portal services to other Group companies. External revenues include sales of devices outside the Group's territories, paid-for alerts and ring-tones and advertising.

In the current year, gross connections through the Online channel doubled compared to the 2003 year to over 1.0 million.

Net operating expenses before exceptional items

Net operating expenses before exceptional items comprises cost of sales and administrative expenses. Net operating expenses from continuing operations (excluding O2 Netherlands) increased by 8 per cent from £4,969 million for the 2003 financial year to £5,412 million for the 2004 financial year. This reflects the increase in the cost of sales arising from the growth in turnover described earlier. Translating the net operating expenses of our overseas businesses at the exchange rates prevailing in the prior year would reduce these costs by £147 million.

Group cost of sales

Group cost of sales from continuing operations increased by 15 per cent from £2,854 million for the year ended 31 March 2003 to £3,291 million for the year ended 31 March 2004. The increase in cost of sales for the 2004 financial year is commensurate with the increase in Group turnover of 22 per cent, partly offset by the improvement in gross margin percentage in our businesses. The gross profit margin of the Group, excluding O2 Netherlands, increased by 4 percentage points to 42 per cent.

The gross margin percentage (gross profit divided by turnover) of our newer business in Germany is lower than those of our more established businesses in the UK and Ireland. O2 Germany is in the process of building its customer base and, as revenues grow, additional contribution is made towards the fixed element of cost of sales, which increases the margin. As a consequence, in the year ended 31 March 2004, O2 Germany increased its gross margin by 10 percentage points to 38 per cent.

Group administrative expenses before exceptional items

Group administrative expenses before exceptional items from continuing operations, which exclude O2 Netherlands, have increased from £2,115 million for the year ended 31 March 2003 to £2,121 million for the year ended 31 March 2004. Given the growth in subscribers and revenues in 2004, the static level of administrative expenses before exceptional items reflects the benefit of a full year of cost savings following the restructuring undertaken by the Group in the 2002 and 2003 financial years, and certain savings already realised from the reorganisation started in 2004. Translating the administrative expenses of our overseas business at the exchange rates prevailing in the prior year would reduce them by £62 million from the £2,121 million reported.

Group administrative expenses before exceptional items from continuing operations, as a percentage of turnover, have decreased from 46 per cent in the 2003 financial year to 38 per cent in the 2004 financial year.

An analysis of the net operating expenses before exceptional items between our operating companies is provided in the table below:

	Year ended 31 March		
	2004 £m	2003 £m	per cent variation
O2 UK	**2,899**	2,691	8
O2 Germany	**1,579**	1,295	22
O2 Ireland	**389**	356	9
O2 Online	**224**	216	4
Other operations and central costs	**120**	71	69
Goodwill amortisation	**201**	340	(41)
Total	**5,412**	4,969	9

O2 UK

O2 UK's net operating expenses before exceptional items have increased by 8 per cent, from £2,691 million for the year ended 31 March 2003, to £2,899 million for the year ended 31 March 2004.

The variable element of O2 UK's service cost of sales has increased in line with the network usage. Interconnection charges increased significantly during the financial year 2004, compared to the year ended 31 March 2003, reflecting increased calls from O2 UK customers terminating on other networks including other mobile networks whose termination charges are generally higher than charges levied by fixed-line network providers.

O2 UK's depreciation charge has increased from £477 million in the year ended 31 March 2003 to £488 million in the year ended 31 March 2004, an increase of 2 per cent.

The advertising and marketing spend for the year ended 31 March 2004 has remained static year on year reflecting the focused nature of the spend in this area. Within this, subscriber acquisition costs have fallen as the unit cost of connections has declined despite an increase in the volume of gross subscribed additions. Post-pay SACs have decreased from £177 to £160 per subscriber and pre-pay SACs have decreased from £25 to £16 per subscriber.

Compared to the year ended 31 March 2003, O2 UK's overheads have increased by 8 per cent for the year ended 31 March 2004, which, despite the increased turnover and concentration on improving customer service, reflects the cost control measures during the year and the cost savings which continue to be derived from the restructuring of the business announced in February 2002.

O2 Germany

O2 Germany's net operating expenses before exceptional items increased from £1,295 million for the year ended 31 March 2003 to £1,579 million for the year ended 31 March 2004.

T-Mobile Deutschland GmbH (T-Mobile) provides national roaming capacity to O2 Germany in areas where O2 Germany has not developed its own network. The cost of the contract is determined based on a fixed number of minutes available to O2 Germany. In February 2003, an extension to this agreement gave O2 Germany access to T-Mobile's 3G network over a longer period. The access provides us with an effective route to provide UMTS services to our customers in Germany.

Net operating expenses as a percentage of turnover was 122 per cent for the 2003 financial year and for the 2004 financial year has fallen to 105 per cent. This reflects the rapid growth in revenues at O2 Germany. For O2 Germany, we expect this ratio to be higher than the same ratio of our more established businesses, as it is a newer business and is in the process of building up its customer base.

The total depreciation charge (for both network and non-network fixed assets) was £295 million for the year ended 31 March 2004, a 14 per cent increase over the charge for the year ended 31 March 2003 of £259 million. This reflects the continuing investment by O2 Germany in their network.

Blended subscriber acquisition costs have increased by 11 per cent from £107 per subscriber for the year ended 31 March 2003 to £119 per subscriber for the year ended 31 March 2004. The Euro-denominated SAC has remained static for both pre-pay and post-pay connections from 2003 to 2004. The increase in blended SAC is mainly attributable to the strengthening of the Euro against Sterling from 2003 to 2004 which increases the SAC when translated into Sterling for reporting purposes.

O2 Ireland

Net operating expenses before exceptional items for O2 Ireland have increased by 9 per cent from £356 million for the year ended 31 March 2003 to £389 million for the year ended 31 March 2004.

The principal reason for the increase is the expansion of the business in the 2004 financial year as the total turnover of O2 Ireland has grown by 20 per cent from the 2003 financial year to the 2004 financial year. The effect of the revenue increase was reduced as a result of the continuing cost control measures.

O2 Online

O2 Online's net operating expenses before exceptional items increased by 4 per cent from £216 million for the year ended 31 March 2003 to £224 million for the year ended 31 March 2004. This reflects the Group's continued focus on developing mobile data capability while at the same time minimising expenditure prior to the transfer of the trade to O2 UK immediately after the 2004 year end.

O2 Airwave

Within other operations and central costs, the net operating expenses of our O2 Airwave business have increased by £68 million from 2003 to 2004 as the business has expanded.

Goodwill amortisation

The Group's goodwill amortisation charge relating to continuing operations before the exceptional impairment charge recognised in the 2003 financial year decreased from £340 million in the 2003 financial year to £201 million in the 2004 financial year. This is due to the impairment charge recognised in 2003 which reduced the ongoing annual amortisation charge.

Exceptional items

In the year ended 31 March 2004, we incurred an exceptional operating charge of £75 million in respect of the restructuring of central functions and the resultant rationalisation of our property portfolio and a non-operating exceptional charge of £5 million relating to the completion of the sale of O2 Netherlands. These are discussed earlier in this operating and financial review and prospects.

In 2003, we recognised an exceptional non-cash charge relating to the impairment of fixed assets in our continuing businesses (being our UK, German and Irish businesses) of £8,300 million.

EBITDA

EBITDA is our earnings before interest, tax, depreciation, amortisation and exceptional items, excluding our share of operating profits and losses of our joint ventures and associates. Our businesses with larger market shares in their countries of operation, O2 UK and O2 Ireland, have generated positive EBITDA over the last three financial years. O2 Germany, a newer business, has historically made EBITDA losses, until the 2003 financial year, during which O2 Germany achieved a positive EBITDA result for the first time and in the 2004 financial year has achieved an EBITDA margin of 15 per cent.

The following table shows contributions of our businesses to Group EBITDA:

	Year ended 31 March		
	2004 £m	2003 £m	per cent variation
Continuing operations			
O2 UK	**1,041**	837	24
O2 Germany	**225**	27	733
O2 Ireland	**208**	157	32
O2 Online	**(43)**	(73)	(41)
Other operations	**(64)**	(90)	(29)
	1,367	858	59
Discontinued operations			
O2 Netherlands	**–**	1	–
Total	**1,367**	859	59

Group EBITDA from continuing operations has increased by 59 per cent from £858 million for the year ended 31 March 2003 to £1,367 million for the year ended 31 March 2004. The increased EBITDA contribution has come from all the trading operations of the Group.

The reconciliation of EBITDA to Group operating profit/(loss), the most directly comparable UK GAAP financial measure, by business is as follows:

	Group operating profit/(loss) 2004 £m	2003 £m	Depreciation 2004 £m	2003 £m	Amortisation 2004 £m	2003 £m	Exceptional items 2004 £m	2003 £m	EBITDA 2004 £m	2003 £m
Continuing operations										
O2 UK	**346**	(2,116)	**488**	478	**150**	175	**57**	2,300	**1,041**	837
O2 Germany	**(72)**	(4,979)	**295**	259	**–**	47	**2**	4,700	**225**	27
O2 Ireland	**87**	(1,331)	**67**	67	**53**	121	**1**	1,300	**208**	157
O2 Online	**(93)**	(122)	**36**	34	**4**	15	**10**	–	**(43)**	(73)
Other businesses	**(109)**	(110)	**39**	20	**1**	–	**5**	–	**(64)**	(90)
	159	(8,658)	**925**	858	**208**	358	**75**	8,300	**1,367**	858
Discontinued operations										
O2 Netherlands	**(1)**	(120)	**1**	74	**–**	47	**–**	–	**–**	1
	158	(8,778)	**926**	932	**208**	405	**75**	8,300	**1,367**	859

Total operating profit/(loss)

We recorded our first ever total operating profit in the year ended 31 March 2004, of £158 million. This compares with a total operating loss of the Group for the year ended 31 March 2003 of £8,773 million which included the exceptional impairment charge of £8,300 referred to above. Excluding exceptional items, the total operating loss recorded in 2003 of £473 million reversed to a profit of £233 million in 2004. This can be ascribed to both increased revenues generated by all our businesses arising from the increased number of subscribers and the rise in ARPUs and to the continuing cost control exhibited by our businesses.

Net interest payable

Net interest payable relates to the finance charges payable on external debt, net of interest received on amounts invested. In the 2004 financial year we incurred an interest charge totalling £58 million, a decrease of 12 per cent over the 2003 financial year reflecting the decrease in net debt over that period. In the 2004 financial year, the principal elements of our interest charge were the interest on our revolving credit facility amounting to £8 million (2003: £12 million) and the interest accrued, of £62 million (2003: £63 million) on our long-term bonds, which we issued in January 2002. In accordance with UK GAAP, we are amortising the issue costs of our bank facility and our bonds over the lives of the facilities (five and ten years respectively), through the interest line in the profit and loss account. Amortisation of these costs amounted to £4 million in the 2004 financial year (2003: £3 million). We also incur interest charges on the O2 UK loan notes and on our finance leases and other borrowings, and have received interest on our short-term investments. See the liquidity and capital resources section on page 35.

Tax on profit and ordinary activities

We have recognised a tax credit of £71 million for the year ended 31 March 2004 compared to a credit of £55 million for the year ended 31 March 2003. The increase in the tax credit is principally as a result of the improved financial performance of the Group for the 2004 financial year and the related recognition of certain losses as deferred tax assets. However, overall the Group continues to have a net deferred tax liability.

Balance sheets as at 31 March 2005 and 31 March 2004

Our Group's summary balance sheet is presented below:

	2005 £m	2004 £m
Fixed assets		
Intangible assets	**7,045**	7,354
Tangible assets	**4,449**	3,996
Investments	**2**	5
	11,496	11,355
Current assets	**2,473**	2,043
Creditors: amounts falling due within one year	**(2,031)**	(1,678)
Net current assets	**442**	365
Creditors: amounts falling due after more than one year	**(1,403)**	(1,375)
Provisions for liabilities and charges	**(254)**	(251)
Net assets	**10,281**	10,094
Shareholders' funds	**10,281**	10,094

Intangible fixed assets comprise goodwill, UMTS licences and other intangible assets. Their aggregate carrying value has fallen from £7,354 million at 31 March 2004 to £7,045 million at 31 March 2005. This is a result of amortisation charges of £200 million against goodwill, £169 million against UMTS licences and £82 million against other intangibles. These charges are partially offset by gains on foreign exchange which arise on the retranslation of our Euro-denominated intangible assets into Sterling, and £59 million of additions.

The carrying value of tangible fixed assets has increased from £3,996 million at 31 March 2004 to £4,449 million at 31 March 2005 as a result of £1,356 million of additions partly offset by depreciation charges of £937 million and currency movements of £36 million.

Investments comprise our investments in joint ventures and associates where the carrying value is positive.

Net current assets have increased from £365 million at 31 March 2004 to £442 million at 31 March 2005, primarily as a result of an increase in cash and current asset investments during the year which is partially offset by the amount owing for the proposed final dividend.

Creditors falling due after more than one year comprise principally our Group's long-term bonds and have increased from £1,375 million at 31 March 2004 to £1,403 million at 31 March 2005. This is primarily owing to the weakening of the Euro during the 2005 financial year which has increased the reported Sterling value of our Euro-denominated bonds. We have also entered into additional finance leases which is partly offset by the movement of amounts nearing maturity into current liabilities.

Liquidity and capital resources

The following table sets forth our cash flows for the years ended 31 March 2005, 2004 and 2003 extracted from our consolidated financial statements.

	2005 £m	2004 £m	2003 £m
Net cash inflow from operating activities	**1,755**	1,391	1,033
Returns on investments and servicing of finance	**(43)**	(62)	(63)
Tax paid	**(15)**	(13)	(4)
Net cash outflow from capital expenditure and financial investment	**(1,348)**	(1,114)	(868)
Acquisitions and disposals	**(2)**	(6)	–
Cash inflow before management of liquid resources and financing	**347**	196	98
Management of liquid resources	**(302)**	(191)	(3)
Net cash outflow from financing	**(27)**	(50)	(47)
Increase/(decrease) in cash in the year	**18**	(45)	48

Net cash inflow from operating activities

Our operating activities provided cash of £1,755 million, £1,391 million and £1,033 million during the three years ended 31 March 2005, 2004 and 2003 respectively. Our Group operating profit of £341 million, £158 million and loss of £8,778 million in each of the years were offset by significant non-cash depreciation and amortisation charges totalling £1,388 million, £1,136 million and £9,637 million (including in 2005 and 2004 exceptional depreciation of £6 million and £2 million respectively and in 2003 an operating exceptional charge of £8,300 million).

Returns on investment and servicing of finance

Net cash outflows for servicing of finance in the 2005 year have decreased from £62 million to £43 million in comparison to the 2004 financial year. The reduction is mostly attributable to higher short-term investments generating an increase in interest income of £15 million, a dividend of £7 million received from our associate and a one-off cash inflow of £22 million arising from the settlement of the cross-currency element of our interest rate swaps. These inflows were offset by cash outflows of £32 million on the settlement of forward foreign exchange contracts as part of our Group's hedging strategy which is discussed in note 26 to the financial statements. The cash outflow for the year ended 31 March 2005 in respect of interest paid was £71 million (2004: £78 million, 2003: £81 million), mostly in relation to our long-term bonds.

Tax paid

The total tax paid by our Group in the year ended 31 March 2005 was £15 million, an increase over 2004 and 2003 during which the Group paid £13 million and £4 million respectively.

Net cash outflow from capital expenditure and financial investment

Cash outflow in respect of capital expenditure for the 2005 financial year was £1,348 million, an increase of 21 per cent over the equivalent outflow of £1,114 million for the 2004 financial year. This increase arises principally in our mobile telecommunications businesses in the UK and Germany. The increase is a consequence of the ongoing expenditure on rolling out our planned UMTS networks, which accounted for 35 per cent of capital expenditure at O2 UK and 30 per cent at O2 Germany in the year ended 31 March 2005. Around 15 per cent of capital expenditure by O2 UK in the 2005 financial year related to investment in new customer care systems.

Capital expenditure at our O2 Airwave business fell in the year ended 2005 from the level in 2004 as the roll-out of the network completed.

Capital expenditure in the year ended 31 March 2003 of £885 million related mainly to tangible fixed asset purchases across our footprint in respect of network expansion and improvement.

Across our Group, there are generally timing differences between the recognition of a new fixed asset in our financial statements, and the cash payment, because we are often able to secure delayed non-interest bearing payment terms with our capital suppliers.

The following table presents the capital additions recognised for each of the years in the three-year period ended 31 March 2005:

	2005 £m	2004 £m	2003 £m
Continuing operations			
O2 UK	**638**	502	362
O2 Germany	**388**	308	141
O2 Ireland	**100**	52	59
O2 Airwave	**218**	243	163
O2 Online	**–**	14	21
Other operations	**14**	11	8
UMTS licences and other intangible assets	**57**	83	131
	1,415	1,213	885
Discontinued operations			
O2 Netherlands	**–**	5	59
Total	**1,415**	1,218	944

Total capital expenditure by continuing operations, excluding O2 Netherlands, for the year ended 31 March 2005 has increased by 17 per cent to £1,415 million from £1,213 million for the year ended 31 March 2004. In 2005, capital expenditure included a network sharing agreement payment in Germany of £57 million, in addition to a payment of £83 million made in 2004. In the 2003 financial year, the Group purchased a UMTS licence in Ireland for £73 million.

We expect to incur significant capital expenditure in the medium term, a material portion of which relates to the roll-out of our UMTS networks. We expect to fund our future capital spend from our bank facilities and long-term bonds described below, and from net cash flows from operations. The Group will maintain tight control of its investment programme, and in particular will aim to match the timing and quantum of capital expenditure on our UMTS network roll-out with the emerging demand for mobile data services.

Acquisitions and disposals

During the year ended 31 March 2005, we invested £2 million in a new joint venture, Tchibo Mobilfunk.

During the year ended 31 March 2004, we sold O2 Netherlands for €25 million. The sale proceeds, net of cash disposed with O2 Netherlands, were £7 million. In 2004, we also invested £5 million in Tesco Mobile Limited, our joint venture with Tesco.

Financing

During the year ended 31 March 2005, we incurred a net cash outflow from financing of £27 million. This was principally in relation to loan repayments of £21 million and the costs of the capital reorganisation and premium paid to mmO2 shareholders totalling £30 million, offset by cash received for issued shares vesting under various employee share option schemes which realised an inflow of £24 million. The cash outflow in the year ended 31 March 2004 was £50 million being mainly in relation to loan repayments of £53 million. We also issued shares vesting under various employee option schemes which realised a cash inflow of £3 million. The cash outflow in the year ended 31 March 2003 was £47 million being mainly the redemption of O2 UK loan notes during the first half of the 2003 financial year. Our financing activities are further described below.

Sources of liquidity and capital resources

Our principal sources of liquidity are cash from operating activities, bank financing and bond financing described below.

Total gross debt at 31 March 2005 amounted to £1,404 million (2004: £1,382 million), including the O2 UK hire purchase obligations (the QTE leases), the obligations of which are fully offset by cash deposits held in trust. Net debt was £78 million (2004: £366 million). Included in the total gross debt are €1,000 million and £375 million of eurobonds issued in January 2002 which have a five year and ten year term respectively. Loan notes outstanding in aggregate amounted to £7 million (2004: £8 million) and are redeemable at any time at the option of the holder.

As at 31 March 2005 bank financing comprised a syndicated facility totalling £1,000 million with a final maturity date of 15 October 2009. During the year, both the previous £1,725m syndicated facility and the £100m bilateral facility, maturing in September 2006, were cancelled. As at 31 March 2005, the syndicated facility was undrawn.

Interest on loans drawn under the syndicated facility is calculated at a margin above LIBOR (or in the case of Euro advances, EURIBOR). The margin varies according to the long-term credit rating assigned to O2 plc by major credit rating agencies but is subject to a maximum of 0.6 per cent. As at 31 March 2005, the syndicated facility bears a margin under 0.5 per cent.

Interest on our eurobonds is at a fixed rate at 6.375 per cent per annum and 7.625 per cent per annum on the Euro and the Sterling bond issues respectively. Interest on the €1,000 million bond issue has been swapped to floating rate and calculated at a margin above EURIBOR. As at 31 March 2004, interest on €500 million of the eurobond was calculated at a margin above Sterling LIBOR as a result of cross-currency swaps. The cancellation of the cross-currency element of those swaps, as detailed below in foreign exchange management, resulted in €500 million of the Eurobond reverting to a floating rate calculated above EURIBOR.

The Group's contractual obligations, including commitments for future payments under hire purchase contracts, and long- and short-term debt arrangements are summarised in the table below. Details of these obligations are fully disclosed in notes 15, 16, 17 and 23 to the Group's financial statements.

				Payments due by period	
Future commitments at 31 March 2005	**Total £m**	**Less than 1 year £m**	**1 to 3 years £m**	**3 to 5 years £m**	**After 5 years £m**
Debentures	1,056	–	683	–	373
Obligations under finance leases and hire purchase contracts	308	40	60	100	108
Loan notes	7	7	–	–	–
Other loans and borrowings	33	9	15	9	–
Other creditors	55	–	13	6	36
Commitments provided in the accounts	**1,459**	**56**	**771**	**115**	**517**
Operating lease commitments[1]	1,931	205	358	308	1,060
Other commitments[1]	112	25	46	41	–
Total future commitments (excluding capital)	**3,502**	**286**	**1,175**	**464**	**1,577**

[1] Not recognised as a liability by the Group in accordance with UK GAAP.

Treasury management and policies

Group Treasury (Treasury) operates as a centralised service for the Group. The role of Treasury is to identify, monitor and manage financial risk within the framework of Board approved policies and delegated authorities. Treasury is not permitted to add to the financial risks inherent in our business and may not undertake speculative activity.

The principal financial risks of our Group are identified below.

Banking covenants

Our current policy is to fully fund our business plan through access to the debt capital markets and other sources of funding. Borrowing is centralised and there are no material local facilities. The Group is committed to maintaining the key financial ratios, as set out in the covenants relating to the multi-currency revolving credit facility, of Group EBITDA to interest and net debt to Group EBITDA. As at 31 March 2005, actual ratios were Group EBITDA to interest of 884.0 times (2004: 23.6 times, 2003: 13.0 times) and net debt of 0.04 times Group EBITDA (2004: 0.3 times, 2003: 0.6 times). As at 31 March 2005, the Group's projected funding requirements were fully funded through a combination of bonds issued under the Group's bond financing programme (£375 million and €1,000 million) and committed bank facilities (£1 billion).

Foreign exchange management

The policy of the Group is to hedge (primarily by the use of forward foreign exchange contracts) identified foreign exchange flows, although the current level of transaction risk exposure is low due to the fact that cash flows are primarily domestic in each Group company. The policy of the Group regarding foreign exchange translation risk is to manage material risk on the translation of foreign currency assets and liabilities into pounds sterling primarily through natural offsets and the use of currency debt, cross-currency and foreign exchange swaps and forwards. At 31 March 2004, the majority of net debt was denominated in pounds sterling after taking account of the effect of derivative and non derivative hedging instruments. As anticipated in the 2004 Annual Report and Accounts, the cash flows in the Euro denominated overseas businesses and the improved visibility of their future financial profile has led us to increase the level of hedging of our overseas assets. This was achieved through the redenomination of our existing Euro debt, through the cancellation of cross-currency and foreign exchange swaps, and the use of forward foreign exchange contracts totalling €1,800 million. The on-going effect of this hedging is that the €1,000 million of Euro borrowings and the forward foreign exchange contracts are exposed to foreign exchange rate fluctuations which are recognised in the statement of total recognised gains and losses as they hedge net investments in overseas businesses.

Interest rate management

The debt level within the Group is a key determinant of the impact of interest rates. It is current policy to fix or protect expected interest flows where Group profits or key financial ratios would be materially at risk from interest rate movements. Treasury maintains the proportion of fixed rate debt within a Board approved range of 25 to 75 per cent by the issuance of fixed rate debt and the use of derivative instruments (primarily interest rate swaps). As at 31 March 2005, and after taking into account the effect of derivative instruments, 38 per cent (2004: 39 per cent, 2003: 36 per cent) of gross borrowings (excluding the QTE lease which is fully defeased) were fixed for a period of at least three years (2004: three years, 2003: three years). Based on the net debt as at 31 March 2005, a one per cent rise in market interest rates would increase debt costs which would be more than offset by investment deposit returns. The effect on our Group's profit before tax of a one per cent rise in market interest rates would be an increase of £3 million (2004: nil, 2003: adverse effect £7 million).

Credit risk management

It is our current policy to mitigate credit risk to our financial counter-parties through the application of strict counter-party limits. Counter-party limits are based on credit ratings issued by the main credit rating agencies and outstanding transactions are weighted according to potential risk to the Group. Counter-party limits are reviewed on a regular basis by Treasury.

Off balance sheet arrangements

We do not participate in, or secure financing for, any unconsolidated special purpose entities.

Research and development, patents and licences

We have not engaged in any significant research and development activities during any of the last three financial years.

Outlook and prospects

In O2 UK, we expect mid-single digit growth in net service revenue, reflecting the remaining five months' impact of the September 2004 termination rate cut, and continuing competition in what is now a highly penetrated mobile market. The EBITDA margin is expected to remain broadly stable reflecting the competitiveness of the market and O2 UK's programme to allocate substantial resources to develop additional customer-facing capabilities, and achieve higher long-term customer retention.

In O2 Germany, we expect to deliver further strong service revenue growth, mainly driven by continued rapid growth of the customer base. The EBITDA margin is expected to improve further, to around 20 per cent, reflecting O2 Germany's continuing prioritisation of revenue growth as well as the impact of UMTS network running costs and the continued costs of national roaming.

Capital expenditure is expected to be broadly in line with the total incurred in the year ended 31 March 2005 (excluding the network sharing agreement payments in Germany), with higher UMTS network investment, particularly in Germany, offsetting the reduction in O2 Airwave capital expenditure due to completion of the police network roll-out.

In the five-year period from 1 April 2004 O2 Germany is expected to incur total capital expenditure in the range €3 billion to €3.5 billion which is €1 billion to €1.5 billion higher than previously planned.

International Financial Reporting Standards

The Council of the European Union announced in June 2002 that listed companies in Europe would be required to adopt International Financial Reporting Standards (IFRS) for accounting periods beginning on or after 1 January 2005. The adoption of IFRS will apply to the Group for the first time for the year ending 31 March 2006.

In 2003, the Group formed a project team to manage the transition from existing UK Generally Accepted Accounting Principles (UK GAAP) to IFRS. The project is sponsored by the Chief Financial Officer and involves specialists from the Group Finance function as well as representatives from each of the Group's operating businesses. The project is mostly complete and we expect to publish our first IFRS reconciliation, comprising our transition balance sheet at 1 April 2004 and the profit and loss account and balance sheet for the six months ended 30 September 2004 and the year ended 31 March 2005, in July 2005 at the time of our first quarter non-financial metrics press release.

The initial phase of the project involved a high level assessment of potential issues, the preparation of a project plan and identification of the key work streams in the operating businesses and at a group level, supported by work programmes in these areas. We also considered which, if any, of the optional transitional provisions within IFRS 1 "First time adoption of International Financial Reporting Standards" to adopt. The second phase of the project involved the restatement and reconciliation of opening balances to IFRS and the adjustment of reporting systems to capture new data requirements for on-going IFRS reporting.

In preparing the discussion below, we have used our knowledge of the expected standards and interpretations which we expect to apply in our first full IFRS financial statements. However, the facts, circumstances and accounting policies we adopt could change by that date. IFRS is subject to ongoing review and endorsement by the European Union, and possible amendment by interpretative guidance from the International Accounting Standards Board may occur. IFRS is also being applied in the United Kingdom and in a large number of other countries simultaneously for the first time. Owing to a number of new and revised standards in IFRS, there is not yet a significant body of established practice to use in forming opinions regarding interpretation and application. Accordingly, practice is continuing to evolve. At this preliminary stage, therefore, the full financial effect of reporting under IFRS as it will be applied and reported on in our Group's first IFRS financial statements cannot be determined with certainty and may be subject to change.

However, our work on the project indicates that the major areas of difference between UK GAAP and IFRS which will impact our Group comprise the following:

Goodwill

IFRS 3 "Business combinations" prohibits the annual amortisation of goodwill and instead subjects such goodwill to an annual impairment review. The carrying value of our goodwill at the date of transition to IFRS is fixed and the amortisation ceases from that date.

Intangible assets

IAS 38 "Intangible assets" considers, inter alia, whether an asset which incorporates both tangible and intangible elements should be classed as a tangible fixed asset or an intangible fixed asset. The treatment is determined by an assessment of which element is more significant. Certain elements of our software, which are currently classed as a tangible fixed asset, will be reclassified to intangible fixed assets.

Pension accounting

Under UK GAAP, we account for our pension schemes using SSAP 24 "Pension costs" and have elected under the transitional rules of FRS 17 "Retirement benefits" to make disclosures only. IAS 19 "Employee benefits" is similar, but not identical to, FRS 17. IAS 19 and FRS 17 are conceptually different to SSAP 24 as they require any defined benefit pension scheme surplus or deficit to be recognised on our Group's balance sheet.

On transition to IFRS, we expect to recognise the full assets and liabilities of our defined benefit pension schemes on our balance sheet. Thereafter, IAS 19 permits two approaches for the recognition of actuarial gains and losses. Under the first option, a portion of actuarial gains and losses are recognised on our balance sheet, based on the application of a "corridor". This corridor is defined as the greater of 10 per cent of the scheme's assets or liabilities, and actuarial gains and losses below this threshold are not required to be recognised. Any actuarial gains and losses exceeding the corridor are recognised in the profit and loss account over a period representing the expected average remaining working lives of employees participating in the scheme. Under the second option, actuarial gains and losses are recognised in full in the statement of changes in equity, rather than in the profit and loss account, in the period in which they arise. The profit and loss account charge comprises an operating cost and an interest cost. Our principal pension scheme, the O2 Pension Plan, operates for the majority of UK employees and is divided into defined benefit and defined contribution sections. The defined benefit section comprises mainly active members because all deferred and pensioner members at 30 June 2002 remained in the BT Pension Scheme following our demerger from BT in November 2001.

Accounting for share schemes

We have historically accounted for share scheme costs under UK GAAP using the intrinsic value. IFRS 2 "Share based payments" requires the value of all share based payments to be measured, and an expense recognised in the profit and loss account, based on fair value. The fair value of the share schemes is estimated using a valuation model and involves complex mathematical modelling. It is often, but not always, the case that the fair value is higher than the intrinsic value. Additionally, under UK GAAP, Inland Revenue approved SAYE schemes are exempt from the requirement to recognise a charge whereas under IFRS there is no such exemption.

Financial instruments

IAS 39 "Financial instruments: recognition and measurement" details how to value and account for all financial instruments, including derivative instruments such as interest rate swaps, cross-currency swaps and forward contracts used to reduce exposure to interest rate and currency risk. Under IAS 39, all financial instruments are required to be recognised on the balance sheet at fair value. If a derivative financial instrument is designated as a hedge, the movement in the fair value of the derivatives can be recognised directly through reserves in certain circumstances, which offsets the opposite movement in the fair value of the hedged item, also in reserves. All other movements in the fair value of financial instruments must be recognised as an income or expense in the profit and loss account.

We have prepared documentation in line with the provisions of IAS 39 for all hedging instruments and have established an ongoing procedure for testing the effectiveness of these hedges which should permit the adoption of hedge accounting for our financial instruments.

Deferred taxation

IAS 12 "Income taxes" bases the calculation of the deferred tax assets and liabilities on the difference between tax carrying values and balance sheet carrying values, rather than the income statement approach required by FRS 19 "Deferred tax". As a result, the scope of IAS 12 is wider than that of FRS 19.

IAS 12 requires a deferred tax liability in respect of rolled over gains to be recognised, irrespective of whether there is an expectation that the gain will crystallise. We expect to recognise a deferred tax liability on transition to IFRS relating to a gain arising prior to our demerger from BT. The gain arose on BT's disposal of the UK Yell business and was rolled over into the goodwill purchased on the acquisition of O2 Germany. On the subsequent disposal of this goodwill for tax purposes, the deferred tax liability will reverse and be recognised as a credit in the profit and loss account of the Group in the period in which it reverses.