2012
Annual Report

Welcome to the connected world

Telefónica
Deutschland

We are shaping the digital future.

Telefónica Deutschland is the third-largest networking operator in Germany. Our products and services are at the heart of millions of people's digital lives. The basis for this is one of the most efficient mobile communications and data networks in Europe. We offer our customers innovative packages and constantly update our service portfolio, making us the driving force on the German telecommunications market – with the aim of making our customers' lives easier.

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The figures in the following have been rounded in accordance with established commercial practice. Figures or additions within a table may therefore result in sums different from those shown in the same table.

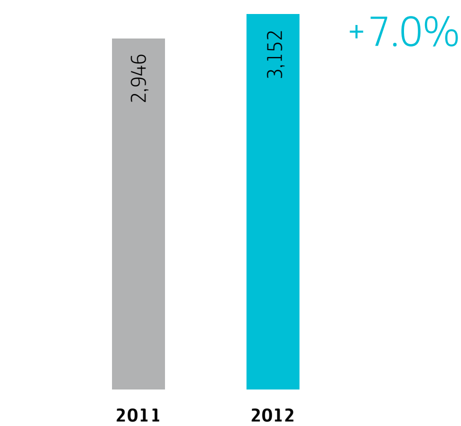
Financial Highlights

Euros in millions

	January – December		
	2012	**2011**	**Change**
Revenues	**5,213**	**5,036**	**3.5%**
Wireless service revenues	3,152	2,946	7.0%
Operating income before Depreciation and Amortization (OIBDA)	**1,279**	**1,149**	**11.3 %**
OIBDA margin	24.5%	22.8%	1.7%-p.
Operating Income (OI)	**146**	**67**	**>100%**
Profit for the year from continuing operations	**308**	**71**	**>100%**
Profit after taxes from discontinued operations	**1,027**	**483**	**>100%**
Total profit for the year	**1,335**	**554**	**>100%**
Basic earnings per share (EUR) from continuing operations [1]	**0.28**	**0.06**	**>100%**
CapEx	**(609)**	**(558)**	**9.2%**
OpCF (OIBDA-CapEx)	**670**	**592**	**13.3%**
Free Cash Flow pre dividends from continuing operations [2]	**674**	**697**	**(3.3)%**
Net Financial Debt [3]	**842**	**(4,316)**	**>100%**
Leverage [4]	0.7x	(3.8x)	n.m.
Total Accesses (in thousands)	**25,373**	**24,483**	**3.6%**
Mobile accesses	19,300	18,380	5.0%
Postpaid (%)	**52.4%**	**50.2%**	**2.2%-p.**
ARPU (EUR)	**13.8**	**13.6**	**0.9%**
Postpaid churn (%)	**(1.5)%**	**(1.7)%**	**0.3%-p.**
% non-SMS data over total data revenues	**56.7%**	**50.4%**	**6.3%-p.**
Employees [5]	**6,019**	**6,281**	**(4.2)%**

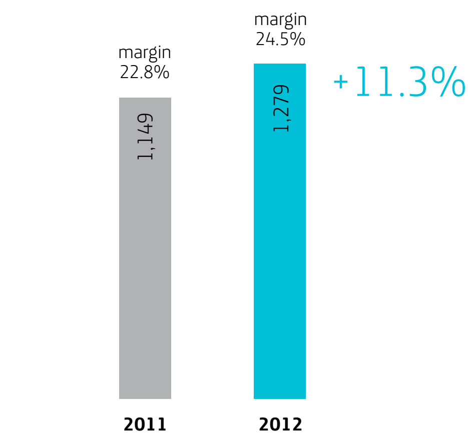
1 For better comparability with future financial information, the current number of shares in the Company of 1,116,945,400 has been used and has been calculated considering the profit for the year from continuing operations.
2 Free Cash flow pre dividends defined as OpCF minus working capital minus interest payments and taxes minus other changes.
3 Net Debt includes interest-bearing financial assets and liabilities which are immediately available for the group without any restrictions.
4 Leverage defined as Net Financial Debt divided by OIBDA excluding non-recurring factors.
5 As of December 31; employees of all entities included in the Consolidated Financial Statements of Telefónica Deutschland Group as of the respective reporting dates.

Wireless Service Revenues Euros in millions



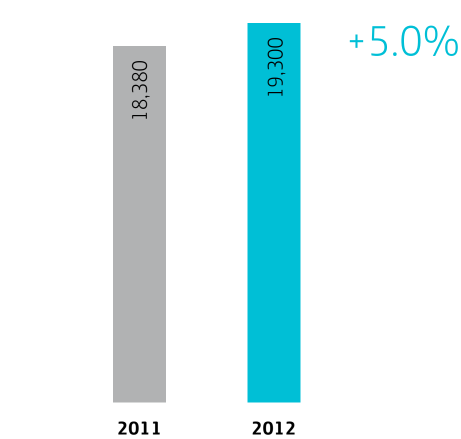
- Up EUR 206m or 7.0%
- Mainly driven by higher smartphone penetration and more wireless data service customers

OIBDA/OIBDA Margin Euros in millions



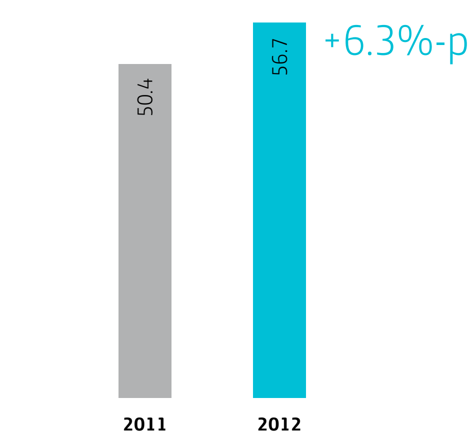
- Up EUR 130m or 11.3%
- Mainly driven by commercial growth in the post-paid segment, monetization of the data opportunity, scale and efficiency improvements

Wireless Accesses in thousands



- Up 5.0% (920 thousand) year-on-year
- Mainly driven by the post-paid segment

Non-SMS Data over Total Data Revenues in %



- Increase of 6.3 percentage points
- Mainly driven by increased penetration of smartphones and mobile data usage

Preface

René Schuster, Chief Executive Officer (CEO), Telefónica Deutschland Holding AG

Dear shareholders of Telefónica Deutschland, ladies and gentlemen,

We have written corporate history in 2012: the IPO resulting in our listing on the Frankfurt Stock Exchange on October 30 was the largest in Germany in many years, and ranked among the top 10 in the world in 2012. It was also completed in record time, and taken to a successful conclusion in spite of a still difficult capital market backdrop. We are very proud of this achievement. To us it really felt like a natural next step, a logical progression in the corporate development of Telefónica Deutschland. And, with regard to the scope of the report that this letter introduces, our first Annual Report to our shareholders, our IPO was only the culmination of a year full of exciting events, progress, and successes. We will not be able to describe all of them in this letter, but some of them deserve mention here.

Most importantly, we delivered strong financial results: Revenue grew by 3.5% year-on-year to EUR 5.2bn, and our efforts to control cost and enhance operational efficiency enabled us to generate an OIBDA of EUR 1.3bn, or an OIBDA margin of 24.5%. Especially our ability to generate cash carries enormous weight as it allows us to make the investments that are essential to strengthen further our position as challenger in the German market. We are particularly gratified, therefore, that we achieved a significant increase of 13.3% in our Operating Cash Flow, which rose to EUR 670m.

The impact of our strategic investments is already becoming clear: in 2012, we have become the third-largest provider in the German telecommunications market by mobile services revenue. Moreover, looking at all of our products and services, we exceeded 25 million total accesses for the first time.

The main strategic driver of our financial results was – and will continue to be – mobile data: more than 90% of mobile devices Telefónica Deutschland sells are smartphones with considerable data processing capabilities. This already represents the highest percentage among all of our German competitors, and the rate is still rising. Of course, this poses challenges to our ability to deliver data to our customers at the highest possible speed. We anticipated that challenge by licensing new frequencies for the next-generation mobile standard LTE from the German Bundesnetzagentur as early as 2010, and have since started to build out our LTE network: In the cities and metropolitan areas of Nuremberg, Dresden, Leipzig/Halle, Frankfurt/Offenbach and Cologne we are already offering O_2 customers LTE. Munich and Berlin are to follow during the first quarter of 2013. Until the end of the first half year 2013 Hamburg, Dusseldorf, Duisburg and Essen will go live.
At the same time we will also carry out improvements in our existing 3G network.

We are convinced that our ability to innovate is at the core of our success. This ability is directly linked to our strategic ambition to make our customers' lives easier through digital products. Our goal at Telefónica Deutschland is to be the focal point of our customers' digital lives. We made big steps in this direction in 2012. To highlight just two of many initiatives, we have introduced financial services products, such as the mobile payment system mpass or the O_2 credit card. We have also opened our very own Wayra Academy in Munich that supports young digital entrepreneurs in their ambition to develop exciting ideas for the future in the field of mobile digital technologies. We are certain that, one day, our customers and shareholders will benefit directly from our collaboration with these imaginative young innovators.

Speaking of vision and ambitions, Telefónica Deutschland is continuously developing its corporate social responsibility: with our CSR program "Think Big", for example, we helped many young people realize their ideas for our society. Altogether, we engaged 27,000 of them through this program. Indeed, it has had such an impact that we were given the "Politikaward" in November, a renowned prize for political communication bestowed by politik&kommunikation in Berlin.

It is a fact that our long-term corporate vision and the strong sense of responsibility all of us feel towards the society we live in are principal drivers for all of us to achieve our objective to make Telefónica Deutschland as successful as we possibly can, in an extremely competitive environment. In that area, too, we made encouraging progress: for instance, our

“Next-Generation Service & Sales” program whose main objective is to provide a personalized customer experience across all channels, has really come to life in 2012. So has our ambition to make each and every one of our employees act as entrepreneurs, as if we all owned this business ourselves: it had a direct impact on our “Operational Excellence” program, which has generated annual efficiencies of more than EUR 5.4m.

An impressive amount of work was done in 2012, and many successes marked. But huge tasks still lie ahead of us, which would be impossible to accomplish without the unflinching commitment of all our employees. This commitment was truly inspiring in 2012, and we are certain that it will continue throughout 2013 and beyond. On behalf of the entire management board of Telefónica Deutschland, I would like to extend my heartfelt thanks to all colleagues for their immense dedication, be they in our shops, on our hotlines, in our offices, or in the field maintaining our infrastructure and systems.

A thank you is also due to a new set of stakeholders – investors who have bought our shares at a time when many market participants were still reluctant to get involved in the stock market. We are fired up by their confidence, and convinced that the success of this company will vindicate it.

The same holds for our long-standing shareholder: the Telefónica Group continues to own a significant share in our company. Without the strong support of our major shareholder, accomplishing what we have in 2012 would simply not have been possible. Thank you.

And finally, thank you to all our business partners for playing such an active role in Telefónica Deutschland’s rapid development. We rely on all of them.

An exciting year indeed, ladies and gentlemen.
But what about 2013 and beyond?

Our data business will remain our most important growth driver, and we are better positioned than ever, in all our segments, to benefit from the opportunities the LTE technology offers. Further LTE rollout and accompanying marketing initiatives will therefore be the big theme for our whole company in the coming year. In 2013 we will further accelerate the rollout of our LTE network and significantly increase the population coverage. At the same time, we focus on convergence between our fixed and mobile offerings.

Telefónica Deutschland has changed in 2012. We have become a more mature company. Our use of resources have improved. Our corporate governance structures are better. Our footprint in Germany has grown. Our IPO in October has raised our profile further, added a new dimension of scrutiny. But in a way, not much has changed: our customers have always expected us to deliver, and we have, and now our shareholders expect the same, and we will. Yes, we have grown up, but we are also still the feisty player we always were. It is as simple as that.

What do we mean by “feisty”? Many things: to start with, we are the challenger in the German telecommunications space, the new kid on the block still. We change things, raise the bar, introduce new levels of quality and service, make our customers’ lives easier. But we also operate with great awareness of the resources available to us. Nevertheless, we will have to do more in 2013, even if we have already become much more reasonable in using these resources. Our company and our culture will have to adapt to ever intensifying cost pressures, to our customers’ ever growing demands for high standards of products and services, to ever mounting competition. Therefore, cost awareness and quality control will have to become essential components of our day-to-day work – part of our identity.

Ladies and gentlemen, the digitalization of our world offers spellbinding opportunities. Smartphones are becoming the remote controls of our personal lives. A mobile revolution is changing the way we do business, too. Telefónica Deutschland is ideally placed to take advantage of this mobile revolution, and we are looking forward to writing the next chapter in our growth story.

René Schuster
Chief Executive Officer (CEO)

The mobile revolution is changing the world. Smartphones and tablet PCs are taking on ever more tasks in our everyday lives. And the future is just beginning: more and more objects – cars, furniture, machines, and even clothes – will soon exchange data through the “internet of things”. We are prepared: Telefónica Deutschland occupies a leading position in this growing market.

Life
in the connected world

3.3

billion smartphones in use worldwide by 2018

90%

of all mobile devices sold by O_2 are smartphones

Life in the connected world

The mobile revolution begins on January 9, 2007. On this day, the first iPhone is presented in San Francisco. A sensation at the time.
Today, only a few years later, smartphones are nothing exceptional anymore – they have long become an indispensable companion to millions of people.

More than just a gadget: controlled from a smartphone, the quadrocopter takes high-quality pictures with its integrated HD camera and displays them immediately. The police are already using similar miniature helicopters, for example for taking photos of accidents.

The future of working

Mobile technologies such as smartphones and tablet PCs simplify communications within companies and enable employees to be more productive. At the same time, staff regard the use of such mobile devices as a relief. These are the results of a representative study presented to the public by Telefónica Deutschland at the ZEIT conference "Digitale Revolution – Zukunft der Arbeit" (Digital Revolution – The Future of Working) in Berlin in December. Decision-makers and staff of 280 medium-sized companies had been surveyed. Every second company has experienced growth in productivity thanks to mobile technologies; furthermore, more efficient work processes save costs and time. Six out of ten companies are able to thereby improve the outcome of their work and their service. Telefónica Deutschland CEO René Schuster explained at the ZEIT conference that "the future of work is digital and mobile. Work processes and communication channels will become faster, more efficient and more flexible. This will allow companies to save money, and staff to design their work more freely and flexibly." More at: www.zeit-konferenzen.de/digitale-revolution-2012

Every second German never leaves home without a mobile phone. Of those under 30 years of age, a whopping three quarters take their mobile phone with them wherever and whenever they go. Smartphones possess so many features – communications center, camera, mp3 player, satnav, radio, video camera, photo album, games console, appointments book, PC, and TV – that using them to call people has almost become a sideshow. Since the invention of the laptop, no device has changed our working day this deeply. Suddenly we can work from anywhere – we can read and write e-mails, arrange appointments or work on documents – no matter where we may find ourselves. This is giving rise to more flexible working models, such as working from home and part time schemes. Futurologists expect that we will spend much less time in offices in the future, simply because working itself has become more mobile. Smartphones will become more and more akin to remote controls for our digital lives.

Smartphones need powerful networks

But one thing is also true: Smartphones are only as good as the network they have access to. High-capacity networks are as important to smartphones as good roads are to cars – without them, the existing potential can only be utilized to a small degree. According to recent studies, the volume of mobile data flow in Germany will rise up to thirtyfold from 2010 until 2015. Telefónica Deutschland is meeting this challenge with a concerted effort to expand the LTE network (see page 18).

And this is not a minute to soon, considering the technology presented at the leading industry shows: for example, manufacturers are experimenting with new control technologies, such as by hand movement without touching. "Context awareness" is another focus – smartphones are more and more capable of recognizing the type of situation their owner is in, and of reacting to it. French engineers have developed an algorithm, for example, which recognizes if a mobile phone has been placed on a table or into a pocket, whether its owner is riding a bike, walking, or driving a car. If desired, the smartphone displays information relevant to the situation – be it that the navigation app is activated or that the users receive drinks vouchers for the club they are dancing at. In order to be able to execute all these functions, smartphones have become little technological marvels, full of more and more new gadgets. The data networks need to be as capable. After all, any mobile phone commercially available today contains more computing power than NASA had at its disposal for the 1969 Apollo Mission to the moon and back. The same power which took a desktop computer-sized device to contain in 2006 now easily fits into the palm of a hand. New technologies such as Near Field Communication (NFC) enable smartphones to transmit data wirelessly over short distances – for example, the device simply has to be held close to a cashier's terminal in order to initiate payment.

Another factor besides smartphones' increasing capacity is their ubiquity. It took Johannes Gutenberg's invention of letterpress printing two hundred years to conquer the world. It still took radio twenty years. The smartphone managed to achieve its global breakthrough it in just five years: At the end of 2012, every third German owned one.

Industry experts reckon that top-of-the-line mobile phones capable of going online will soon have replaced older models. More than 90 per cent of models sold by O_2 are already in this category. Globally, every third mobile phone will be a smartphone by 2018 – 3.3 billion devices in total.

Mobile payment is the future

Considering the still increasing spread of mobile phones and the increasing number of tasks they can discharge, it is obvious that smartphones will take over more and more daily routine tasks. Mobile payment is one of these and an area in which Telefónica Deutschland is one of the significant leaders. The industry is certain that smartphones will replace traditional ways of payment such as cash and credit or debit cards. According to the German Federal Bank, eight out of ten payments are still made in cash in Germany.

Telefónica Deutschland is aware of the great potential inherent in

Left: The smartphone as a shopping advisor: an app calls up test reports, customer comments and price comparisons there and then.
Bottom: The smartphone as a shopping cart: in South Korea, people can already do their supermarket shopping via smartphone. An app calculates the total price while scanning the product pictures. The shopping is delivered to the customer's home at an arranged time.

How does mpass work?

Telefónica Deutschland started the mobile payment system “mpass” in German retail in October 2012, the first network operator in Germany to do so. Customers can use their mobile phones for noncontact payments in thousands of shops all over Germany and in more than 500,000 outlets which display the MasterCard “PayPass” logo globally. The payment is processed using secure NFC technology: The customer simply needs to hold his mobile phone up to the PayPass terminal. For sums exceeding 25 euros, a PIN must be entered additionally. mpass works with all mobile phones and is also open to customers of other telecommunications companies. In the launch phase, customers receive an NFC sticker, which they need to affix to the back of their mobile phones, free of charge. In February 2013, the second phase was launched with the virtual O_2 Wallet, which will allow mobile phones with built-in NFC chips to be used for mobile payment in retail. Special NFC SIM cards are used for this purpose. mpass will be integrated into the electronic wallet as one payment method besides other debit and credit cards. More at: www.mpass.de/o2

this business. In October 2012, the company became the first network operator to launch a nationwide mobile payment system for retail, mpass. “From now on our customers can use their mobile phones to pay in shops,” explained Michiel van Eldik, Managing Director Wholesale & Partnermanagement, on the launch of the service. Thanks to the cooperation with MasterCard, the system is available to registered mpass customers in thousands of shops in Germany and at half a million cashier’s terminals worldwide. All transactions are efficiently protected by the established security standards of the banking and credit card industry. “By adding noncontact payments in retail to our product portfolio, we have taken a further important step on the way to establishing an ‘ecosystem’ around financial services,” van Eldick added. In November, the company further extended the services on offer by launching the O_2 credit card.

The end of plastic cards

The virtual O_2 Wallet is at the core of the mobile financial services portfolio. Since the middle of February, the product has been in a test phase and used by selected customers. Industry experts regard the virtual wallets, which are saved to the smartphone directly as apps, as the true future of mobile cash: They can be the virtual deposit not only for cash, but also for debit cards, credit cards and loyalty cards. If a customer goes to a café or restaurant, for example, he will in future only need to hold his smartphone close to the cash register to effect payment. If he is a regular, his loyalty points can be credited to his account automatically, or he can redeem virtual vouchers, which are, of course, also saved in his wallet. All the many payment, membership, and loyalty cards we all carry around with us can be digitally concentrated in one place in this way. The advantages for retail businesses are obvious, too: Shops and companies can offer much more individualized services to customers with digital wallets, for example by automatic discount offers or customer programs. At the same time, they save money and staff: According to studies, cash payments at registers take 29 seconds on average. Payments by debit or credit card using a PIN still take 27 seconds. Noncontact payments, in contrast, take only five to twelve seconds. This may soon make the long lines at supermarket cash registers history.

The smartphone as a shopping cart

The smartphone could change retail more generally. An example from South Korea: A department store chain opened the country’s first virtual supermarket in the metropolis Seoul in 2011. Instead of shelves with real products, there are photo walls with pictures of the goods: milk, vegetables, fruit, frozen pizza – and when the subway passengers want to buy something, they hold their smartphone to the photo. An app scans the products and calculates the price. The goods are delivered directly to the customers’ home at an arranged time. Meanwhile, the company has added 20 virtual supermarkets at bus stops. Younger Koreans between the ages of 20 and 30 in particular appreciate this virtual way of shopping.
Shopping via mobile phone is a growing trend in Germany, too. Two developments are the reason: More and more people are using smartphones for shopping advice. Special apps turn the devices into barcode scanners, which allow customers to scan products immediately in the shop and promptly receive test reports, customer feedback and price comparisons. According to a study commissioned by the online trading portal eBay, 60 per cent of Germans think their smartphones are an important source of information when shopping. The second development: The mobile internet itself is used for shopping more and more often and is replacing traditional retail channels. Almost four million people in Germany already use their smartphone for shopping, according to a survey.

When smartphones measure your blood sugar levels

There seem to be no limits to the areas in which mobile phones can be used. A US company has developed an app which turns the iPhone into an ECG measuring device by plugging in two electrodes. An inven-

When machines communicate with each other

Why not sell our shirts from a vending machine?, renowned Bielefeld manufacturer Seidensticker thought to itself and started a cooperation project with Telefónica Deutschland two years ago. After all, the machines were not only to sell “shirts to go” but also update the sales selection automatically. Telefónica developed a customized machine to machine communication (M2M solution), which means that the machines are always linked to the company intranet through a mobile connection and can automatically order new stock if necessary. The shirt vending machines will be placed in large office buildings, hotels and exhibition centers, in airports and in train stations. M2M means the automated exchange of information between terminals. These may be machines, robots, and vehicles, but also containers which communicate with each other or with a control center. M2M can rationalize work processes in all industries, leading to increases in productivity.

tion by a pharmaceutical company goes in the same direction: Sufferers of diabetes can use their smartphone to measure blood sugar levels. Other apps measure the regularity of the users’ sleep or their alcohol or caffeine consumption patterns. Smartphones and tablet PCs are becoming all-round diagnostic tools which can support doctors in treating ailments. This trend, known as e-health, will grow strongly in future. Mobile solutions may particularly unburden physicians and care workers from routine tasks in medically monitoring chronic patients and the elderly, giving the former more time to deal with the latter personally. In developing countries, mobile diagnostic and communications devices could also improve the availability of health care. But not only smartphones and tablet PCs use the mobile phone networks to transmit increasing amounts of data. A growing number of everyday devices are linked in to the mobile data network. Cars are just one example: More and more often, they feature electronic entertainment and communications devices connected to mobile data networks.

Connected cars and containers

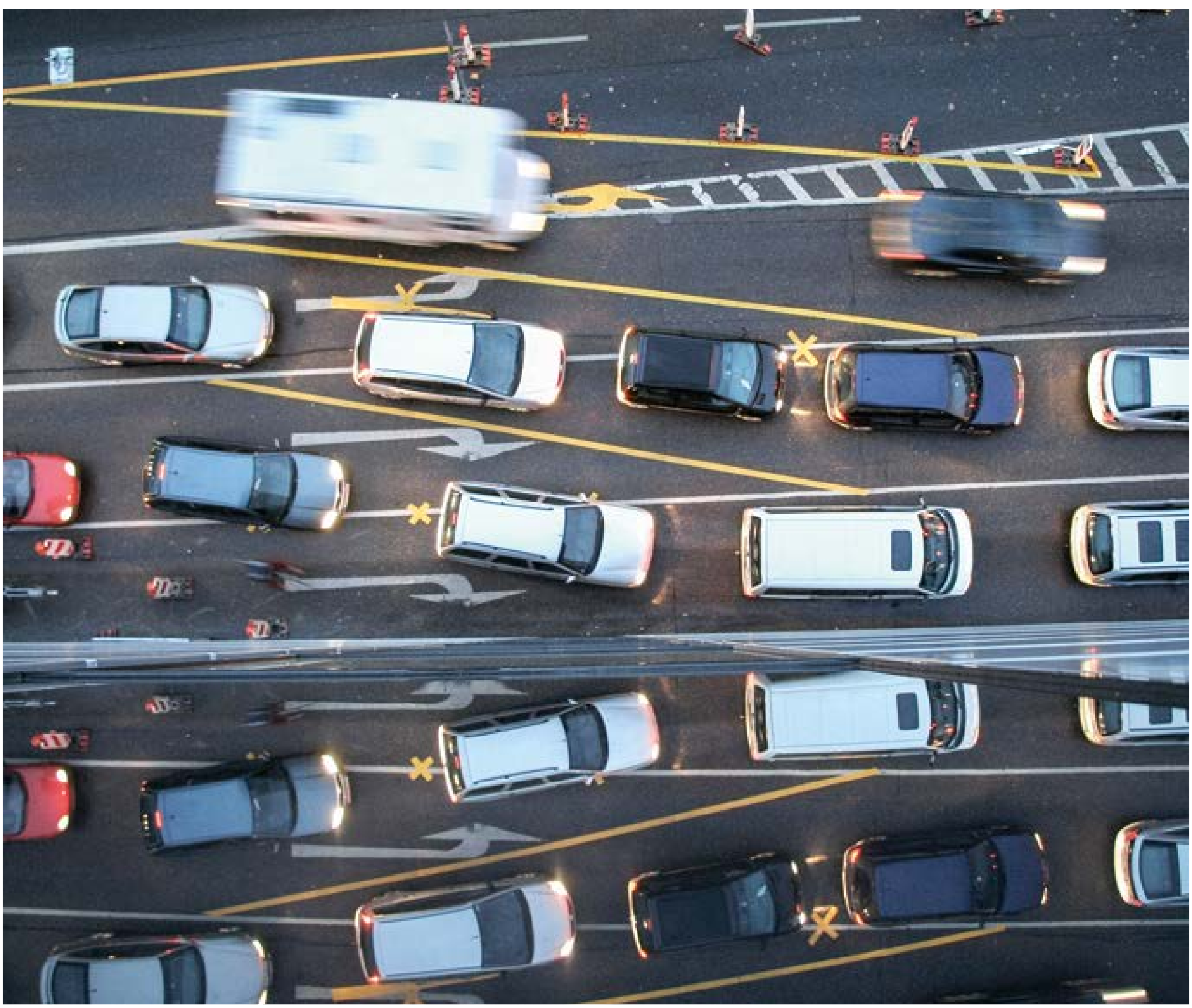
“Will people soon refuse to buy a car that can’t send tweets?” was a question the German news magazine “Der Spiegel” asked. It appears that cars will at least steer themselves in future. Companies and research institutions have proved in trials that digitally connected driverless cars can navigate traffic safely. Prototypes of such self-steering cars have already run up a total of over 480,000 accident-free miles on US roads. In the summer of 2012, the German Federal Minister of Science safely rode through Berlin’s city traffic in a driverless test car. It may take a while for these projects to reach serial production. But as early as 2015, an EU regulation will come into force which stipulates that all new cars must be connected to the mobile phone network. This is to enable them to make an automatic emergency call, an eCall, when they are involved in an accident, which will not only enable emergency services to arrive at the scene of the accident much more quickly. It will also tell doctors immediately how many injured persons they need to prepare to treat, since the system also registers how many airbags have deployed. Experts in the field call this automatic networking “machine to machine” (M2M). These mobile connections are particularly often utilized in industrial application: Even today, networked containers send their location data to central offices, where programs monitor and control goods traffic in real time. In the same way, fleets of trucks are directed, weather data transmitted and production processes integrated through the communication of machines with each other. As one of the leading providers in this field, the Telefónica Group has set up a global M2M unit based on London.

Intelligent electricity grids and smart clothing

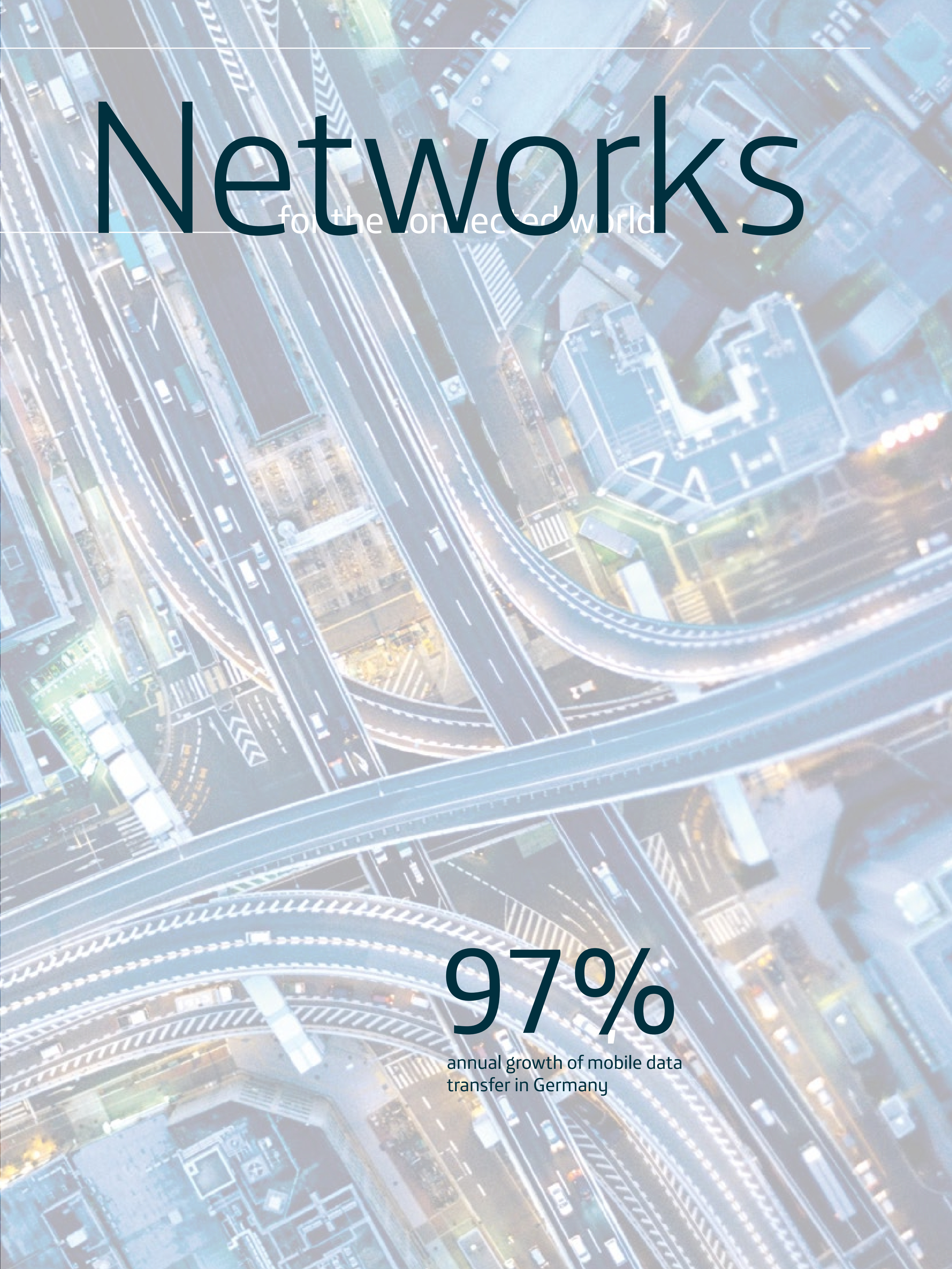
Experts are already referring to an “internet of things”. By 2020, up to 50 billion objects worldwide could be connected to each other. In future, lamps and furniture will adapt to their users’ wishes. In industry, researchers are working on “smart clothing”: Machines will shut down automatically if, for example, a worker comes too close. Furthermore, intelligent electricity grids offer enormous opportunities. Such “smart grids” could avoid up to 30 per cent of energy waste. An EU regulation stipulates that by 2020 80 per cent of all electricity meter readers have to be linked in. This will enable the operators of power plants to adjust the output exactly to the demand. Similar plans are underway for intelligent traffic grids. In phases of congested traffic, the frequency of subway trains could be increased, for example. Such concepts are called “smart city” by urban planners. The Telefónica Group is already working on solutions for the smart city network in several pilot projects, for example in the northern Spanish metropolis of Santander and the Italian city of Trento.

A world which is closely interlinked, which uses its resources more efficiently, cities of the future, self-steering cars, smart grids, virtual supermarkets, devices controlled by gestures: The mobile revolution, which began a few years ago with the invention of a new mobile phone, will continue to change all our lives. Telefónica Deutschland is determined to play a leading role in this development.

Right: Networked containers automatically transmit their position to the control center, where programs monitor the goods traffic in real time.
Bottom: Intelligent cars and smart traffic networks: there are already prototypes of cars linked in to the mobile network which navigate traffic without a driver. The “smart city” concept could in future shorten the interval times in public transport when there is heavy traffic.



Strong networks are the foundation of the digitalized world. Without them, there would not be a smartphone or tablet PC boom. LTE, the next generation of mobile communications, will ensure a smooth ride on the data highway in future. It will, for example, make new mobile services like high-resolution internet TV on smartphones a reality. Telefónica Deutschland is a trailblazer in this future technology. In 2013 we will further accelerate the rollout of our LTE network and significantly increase the population coverage.



Networks

for the connected world

97%

annual growth of mobile data transfer in Germany

Life in the fast lane

LTE, short for "Long Term Evolution", is the future of data transfer. The three letters represent a significantly faster and more efficient data transmission network. But more than that: LTE is creating completely new digital possibilities and has the potential to fundamentally change the way we live and work. Telefónica Deutschland is one of the key drivers of the LTE network expansion. This way, the company can open up additional market potential and consistently cater to the customers' demands.

April 12, 2010: It is the beginning of one of the most exciting auctions in German history. The Federal Network Agency has invited representatives of the four largest telecommunications companies to a former army barracks in Mainz in order to bid for the new mobile communications frequencies. Dozens of reporters are waiting in front of the building. The bidders are strictly separated from each other, sitting in separate sound-proofed rooms. For this auction is not just about nine-figure amounts. More importantly: The starting positions for LTE, the future of mobile communications technology, are being handed out.

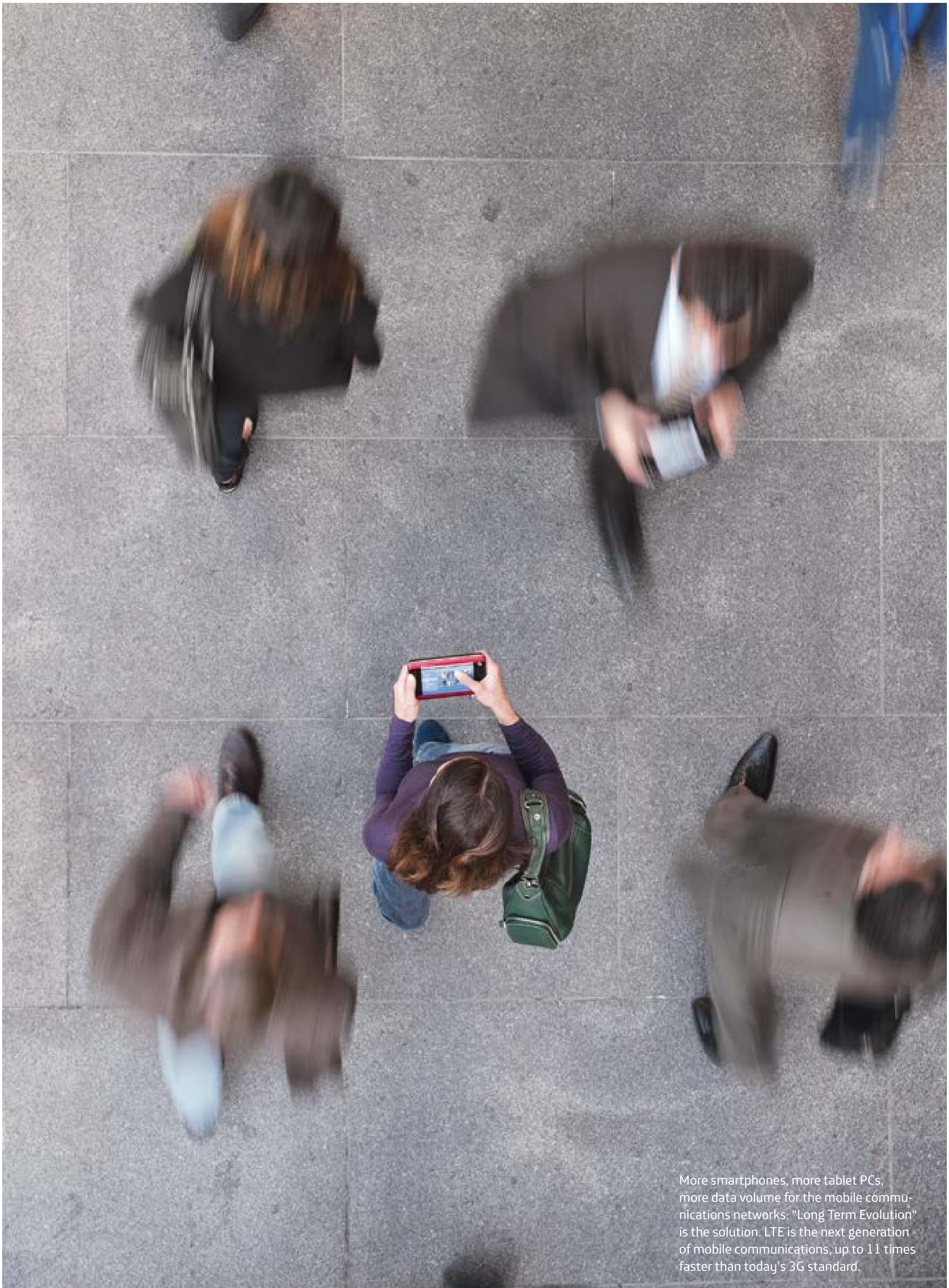
LTE, or "Long Term Evolution" is the next generation of mobile communications networks. The three letters do not only represent significantly faster data transmission – technically, speeds of up to 150MB per second are possible. Starting from the first stage, LTE is about eleven times faster than the previous 3G standard and achieves about the same surfing speed as a wire connection to the internet. Since LTE is much more efficient than its predecessor technologies such as GSM or UMTS at 800MHz, relatively few mobile phone masts cover large areas. It is thus a technology ideally suited to the growing data traffic caused by the smartphone and tablet PC boom.

But first, the companies must prevail at the frequency auction, since the frequency bands available are not sufficient for all network operators. The auction in Mainz takes more than five weeks. The rules are strict: The participants, three from each company, are not allowed to take mobile phones into the building. For communicating with headquarters, one telephone and one fax landline each are available. "We had spent months preparing for the auction and developing a sophisticated bidding strategy," Head of Strategy Markus Haas recollects. A war room has been installed on the O_2 Tower's twentieth floor. There, Telefónica experts analyze the auction's development around the clock.

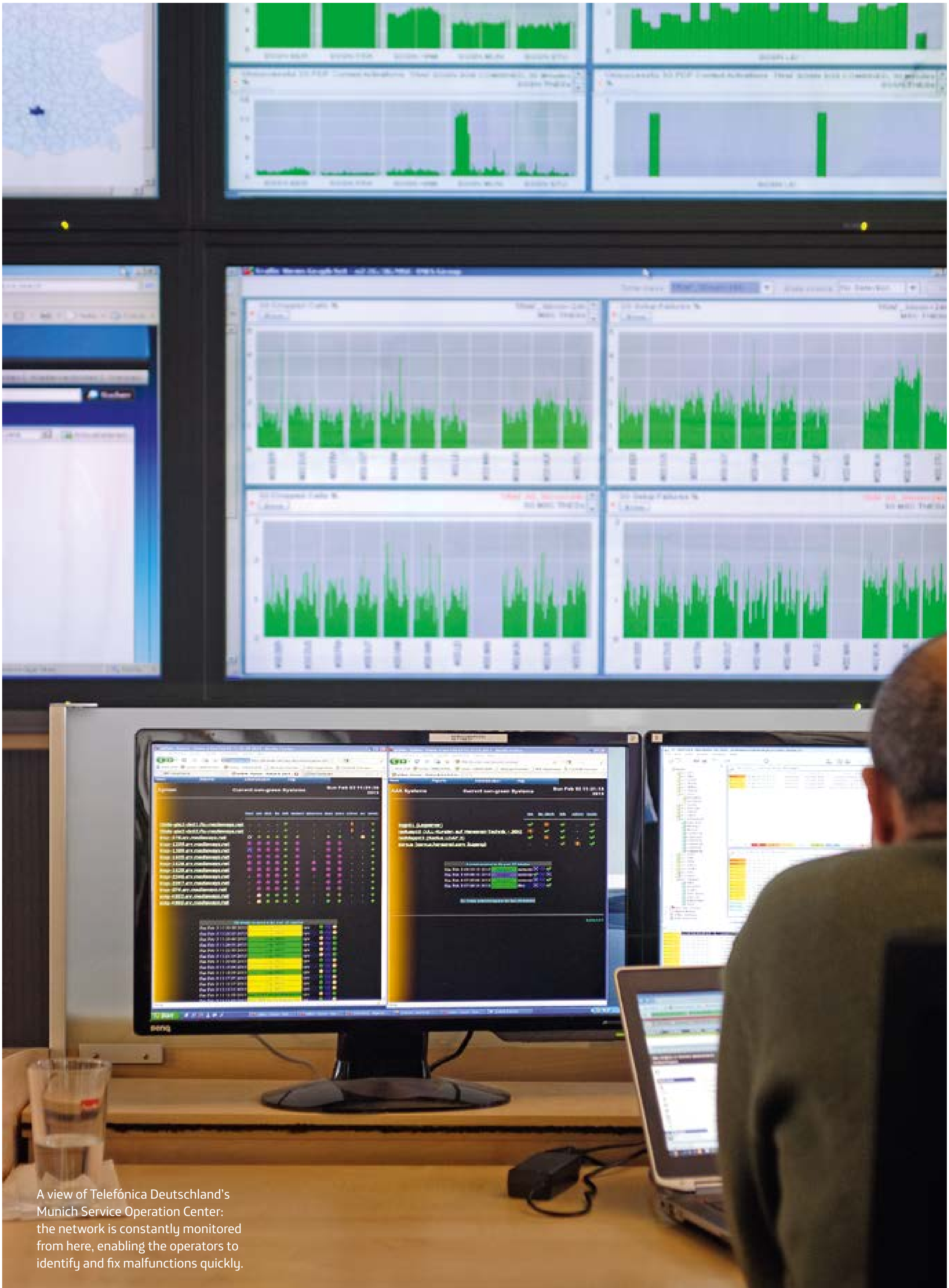
After 27 days and 224 bidding rounds, the result is announced. For Telefónica Deutschland, it is a resounding success: As one of only three companies, Telefónica Deutschland manages to secure two frequency blocks in the 800MHz range for itself – these frequencies were the most sought-after in the auction. Those two blocks and some further frequencies represent an investment by Telefónica of EUR 1.38bn. In total, the participating telecommunications companies send more than EUR 4.3bn the Federal Network Agency's way.

LTE – the future has started

Today, three years later, the network of the future has become a reality for Telefónica Deutschland subscribers. O_2 customers can already use LTE in in five metropolitan high-speed areas (Nuremberg, Dresden, Leipzig/Halle, Frankfurt/Offenbach and Cologne). In 2013,



More smartphones, more tablet PCs, more data volume for the mobile communications networks: "Long Term Evolution" is the solution. LTE is the next generation of mobile communications, up to 11 times faster than today's 3G standard.



A view of Telefónica Deutschland's Munich Service Operation Center: the network is constantly monitored from here, enabling the operators to identify and fix malfunctions quickly.

we will continue to push ahead with the expansion of our LTE network and significantly increase the amount of people to whom it is available: In Munich, Berlin, Hamburg and the Rhine-Ruhr region the rollout is already in full swing.

The expansion of the new technology has come at the right moment. Since more and more people have been using the services of smartphones and tablet PCs, mobile data flow has been increasing rapidly. More than 90 per cent of devices sold by O_2 are now smartphones. One out of three Germans now owns a smartphone and is thus always "on", is constantly exchanging information with the mobile data network. The devices connect to the nearest base station to access background data about 1,500 times every day. That's once a minute. New services and user habits create ever greater data volumes: Downloading a YouTube video takes as much capacity as 500,000 text messages. As a consequence, mobile communications networks have to become more and more efficient and transport much more data. While in the past the maximum capacity was reached on only a few days each year – for example, New Year's Eve – today practically every day is New Year's Eve. In only two years, the number of conversations on the O_2 network has doubled, and the number of data requests has even grown six-fold.

Telefónica Deutschland continuously invests in its existing network to meet the growing demand. More than 250 technicians work around the clock, servicing the more than 30,000 base stations. Last year alone, they took several thousand measures to increase capacity, and brought several hundred new base stations online. The transportation network is an important factor in extending the network: No matter how efficient it is, every mobile network soon reaches its limits when it does not have sufficient capacities at its disposal to send the data onwards. To this end, Telefónica Deutschland signed a long-term network cooperation agreement with Deutsche Telekom. The agreement provides for the connection of the mobile phone facilities to Telekom's fiberglass network, securing sufficient network capacity for the growing data boom. The many different measures and investments aimed at improving the network are bearing fruit, which independent tests confirm: connect, an industry publication, granted the O_2 network an overall grade of "good" in November 2012.

From public national radio service to digital networks

Hardly anybody would have guessed at mobile communications' stunning development when German Federal Mail, as it was then known, launched the "public moveable national radio service" in 1958. This technology, later known as the A network, was Germany's first mobile communications network. But the devices, fitted with tubes, were so big that they fit only into the trunks of large cars. Every call had to be put through by hand. This changed only on arrival of the B network, which went into operation in 1972: For the first time, calls were automatically put through in both directions, that is, from the mobile to the stationary network and vice versa. In 1986, the B network had 27,000 users. But the technology suffered one major disadvantage: To call somebody on the mobile phone, you had to know their approximate location, since every base station had its own station code which had to be dialed first.

Only the launch of the C network in 1985 made mobile communications as user-friendly as it is today. From then on, all mobile phone service subscribers could be reached by dialing a unified code. The devices became much smaller, and some were even portable, a sensation at the time. For the first time, calls were not cut short when devices left the area covered by an individual cell. The new technology allowed the automatic transmission of the call to the next cell – the so-called "handover" had arrived. With the global introduction of the GSM standard in the 1990s came the first digital networks which also provided for the transmission of data. This was the hour of Telefónica Deutschland's birth: In 1998 the company, then called Viag Interkom, launched its network operations. And since Telefónica Deutschland has striven from early on to implement cutting-edge technology, its mobile communications network is one of the most modern in Europe today.

Mobile data traffic growth is exploding

But future mobile communications networks will have to meet much greater requirements: By 2015, the volume of data sent in Germany will have increased by a factor of thirty compared to 2010. In fact, the volume of data is growing so quickly that the familiar units of gigabyte or terabyte no longer suffice: According to projections, the monthly mobile data traffic in Germany alone will reach 317 petabyte in 2015, which represents the same amount of data as 874 million text messages per second. And the data boom will continue unabatedly thereafter.

Telecommunications companies across the globe are therefore backing LTE. There are commercial LTE networks in 51 countries so far, and 360 network operators around the globe are investing in the new technology. After all, one of LTE's advantages is that the existing infrastructure continues to be useful. Normally, no new mobile phone masts need to be erected; instead, it is enough to add the new and more powerful LTE modules to existing masts. A further pro is the reduced latency period, that is, the network's reaction time: Web pages and streamed videos run faster and at top quality, jerking and mismatched sound and video are thus a thing of the past. Since the system also features improved mobility properties, LTE connections are also not disrupted when driving or riding the train.

New services and business models

But the real potential of LTE lies in all the new applications and services the technology enables. Experts predict that more and more objects will be connected to the internet in future. LTE offers almost limitless opportunities: Linked-in cars will soon be able to stream radio and TV channels from the internet, predict traffic jams and make automatic emergency calls if involved in accidents. Even today, fleets of trucks and containers are fitted with mobile transmitters and can be controlled by a central logistics office no matter where in the world they are. Medicine is developing linked-in devices for the home, such as blood pressure readers which automatically transmit data to the family doctor. Experts call this the "internet of things" – comprising everything from linked-in household appliances through TV sets all the way to "smart" clothing. According to studies, 50 billion devices and things will be linked in by 2020, which is an enormous challenge to mobile network technology, but also a great opportunity.

LTE – basis for future growth

As Germany's third-largest networking operator, Telefónica Deutschland is ideally prepared for this challenge. The company is tapping new growth markets with new services, making the most of the potential offered by the ever more powerful mobile networks. Mobile payment is one such innovation. Being able to deal with all financial transactions on the go via our mobile phones will significantly change our lives: online banking in the car, doing the shopping from the subway train, authorizing money transfers from the bar. Telefónica Deutschland is a driver of this development with its innovative services: Since October 2012, as the first company in Germany, it has been offering "mpass", a payment function allowing for convenient payment in retail outlets using smartphones. This will be followed in February 2013 by O_2 Wallet, a digital wallet which enables payments between private individuals and, in future, many more payment options (see page 13).

This example shows that LTE is the basis of Telefónica Deutschland's future growth. By making good use of it, the company is not only well-equipped to deal with the rapidly rising demand for data services occasioned by the sustained boom in smartphones and tablet PCs. Telefónica Deutschland also uses its strong position as a network provider to develop new services and business models for the mobile revolution. The background for this is the company's long-term network strategy, an important milestone of which was the spring 2010 frequency auction. The success back then created the conditions which even now allow O_2 customers to travel the network of the future.

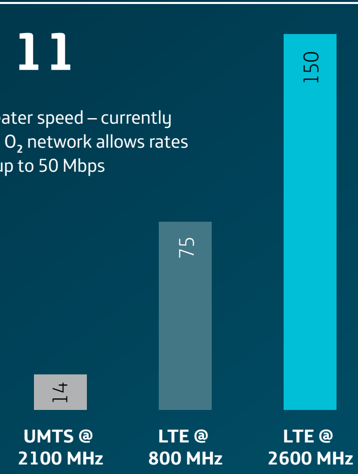
High Speed

More data transfers,
greater speed,
shorter response times
online – thanks to LTE.

Maximum data transfer rate (Mbps)

x 11

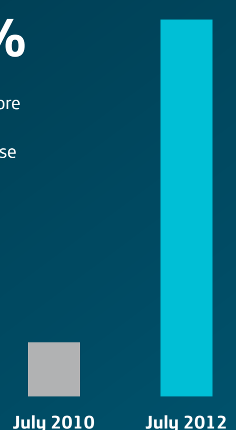
Greater speed – currently the O_2 network allows rates of up to 50 Mbps



Number of data requests in the O_2 network

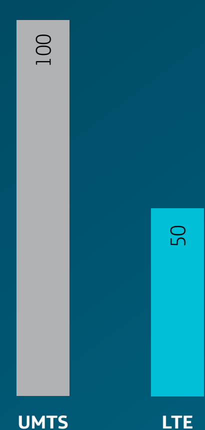
+ 600%

More customers, more smartphones, more apps have led to a rise in data transfer



Latency period (msec)

in %



- 50%

Web pages and streaming video are loaded more quickly and at top resolution

LTE-capable end devices

Almost all manufacturers already offer LTE-capable end devices: from smartphones and tablet PCs to surf sticks for your laptop and LTE routers for your home.

“Our network is among the most modern in Europe”

Heribert Dumont, Vice President Network Technology at Telefónica Deutschland, on the challenges posed by the mobile internet, the extension of the fast new LTE network and not so funny emergencies in the control center.

Mr Dumont, what must a mobile communications network be able to achieve nowadays?

■ Most importantly, it must meet our customers' expectations. In the past, users of mobile phones were mainly interested in being able to make calls from anywhere. Text messaging was also an important service. Now, more and more customers also want to use fast data services. Technology is developing accordingly: from 2G, the first digital technology, to today's standard 3G and onwards to 4G, the LTE mobile communications network of the next generation, which will be able to offer comprehensive coverage for fast data services.

What distinguishes your network compared with your competitors'?

■ Firstly, our network is clearly adapted to our customers' needs. We have succeeded in setting up a very efficient and at the same time economical network. We are also seeing this in the development of LTE, where it is our aim to make the relevant technology available where and when customers need it. The second factor is that we consistently apply cutting-edge technology, which is why our network is among the most modern in Europe.

And the customers want to be able to use the mobile internet more and more?

■ Yes, and this is obvious from end devices sales, too. Nowadays, O_2 customers almost exclusively buy smartphones. There may still be some people who want to use their phones primarily for making calls. But the mobile internet is becoming more and more important to customers, so we have to create the conditions which enable them to make the best use of it.

How have the demands made on a powerful network changed due to the mobile internet?

■ The demand for capacity has risen in the past two years by up to ten times. And not only has the actual data traffic increased. In our network, signaling transfer has grown almost more rapidly. This is the exchange of data which is necessary to keep our cell phones connected to the network.
Since smartphones continually communicate with the network – for example for downloading e-mails or loading new web pages – data traffic in the network has practically exploded. On the one hand, this is a gratifying development, as it shows us that

Heribert Dumont,
Vice President Network Technology

Heribert Dumont has been working for Telefónica Deutschland for 17 years. He joined Viag Interkom, Telefónica Deutschland's predecessor, after having gained a degree in Information Science. Today, he is responsible for extending and maintaining the O_2 network.

our customers use data services more and more. But for us as technicians it is also a challenge, particularly in metropolitan areas. There we are investing large sums in adapting our capacities to the growing demand.

This is why LTE's importance as a network technology keeps growing?

That's right. It may be true that most of our customers still use 3G in data transfer, too, which is why the large majority of the traffic is handled using this technology. But LTE traffic is growing rapidly, so it absolutely is a priority for our company to ensure that most of the data traffic can be handled through LTE in the medium term.

How far along are you with the extension of the LTE network?

Since late 2012, LTE has been available to 15 per cent of the population. The metropolitan areas around Nuremberg, Dresden, Leipzig/Halle and Frankfurt/Offenbach are already well provided. In January, Cologne reached this status, and a large number of towns will follow in the coming months.

What is it that LTE can do but UMTS couldn't?

The successful bid for a spectrum in the 800MHz frequency range means that we can provide fast mobile data services over large areas significantly more economically with LTE than with 3G, and we also serve buildings better. Furthermore, its capacity is many times greater than that of UMTS. As a consequence, we can provide much greater bandwidth with a single site and can achieve much higher data rates at peak times, which may well reach peak values of 75MB per second. If necessary, we have access to a sufficient spectrum in the 2.6GHz frequency range to expand our capacity further, even reaching peak data rates of up to 150MB per second. And the third point, which is not mentioned that often, but is essential for many customers, is that the latency period, that is, the technical response time, is much shorter with LTE. It is about 50 milliseconds, which makes a clear difference when surfing, for example when loading web pages or playing online games. This aspect renders LTE even more comparable to the experience of DSL internet.

How do you construct such a network? The frequency auction is the beginning. What are the next steps?

The most important thing is having a sound long-term plan. To arrive at such a plan, it is first of all necessary to identify which demand will develop where and whether it is technologically feasible to meet this demand. A second decisive factor with LTE is setting up the transport network, since the data traffic the customers generate needs to be forwarded to our core network.

> *"More and more customers want to use fast data services"*

You cannot link this in to the existing transport network?

No, we are basically building an entirely new network, since LTE's bandwidth demands are much greater than they were with 2G or 3G. This is true especially of the access points: There, specific transport networks are required, usually set up using radio relay systems or so-called points of concentration. These are connections to the fiberglass network of Telekom, who we cooperate with in this area. To ensure greater system stability, larger transport rings – comparable to beltways around major cities – are usually built, to which the LTE access nodes are then connected. For this, we use existing 2G or 3G sites wherever possible.

This means you add new LTE components to existing stations?

That's right. We negotiate with building owners and general contractors to get the new technology installed on the rooftops. These, at a quick glance, are the strategic considerations we are taking into account when setting up the new network. Besides those, there are of course plenty of challenges which come along with practical implementation and which keep us on our toes. You need to remember that we have more than 30,000 base stations in Germany.

What are the costs of setting up an LTE network?

Right now, we are investing a total of about half a billion euros annually in our infrastructure. A significant share of this money goes into setting up and expanding our network.

Setting up a network is a challenge, but maintaining it can't be much less of a task.

Yes, this is a very important task. In order to manage it, we run our Service Operation Center, from where we monitor the network around the clock. This is the nerve center, allowing us to notice faults early on and to react immediately. We then, for example, send a technician to fix the fault without delay. This has become a routine operation. Likewise, there is a team taking customer complaints, analyzing them and initiating repairs if a network fault is the cause.

What was worst situation you have ever experienced?

The greatest challenges are faults occurring in major sites when we are unable to act, for example because we are prohibited from accessing the building for security reasons. This happened in Nuremberg last year, when we had to wait for the fire department to allow us to re-enter the building after a fire. But such cases are extremely rare. At our core sites, our technology contains redundancies, so that in case of faults there is always a backup system. The worst case is when a lasting energy outage is combined with our inability to access a site. This I have experienced exactly once in all my many years here. Then all the alarms bells go off, and that's not so funny.

If you shape the digital future, you bear responsibilities – for society and the environment, for customers, suppliers and staff. We cherish these responsibilities, as they are intimately connected to our economic success. Behind them, there is a clear vision: we want to improve the quality of people's lives and drive social progress through digital products and services.

Respon-sibility

in the connected world

1,300

ideas promoted

27,000

participants in the youth program Think Big

Creating sustainable

“Sky is the Limit” – rapper Kool Savas wrote this song especially for Think Big. At the grand finale he got the young people to join him on stage. Everything is possible!

progress

Mannheim: Ten teenagers share the huge stage of the SAP Arena with German rap star Kool Savas and singer Xavier Naidoo while an audience of 14,000 listens eagerly. What an unforgettable conclusion to the Think Big Year 2012! “Sky is the limit”, a song written specifically for Think Big by Kool Savas, is the perfect manifestation of the program’s core idea: Move things, draw on your skills, believe in yourself, and change your environment. Kool Savas: “We wanted to show everybody what teenagers are capable of and encourage others to believe in themselves and their ideas, too.”

Munich: Michael Braunger works for Telefónica Deutschland as a team assistant in Corporate Responsibility. He participates in meetings, answers the phone, organizes trips, and takes care of technical matters. Nothing special, you might think. But it is for Michael Braunger, who is hearing impaired. But this does not keep him from being a fully integrated member of the team. Technical aids, such as the VerbaVoice app, make day-to-day work life easier to him – as do the understanding of his colleagues and an open corporate culture.

All across Germany: Old mobile phones lie forgotten in drawers, most of them broken and not needed by anyone anymore. But they are carriers of valuable raw materials, which could be recycled – simply by sending an email to umweltmanagement@telefonica.com. In return, the sender receives a recycling bag addressed to the recycling partner of Telefónica Deutschland. If the mobile phone still works, stored data is deleted and the phone is sold back into the cycle of usage. Broken phones are disposed of in an environmentally friendly manner, which means that valuable raw materials are recycled. Telefónica Deutschland donates the generated proceeds to not-for-profit environmental organizations across Germany.

Setting priorities, maximizing effects

These are three examples that demonstrate what Corporate Responsibility means for Telefónica Deutschland. “We aim to improve people’s quality of life and to be drivers of social progress,” explains Dr. Roland Kuntze, Vice President Corporate Communications at Telefónica Deutschland. “And we do so exactly where we think we can achieve maximum effect.” Consequently, the company has set three priorities: Think Big, access to life via telecommunications, and environmental and climate protection.

The focus of activities is primarily on children and teenagers. And that is only logical. For those – like Telefónica Deutschland – who want to shape the digital future are well advised to prepare the next generation for this future. Since 2006, the company has been a member of FSM (Voluntary Self-Monitoring of Multimedia Service Providers) and has also signed the association’s Voluntary Agreement of Mobile Service Providers for the Protection of Minors. This agreement is supposed to ensure that children and teenagers do not get to see content that could hamper their development.

As a founding member of the “A Net for Children” initiative, Telefónica Deutschland also supports the development and operation

They understand each other – not least thanks to VerbaVoice: Michael Braunger, hearing impaired staff member at Telefónica Deutschland, and René Schuster, CEO

VerbaVoice is Germany’s first mobile speech-to-text interpreter service. A sign language or speech-to-text interpreter is connected via the internet. Their text or video is sent directly to the user’s laptop or smartphone so that hearing impaired participants can follow conversations in real-time. The live transmission serves as direct communication aid for the hearing impaired as well as live minutes and subtitles at events. The service is applied by schools, universities and companies as well as in everyday life and as a tool to ensure barrier-free events. Telefónica Germany has been supporting the development of VerbaVoice since 2009.

Dr. Heike Kahl, Managing Director of the German Children and Youth Foundation, Think Big program partner

Think Big – Together we can empower young people

"We believe in young people – with this conviction, Telefónica Deutschland approached the German Children and Youth Foundation (GCYF). GCYF has been striving for years to improve the chances young people have of contributing to shaping society and to give them the chance of engaging with their fellow citizens on an equal footing. Telefónica wants to invest in the young people of Germany and Europe. Think Big is a convincing example of how this wish can become reality.
Think Big is one of the few programs in Germany which gives young people themselves the funds to launch social projects. This often surprises the teenagers: most people think they are incapable of getting anything done, and now they are suddenly entrusted with this responsibility? 27,000 young projectors have so far participated in 1,300 Think Big projects. An evaluation carried out by Durham University has shown that about 39 per cent of these projects were managed by young people who belong to the group of the so-called socially and educationally disadvantaged. This is an enormous success, since the dedication and the experience of these young people are important resources for a diverse and vibrant society.
We are especially impressed by Telefónica's success in getting many very different partners – for example agencies, social entrepreneurs and youth initiatives – together as a team to get the shared project Think Big off the ground. This was surely also one of the reasons why Federal Minister Dr. Kristina Schröder decided to become the patron of Think Big."

of fragFinn.de. The media educators, permanent staff of the fragFINN e.V. association only include websites that have been evaluated according to pedagogical criteria and approved for children. Thanks to the browser of the fragFINN app for smartphones and tablet PCs, youngsters can always surf a safe internet, even when on the move.
The biggest Corporate Responsibility initiative at Telefónica Deutschland is Think Big, a program that assists children and teenagers in making their ideas come true and changing their environment (see page 32). In this endeavor, Telefónica Deutschland cooperates closely with the Fundación Telefónica and the German Children and Youth Foundation, which develops projects for young people that encourage them to learn and experience initiative, entrepreneurial spirit, participation and responsibility as well as a democratic culture of coexistence. "An ideal partner for Think Big," according to Claudia von Bothmer, Head of Corporate Responsibility at Telefónica Deutschland. And just like in many of these activities, employees of Telefónica Deutschland play an important role in Think Big. They can get actively involved in the initiative by participating in the corporate volunteering program – an opportunity several hundred employees seize with great commitment every year.
The second priority for Telefónica Deutschland is people's access to telecommunications. "We want to give as many people as possible barrier-free access to communications and allow them to live a more independent life," says Claudia von Bothmer. One example: Since 2009, the Company has supported VerbaVoice, a speech-to-text interpreter service for the hearing impaired. In 2012, the VerbaVoice app for the iPhone and iPad as well as for Android devices was launched. Michael Braunger also uses the service on his tablet PC in meetings with so many participants that he cannot keep eye contact with everybody. "Thanks to VerbaVoice, I can actively participate in meetings without having to ask the others to take my hearing impairment into account," explains the 40-year-old and adds with a smile: "I always have the complete minutes right when the meeting is over. Nobody can do that faster." Braunger is one of 14 employees who were placed at Telefónica Deutschland by the Pfennigparade Foundation. Strategically selected, they perfectly support the day-to-day operations at their respective departments.
Priority Three: environmental and climate protection. Dr. Markus Sardison, CR Manager of Telefónica Deutschland and responsible for environmental affairs, explains: "96% of our energy consumption and thus also the majority of our CO_2 emissions are generated in connection with operating our network. Running a Germany-wide network with more than 30,000 base stations and the respective network technology requires a lot of energy." The goal: An energy reduction of 30 per cent per landline and mobile connection by 2015 (basis: 2007). The approach: Continuous investment in energy-efficient technologies. This means specifically to exchange inefficient rectifiers, to retrofit free cooling units, and to update the entire network technology continuously – investments that keep the network efficient while at the same time benefitting the environment.
Customers are also encouraged to get involved in the activities through initiatives such as the mobile phone recycling described

Mobile phone recycling made easy: Just request your envelope per email or at an O_2 shop and send your old mobile phone off free of charge. Proceeds go to an environmental organization – so the environment actually benefits twice.

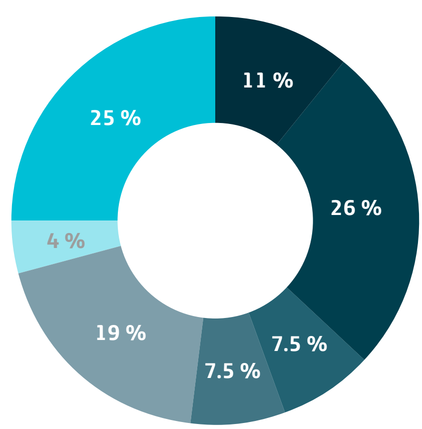
above. Or through Eco Index, developed with the sustainability experts of Forum for the Future. Since 2011, a majority of mobile phones from the O_2 portfolio has been evaluated according to sustainability criteria, including the environmental impact of a specific device as well as its contribution to more sustainable living conditions and the ethical principles of its manufacturer. Based on this information, which is available on the O_2 website, customers are able to make an educated buying decision. Even though the effect of a single device may be insignificant, at around 112 millions of active mobile connections in Germany in 2012, according to the industry association Bitkom, the effect of such decisions is indeed significant.

Success builds on responsibility

The positive environmental and social effects of the Telefónica Deutschland commitment aside, why would a for-profit organization launch these activities? CEO René Schuster: "There aren't many technologies that have the potential to change our lives as much as telecommunications in the years to come. So there is great potential for our company. However, this chance comes with an enormous responsibility – for about 6,000 employees, over 1,500 suppliers, and hundreds of millions of customers. As a telecommunications company, we are drivers of digitalization. This is how we make a contribution to social progress, and we aim to do so in the most responsible manner. After all, social progress, responsibility, and not least economic success are closely connected. Only those who create sustainable change will remain successful in the long term."

Eco-Index Points

Seven areas of assessment shine a light on various aspects of sustainability, including mobile phone functionality.



- Company-related impacts
- Raw materials and impact of production
- Impact of materials used
- Packaging and delivery
- Impact of use
- Impact of disposal
- Functionality

Think Big

The future is now – how the Think Big youth program promotes creative ideas

People who love to play football know this situation: Driven by the urge to score a goal, shoes laced, ball at the ready, one arrives at the next football field – but there are no other players. Or not enough to form two teams. And most probably, some likeminded spirits on another football pitch only a few kilometers away are facing the same problem at the exact same time. Together, all these people could have a great afternoon kicking a ball around. But: The two groups don't know of each other's shortage of players.

Finding solutions together with O_2

Julius Korn (23), a passionate football player in his free time, wanted to change that situation and came up with the idea for the website "wo-wird-gekickt.de", which allows football players to make arrangements for a game. They simply mark on a map where and when they are going to play, and other young people who wish to join can find pitches and other players close by. A kind of grassroots German Football Association, it is a great undertaking that started on a small scale.

This idea is one of 1,300 that have been supported by Fundación Telefónica and the German Children and Youth Foundation together with O_2 since the launch of Think Big in 2010. The idea behind the program: to assist young people between 14 and 25 years of age in believing in their ideas, pulling together to make things happen, and changing their environment.

Telefónica Deutschland supports promising projects with funding of 400 euros and an expert coach provided by a local not-for-profit partner organization. 1,000 euros in project funding are available to those who have completed the first support level. In a third step, 5,000 euros plus a place in a co-working space in Berlin are on offer.

The idea is proving a big hit: Think Big demonstrates impressively how great the commitment and innovative potential of young people is. "This is what we want to promote strategically by the application of digital media," comments René Schuster, CEO of Telefónica Deutschland Holding AG. "As a telecommunications company, we are significant drivers of the digitalization of our private and professional lives. We want to assist young people in seizing the opportunities entailed in the digitalization and in realizing their own project ideas so as to develop positive private and professional perspectives for themselves."

The employees are game

"We" – that does not only refer to the management board of Telefónica Deutschland, but to the entire company. So far, more than 1,000 employees have contributed to the program by providing expert advice and practical support: Members of PR departments develop core messages for individual projects; colleagues from HR help build teams whose members act from different locations; IT experts provide input to the development of apps and websites; and social media specialists assist in building sound online communities to increase the number of followers. "This shows how well established this initiative is at our company," comments Miriam Wolf, Project Manager for Think Big at Telefónica Deutschland. "Collaborations are most efficient if organizations do not only provide funding, but also the expertise of the company and its staff to young people."

Top: Coming up with ideas – and implementing them, too: Think Big aims at helping young people turn their projects into reality and thereby develop new life and career opportunities for themselves.
Bottom: Team work: more than 1,000 Telefónica Deutschland employees have so far collaborated with young people as part of the Think Big program.

WorldCitizen: this campaign, developed by three young people as part of Think Big, aims at improving the dialogue between cultures, religious communities and people of different backgrounds.

This approach has also been recognized: In 2012, teenagers were given the chance to present the project to a wider audience at the official summer party of the German President. Moreover, Telefónica Deutschland won the renowned "Politikaward" in the category Corporate Responsibility for Think Big. "A great recognition both for all program partners and the over 27,000 young people who have so far participated in Think Big," comments Claudia von Bothmer, Head of Corporate Responsibility at Telefónica Deutschland.

A broad range of creative ideas

The range of ideas the young people are dedicated to is broad and refreshingly creative: They stage hip hop and breakdance competitions, weld crazy bicycles from junk, or cook for their parents to say thank you for everything the latter have done for them. WorldCitizen, the idea of three young people from Berlin who are committed to overcoming prejudices and building bridges between different cultures, has even become an internet phenomenon. Their online photo gallery is a platform for the presentation of very different people, some of which just met by chance: tall and short, overweight and skinny, light-skinned and dark-skinned. "Differences connect – everywhere around the world." This is the message of the project, which includes workshops and specific coachings at schools – always with the goal in mind to break down cultural barriers.

"I am a WorldCitizen"

"I was born in Trier, Germany," says co-initiator Salah Said. "And I have been a Berliner-by-choice, or Kreuzberger to be exact, for ten years now. But again and again, I was asked where I come from. People reduced me to the way I look and the origin of my parents. But I am more than what others see in me, and more than the information in my passport. For I am a WorldCitizen." His colleague Hans Storck adds: "I live in Berlin-Kreuzberg, so the intercultural exchange has always been an elemental part of my life. And I just can't stand by and watch how others fight for a better world and try to make a positive change without getting involved myself. I want to be a part of this movement and inspire as many others as possible." Their project was given the ultimate accolade of pop culture when the reggae musicians Jahcoustix and Shaggy dedicated their song of the same name to the WorldCitizen project, scoring a summer hit in 2012 and raising awareness for the spontaneous idea of the three friends from Berlin.

"Think Big has changed my life"

Music also led Simal Bervari to join Think Big. The 20-year-old Munich resident heard about the program by chance and immediately loved the idea. Today, he is one of approx. 30 Peer Scouts, as the Think Big ambassadors are called. He visits schools to encourage students to participate in the program, shares his experiences with rookie project coordinators, and has participated in a professional Think Big video. "I realize that this might sound like an advertising slogan, but Think Big has changed my life," says Bervari. He adds that, when he was younger, he didn't know what to do with himself and his time – which only changed when he joined Think Big. Now he wants to go to university and apply for a film job afterwards. "Think Big has given me more self-confidence. I have learned how to present myself and my ideas to a larger audience." Positive momentum for the first steps into professional life – and Simal Bervari seems dead set on using it.

Open source guru John Maddog Hall advises Think Big youngsters at the 2012 Campus Party in Berlin during a pan-European Think Big app workshop.

The breathtaking speed at which telecommunications are developing is revolutionizing companies and industries, leaving fertile ground for new business models all over the world. Innovations are the key to future success. This is why Telefónica Deutschland not only invests in a modern infrastructure, but in smart ideas as well. For example in the Wayra Academy, where young start-up founders develop new digital business models and take them to the market. We offer them a helping hand as their investor and mentor – and shape the digital future together.

Innovation

in the connected world

10

places available

268

applicants for the German Wayra Academy

Lifetime Opportunities

Wayra Academy as an incubator for ideas

Tanja Kufner, director of the German Wayra Academy, and José María Álvarez-Pallete López, responsible for Wayra throughout Europe as Telefónica S.A.'s COO.

Kaufingerstraße in Munich, straight across from Frauenkirche Cathedral, the city's landmark. There could hardly be a more prestigious business address in Germany: department stores, the flagship stores of great fashion houses, and long-established Munich stores are in the immediate vicinity.

In this top location, Wayra Academy occupies one entire office building floor. "Wayra" means "wind" in the language of the indigenous Quechua people. Quechua is spoken in the Andes region. It was there, in South America, that the idea of the Wayra Academies took flight. So far, start-up centers like this one have been established in twelve countries, from Great Britain to Brazil.

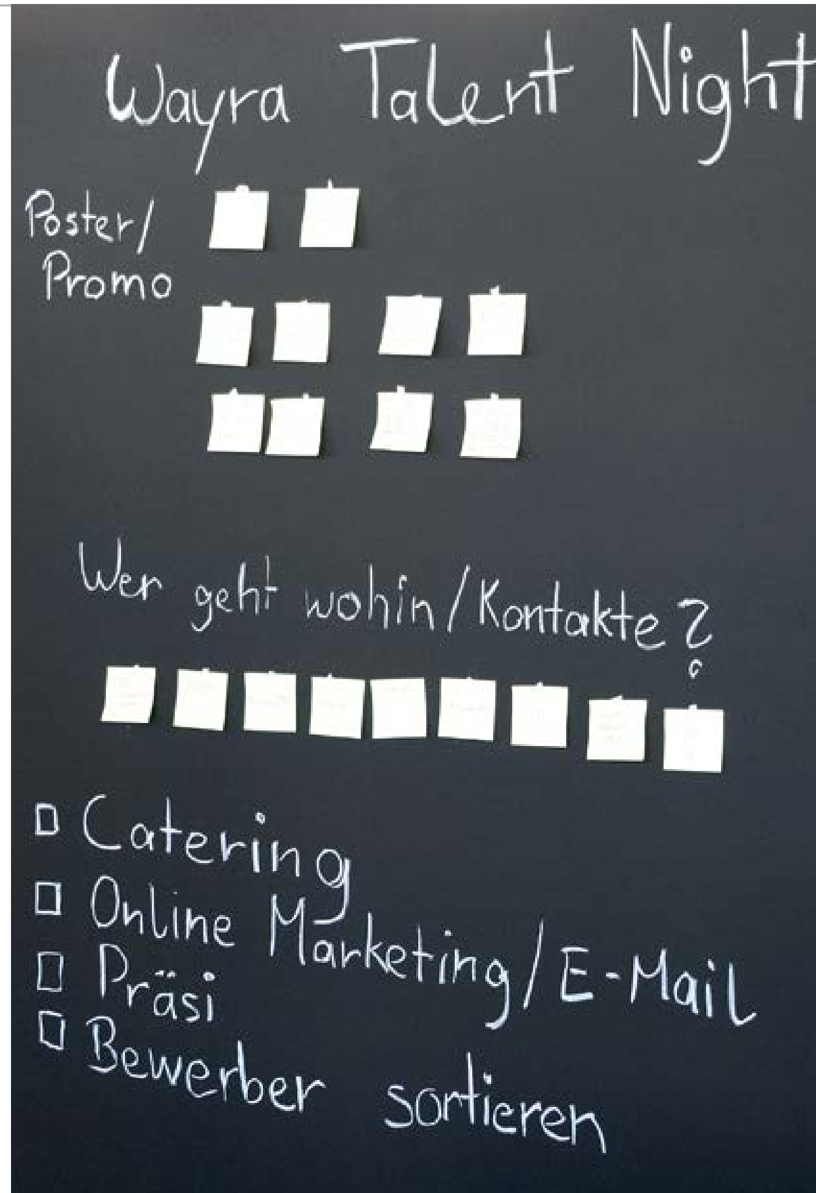
The Munich Wayra Academy is Teléfonica Deutschland's creative lab: a loft covering more than 1,000sqm, colorfully kitted out, with beanbags in a spacious central encounter zone, top-of-the-line IT equipment, and featuring a table-tennis area for nonverbal sparring matches – separated by a glass door. But most importantly, it provides office space for ten teams of junior entrepreneurs. "This is where we accelerate the development of business models from the internet and telecommunications industries," says Tanja Kufner, Wayra Country Manager for Germany. "We assist our teams in implementing their ideas. We provide them with expertise and offer them the opportunity to exchange their knowledge and experience. It is our goal to guide all projects to marketability – and of course to discover a great business idea now and then."

Promote clever ideas, discover talent

Every team receives funding of up to 50,000 euros. In making this funding available, Teléfonica Deutschland is not primarily interested in tapping new business areas for itself. The contracts do provide for a five per cent share of Teléfonica in every start-up. "But it is much more important to us to promote clever ideas," says Kufner. And to find talent capable of embarking on a successful career in the parent company. "Many of the great ideas and changes which will shape the world in the 25 years to come are already being discovered by unknown innovators in their homes or teaching labs," explains COO of Teléfonica S.A., José María Álvarez-Pallete López. "We founded Wayra with just that spirit of innovation to discover and develop the best technology ideas and talent."

Each of the teams, usually comprised of three members, spends half a year at the Munich Academy. Kufner organizes lectures and series of debates in the premises' small auditorium. In addition, up to three 'board advisors' support each team in developing a business strategy and lend a hand with contacting potential investors or partners. "The participants attend a sort of condensed MBA course customized for entrepreneurs," is Kufner's summary of the program.

Great prospect: the Wayra Academy, Telefónica Deutschland's creative lab right in the heart of Munich, provides office space for up to ten teams of young entrepreneurs.

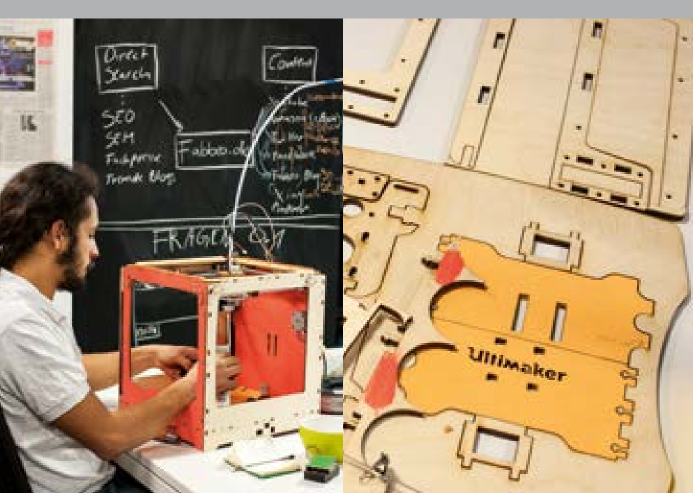


Telefónica Deutschland as a brain pool

But the greatest opportunity for teams is being able to access the greatest pool of experience Teléfonica Deutschland could possibly offer: the expertise of its staff. In Germany alone, 60 employees of the company have registered as mentors, ranging from lawyers to programmers. All of them support the Wayra participants with words and deeds.

“Naturally, this is a terrific opportunity,” says Markus Stiefel. The 30-year old is a co-founder together with two fellow entrepreneurs of “Pockets United”, a mobile payment service which allows groups of friends to settle shared bills. “Whenever we have a problem, for example a legal question, we turn to one of our mentors in the company. And we receive prompt assistance. We have never been disappointed,” says Stiefel.

“Pockets United” is one of the enterprises at the Munich Academy which have progressed particularly well on their way into the real world of business. Markus Stiefel thought of the basic idea after one of those typical student nights, when he had gone out with friends and one of them paid the bill for all – and ended up not being reimbursed by the others. They needed a way of somehow calculating and balancing the various shared expenses without using cash. So Stiefel went and developed an app. The software is now almost done, all that remains is work on technical details. This is what Matthias Schicker is busy with practically day and night. Also 30 years old, the software engineer left Google and the Silicon Valley because just like Stiefel he wanted to do “his own thing”.



State-of-the-art equipment: The teams also have access to a 3D printer to help them develop their projects.

“Pockets United“ is a platform which allows for swift, secure and convenient shared payments.

Lots of space for exchange – between the teams and the mentors from Telefónica Deutschland

"Cleverlize", developed by An Tran (left) and Lukas Steinbacher (right), is a software tool with which teachers, lecturers, even parents can program learning apps for smartphones or tablet PCs without any prior experience.

An international network

Their example shows that Teléfonica Deutschland has succeeded in getting some of the best young entrepreneurs and talent of the IT scene to join the Wayra Academy. The company considers all of them capable of securing investment from venture capitalists or of eventually going public, otherwise they would not be here. Such as Lukas Steinbacher and An Tran of "Cleverlize", both around 30, like most of the participants, and working on a software tool allowing teachers, lecturers and parents without programming skills to develop learning apps for smartphones or tablets.

"Imagine a tutor," Steinbacher explains, "who can provide students with an app which lets them revise their lesson material already on the way home from school on the underground". E-learning for use at home is an up-and-coming market. "Wayra's great international network can help us make a name for ourselves and develop global distribution channels," Steinbacher says. "On our own, we would never have the chance." His company was one of two start-ups from Munich which had the opportunity to present themselves to American investors at Wayra's international Demo Day in Miami.

Tough selection process: 20 international teams presented their projects at Wayra's 2012 Campus Party in Berlin. Seven were selected and were fortunate enough to take up residence in the Wayra Academy in Munich.

Easier access to markets

Dorna Hekmat, CEO of i-frontdesk, a service for hotels, also hopes to gain speedier access to markets. "With the Wayra seal of approval it is, of course, easier for us to find customers because they trust us from the get-go," she says. With her partner Peter Duesing, Hekmat is developing a virtual concierge for hotels. It will enable guests to access services through their tablet, for example to get some last-minute tickets for the almost sold-out opening night at the opera the same day. "I want to give small hotels the opportunity to offer a five-star level of service," says Hekmat, who used to manage hotels herself in the past. At present, she is negotiating the use of her service with well-respected hotels.

"New Silicon Valleys all over the world"

The range of business ideas finding support at Munich's Wayra Academy is remarkably broad: "Fabbeo", for instance, aims at managing communication between 3D printing companies and their customers; "Clearkarma" is developing an app which will help identify certain ingredients in foods; "Chuisy" will facilitate the exchange of experiences with shops and shopping; and "Spotfav" provides optimized weather information for planning outdoor sports activities.
All of them had to prevail against a host of competitors in 2012 in order to gain admittance to the Academy. 268 hopeful junior entrepreneurs applied for a place in the first round, 20 teams were invited to the final in Berlin. There, they presented themselves over three days at the Campus Party, something akin to a Woodstock Festival of digital youth culture, on the premises of the former Berlin-Tempelhof airport. "It was a difficult pitch," is "Pockets United" co-founder Markus Stiefel's comment. "Seems, though, we weren't all that bad, as we beat the competition."
The selection criteria are strict. "We are looking for the best talent, the very best," says Simon Devonshire, Wayra's European Director. An eight-member industry panel of judges painstakingly examines every business model. Selection rounds are to be held twice yearly in future. The teams do not get more than six months within which to acquire follow-up funding. After all, the Academy is meant to be a career accelerator, constantly renewing its intake.
"We are funding lots of new Silicon Valleys all over the world," is how Simon Devonshire explains the concept. Teléfonica expends a lot of expertise and resources on supporting its protégés, but the company demands commitment in return. Those who do not demonstrate enough commitment or whose ideas fail to prove sustainable may be advised to leave the Academy. The places are too sought-after in the digital scene, and the contact to possible investors – and a huge audience – is too attractive. "Basically, we offer the participants access to all 300 million Teléfonica customers all around the world," Devonshire says. Wayra can become a massive springboard for the new businesses – and allow them to jump to the top of their field.

Generating Inspiration

Fernando Burgos, Vice President New Business & Innovation, on Telefónica Deutschland's Innovation Management

Mr Burgos, you head a team of 15 staff who look for innovative products and services on behalf of Telefónica Deutschland. At what point do ideas become innovations?

■ Quite simply: When these ideas generate new business, new turnover and additional profit. Only by being economically useful does an idea become valuable for a company.

In your personal opinion, what has been the greatest innovation of the last years?

■ "Joyn" is a very important innovation for us. It is a communication service across different devices and networks which will allow fantastic applications in future. But the innovation is not just the product itself; rather, "Joyn" is a milestone in the cooperation between the players in our industry. It is an example which shows that by working together and standing shoulder to shoulder we can really get things on the road.

Innovation requires creativity, focus, and thinking commercially, all at the same time. How do you integrate these factors into a single process?

■ By never losing sight of the objective and by keeping on the lookout for new ways of reaching this objective as quickly and efficiently as possible. This has a lot to do with entrepreneurial spirit. If you think like an entrepreneur, you are open to new ideas and structures – and you know what needs to be done to get new ideas onto the market profitably.

Is this why you support startups through Wayra?

■ Our main objective regarding Wayra is gaining new inspiration. We support these start-ups at a very early stage. We accelerate their development considerably – and if their product is good, they can continue at that high speed, with a perspective on the global market. As a company, we benefit from the energy, the spirit and the curiosity of these businesses. They are a valuable inspiration for us, and this is at least as important as the Wayra start-ups' economic success we naturally also hope to share in.

But start-ups are only one element of our strategy. Besides openness and curiosity, innovation also requires communicating with a wide variety of target groups. We follow the concept of "open innovation" and invite staff, customers, and other drivers of innovation to join in our activities – and start-ups, through Wayra, are one of these groups.

"Germany is an excellent breeding ground for innovations"

In doing so, we profit immensely from the flow of ideas within the Telefónica corporation, especially from the cooperation with Telefónica Digital. In this way we are integrated into a worldwide network, giving us the opportunity to identify global developments early, contribute to shaping them and translate them into customized products for our market.

What is Telefónica Deutschland's role in this network?

■ Germany, with its strong automotive industry and a healthy retail market, is an excellent breeding ground for innovations. Consequently, we want to become a pioneer within the Telefónica Group, too, with our innovation management. And we took important steps towards this goal in 2012.

With specific results?

■ Yes, of course. For example, we conceived and developed several products last year which will be launched onto the market in 2013. Just two examples: In 2012, we continued our development of an innovative insurance concept which could revolutionize motor insurance. Or Digital Signage, a new service which is part of our strategy of tapping the segment of smaller medium-sized enterprises.

The store next door, basically?

■ Exactly – and the baker, the tailor, the dry-cleaner, the newsagent and many more. All these businesses are looking for ways in which to contact their customers quickly and effortlessly, through a modern medium. We are lowering the technological barriers for these customers, offering them access to digital forms of advertising.

How does this benefit Telefónica Deutschland?

■ We are tapping into a new market segment, with great potential for growth and additional turnover in years to come. New markets, new potential, new chances – this is, after all, the point of all innovation.

Information for our Shareholders

Telefónica Deutschland on the stock market

Top: Telefónica Deutschland starts trading at Frankfurt stock exchange. From left to right: César Alierta Izuel, Executive Chairperson and CEO Telefónica S.A.; Dr. Reto Francioni, CEO Deutsche Börse AG; René Schuster, CEO Telefónica Deutschland Holding AG; Frank Gerstenschläger, Chairperson of the Management Board Deutsche Börse AG.

Right: The management board of Telefónica Deutschland Holding AG in front of the bull. Markus Haas, Chief Strategy Officer; Rachel Empey, Chief Financial Officer and René Schuster, Chief Executive Officer (from left to right).

Going public

The initial public offering of Telefónica Deutschland Holding AG took place on October 30, 2012 with the debut on the regulated market (Prime Standard) of the Frankfurt Stock Exchange. In a public offering in Germany and Luxembourg and a private placing with certain institutional investors outside Germany and Luxembourg, interested investors could subscribe to the new share in the period from October 17 to October 29, 2012. A consortium of 12 national and international banks managed the process. Interest in the Telefónica Deutschland shares was particularly high and consequently the offering was oversubscribed multiple times despite challenging market conditions and an uncertain macro and sector environment.

Telefónica Deutschland, Telefónica S.A. and the syndicate banks set the issue price for the shares offered within the initial public offering at EUR 5.60 per share. In total, 258.75m shares were placed with investors (including 33.75m over-alloted shares in connection with the greenshoe option). The issue volume (including overallotment) thus totaled EUR 1,449m and allowed Telefónica Deutschland to complete the largest initial public offerings in Germany in over five years and in Europe in 2012.

Development of the share price

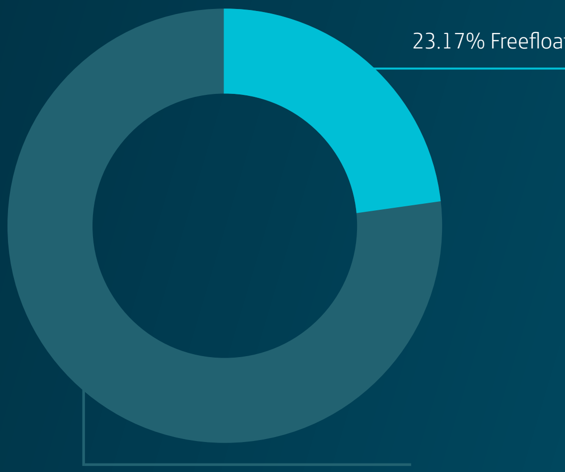
The IPO of Telefónica Deutschland took place in a highly uncertain macro and sector environment. After an upward trend in the summer of 2012 and a stock market rally post positive decisions from policy makers in Europe to tackle the spreading sovereign debt crisis in mid-September, the equity markets have lost some momentum. In addition, equities lost ground as the earnings season kicked off with major indices declining, cyclicals underperforming and volatility increasing. The uncertain environment reduced issuance activities on the German stock markets.

Despite these headwinds Telefónica Deutschland had a successful stock market debut. On October 30, 2012 the Telefónica Deutschland shares were listed on the regulated market (Prime Standard) of the Frankfurt Stock Exchange for the first time. The issue price was EUR 5.60 and the first share price was EUR 5.70. Following a significant trading volume during the course of the day, the share price reached an initial high of EUR 5.83, representing an increase of 4.1% on the first trading day. Driven by a continuous rise in interest and strong Q3 2012 results, the Telefónica Deutschland share price reached a high for the year of EUR 5.98 on November 5, 2012.

Capital Market Information

Issue Price	EUR 5.60
XETRA closing price on December 28, 2012	EUR 5.77
Low/high in reporting period (XETRA)	EUR 5.38/5.98
Market capitalization on December 31, 2012	EUR 6,444,774,958
Free Float on December 31, 2012	23.17%
Official market	Frankfurt Stock Exchange (Prime Standard segment), XETRA
Number of shares	1,116,945,400
Stock market symbol	O2D
Security identification number (WKN)	A1J5RX
ISIN	DE000A1J5RX9
Reuters/Bloomberg codes	O2Dn.DE/ O2D:GR

Shareholder Structure



Telefónica Germany Holding Limited is an indirect wholly owned subsidary of Telefónica S.A.

During the reporting period, the Telefónica Deutschland share stayed close to its issue price of EUR 5.60. The share price closed on December 28, 2012 at EUR 5.77 on the XETRA platform, an improvement of 3.0%. In the same period, the DAX rose by 4.8%, the TecDAX by 3.22% and the MSCI Europe Telecommunications Services Index dropped by 3.23%.
The average number of Telefónica Deutschland shares traded every day over the period under consideration was approx. 1.2m shares. Since the IPO, two designated sponsors (UBS Investment Bank and J.P. Morgan) have ensured that there is adequate liquidity in the shares and that buy and sell orders can be carried out.

Shareholder structure

The registered share capital of the Telefónica Deutschland Holding AG amounts to EUR 1,116,945,400. It is divided into 1,116,945,400 shares with no-par value and a notional amount of the registered share capital of EUR 1.00 each.
Telefónica Deutschland has a free float of 23.17%, representing 258.75m shares of the total number of shares. 76.83% or 858.1m shares are held by our main shareholder Telefónica Germany Holdings Limited*. The free float of the Telefónica Deutschland share is dominated by international institutional investors.

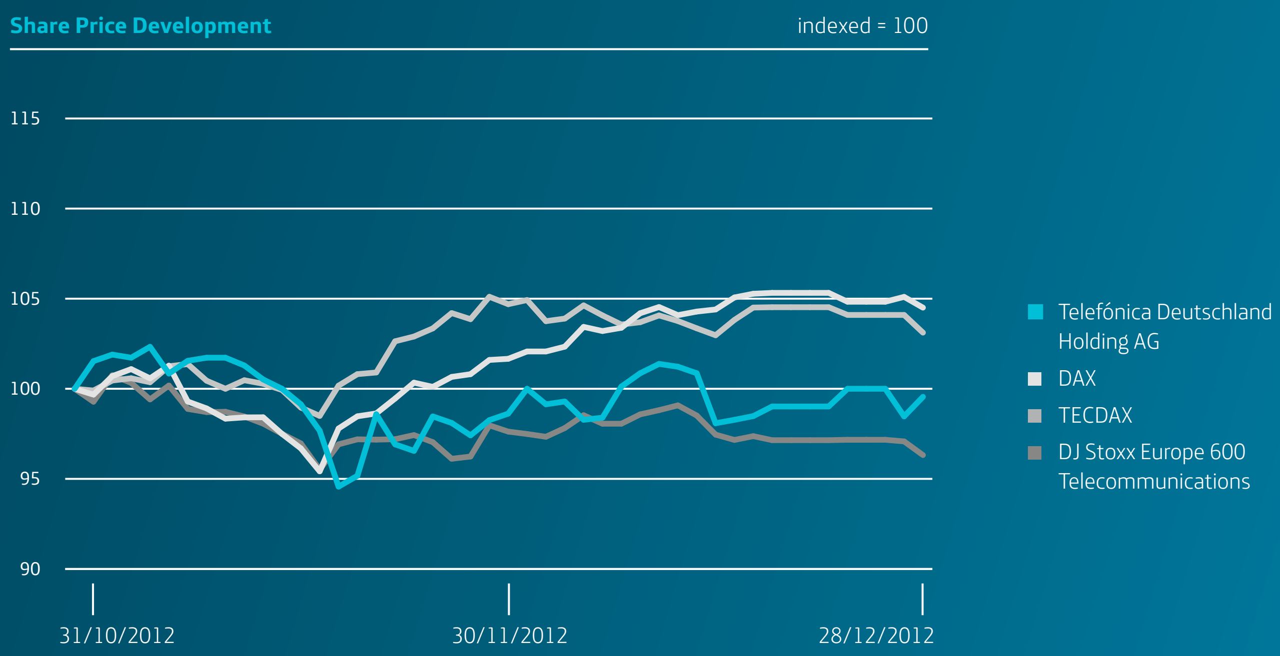
* Telefónica Germany Holdings Limited is 100% owned by O2 (Europe) Limited and O2 (Europe) Limited is a wholly owned subsidiary of Telefónica S.A.

Analysts' opinions

At the end of the reporting period the Telefónica Deutschland share was covered by 15 research analysts of renowned national and international banks. Therefore, interested investors can use several independent reports to form an opinion on the Telefónica Deutschland share.
As of end of December 2012 80% of the analysts (12) gave a buy recommendation for the Telefónica Deutschland share, 20% (3) recommended holding the share, no sell recommendation.

Investor relations

Telefónica Deutschland desires open and transparent communication with its shareholders and the financial community. We are committed to the equal treatment of all shareholders, investors, analysts, the financial community and the general public, prompt communication of information and continuity in reporting.
In order to inform the interested public fairly and equally about developments at Telefónica Deutschland, we use the Internet in particular. On our website www.telefonica.de we have created an Investor Relations section. Here shareholders will find more than just information on the share and the development of the share price. A financial calendar gives inter alia and the publication dates of our quarterly and annual reports the annual General Shareholders' Meeting. The reports and the latest presentations can be downloaded. Information on the subject of Corporate Governance, to which Telefónica Deutschland attaches great importance, is also found there.



Naturally, anyone interested in Telefónica Deutschland can also contact us by phone (+49 89 2442 1010), e-mail (ir-deutschland@telefonica.com) or by mail (Telefónica Deutschland Investor Relations, Georg-Brauchle-Ring 23-25, 80992 Munich). The Investor Relations team will be pleased to answer your questions on Telefónica Deutschland and the share.

Roadshow and conferences

In a two-week international road show associated with the IPO, the Telefónica Deutschland Board of Management met with over 200 investors. There, we informed investors about Telefónica Deutschland in one-to-one and group talks as well as further investors at presentations held before a large audience.

To maintain close contact with our current investors and establish contact with potential new investors, the Telefónica Deutschland Board of Management and the Investor Relations team will regularly go on road shows and attend capital market conferences.

Countless phone calls with investors, analysts and private shareholders round off the spectrum of our Investor Relations work. At the end of 2012, Telefónica Deutschland participated in an investor day event organized by UBS Investment Bank, allowing it to present its business model with its powerful brand portfolio and clear focus on innovative data solutions, converged offers and strong distribution channels.

The good cooperation with investors and analysts and the positive feedback on Telefónica Deutschland's investor relations are incentives for us to maintain and intensify our open dialogue with capital market players.

Financial calendar	Date
Release of preliminary financial results for Q1 2013	03/05/2013*
Annual General Meeting	07/05/2013
Release of Q1 Report 2013	14/05/2013*
Release of preliminary financial results for Q2 2013	24/07/2013*
Release of half-year report 2013	13/08/2013*
Release of preliminary financial results for Q3 2013	07/11/2013*
Release of Q3 report 2013	13/11/2013*

* All dates are preliminary and subject to change.
www.telefonica.de/financial-calendar

Dividend proposal

The management board and supervisory board of Telefónica Deutschland AG has proposed a cash dividend for the fiscal year ending December 31, 2012 of EUR 0.45 per share. The aggregate amount of the distributed dividend would therefore amount to EUR 503m. Subject to approval of the corresponding resolution by the Annual General Shareholders' Meeting, the dividend will be paid in 2013. Telefónica Deutschland intends to increase the amount of dividends to be distributed in future years.

Report of the supervisory board for the fiscal year 2012

Eva Castillo Sanz,
Chairperson and Chief Executive Officer
of Telefónica Europe and
member of the board of Telefónica S.A.

Dear shareholders,

The supervisory board of Telefónica Deutschland Holding AG has monitored, and advised on, the activities of the management board in accordance with the rules of the German Stock Corporation Act, the Articles of Association of the Company and the by-laws for the supervisory board.

Composition of the supervisory board

The supervisory board was installed by the shareholders' meeting of the company on September 18, 2012.
The following six shareholders' representatives were elected: José María Álvarez-Pallete López (chairperson), María Pilar López Álvarez (deputy chairperson), Angel Vilá Boix, Patricia Cobián González, Christoph Herbert Günter Steck and Enrique Medina Malo.

José María Álvarez-Pallete López and Christoph Steck both resigned from their office by each submitting a resignation letter dated October 3, 2012.

On October 5, 2012, the shareholders' meeting appointed Eva Castillo Sanz and Michael Hoffmann as new members of the supervisory board, and subsequently, Eva Castillo Sanz was elected as chairperson of the supervisory board. The German Stock Corporation Act provides that at least one independent member of the supervisory board of publicly traded companies must have expertise in the fields of accounting or auditing. On the supervisory board, Michael Hoffmann has the required financial expertise and independence and is the financial expert pursuant to section 100 paragraph 5 of the German Corporation Act.

In due course, the supervisory board will consist of twelve members (six shareholder representatives and six employee representatives). Election of the employee representatives to the supervisory board will take place in accordance with the provisions of the German Co-Determination Act (Mitbestimmungsgesetz). The central election committee was constituted in December. Regional election committees were constituted additionally in January 2013. By February the regional committees evaluated and decided about the voters' registers. The process has continued with the period of candidate proposals. Candidates may be employees and representatives of workers' unions. Two of the six employee representatives will be representatives of workers' unions. The election is expected to take place in spring 2013.

Cooperation between the management board and the supervisory board

The management board provides the supervisory board monthly with written reports. These reports cover in particular relevant financial key performance indicators (KPI).

In addition, the chairperson of the supervisory board, the chairperson of the management board and the other members of the management board were in constant contact outside the supervisory board meetings. Communications dealt with the present status and the future development of the company as well as the progress of ongoing projects. The chairperson of the supervisory board informed the other members of the supervisory board of the main issues discussed.

The management board involved the supervisory board in due time in all actions requiring its approval. The supervisory board made all of its decisions on the basis of the detailed and comprehensive documents provided.

Meetings of the supervisory board

The first – constituent – meeting of the supervisory board took place on September 18, 2012, immediately after the establishment of the supervisory board by the shareholders' meeting on the same day. In such meeting, the supervisory board resolved inter alia on the appointment of the members of the management board and the conclusion of service agreements with the members of the management board as well as on the approval of the by-laws for the management board.

The second supervisory board meeting took place on December 5. The supervisory board dealt especially with Telefónica Deutschland's business and financial situation and discussed the quarterly results as of September 30, 2012. It further addressed fundamental questions of corporate policy, strategy and development, in particular the market environment, competitors and technological investments, and discussed, and resolved on, the budget for the financial year 2013.

Both supervisory board meetings were attended by all members.

Apart from these regular meetings, the supervisory board resolved on urgent matters by way of circular resolution when needed. Such resolutions were passed inter alia on the principles of the remuneration of the management board and the new by-laws for the management board (circular resolutions dated October 3, 2012) as well as on the appointment of Eva Castillo Sanz as chairperson of the supervisory board, the adoption of by-laws for the supervisory board and the formation of committees (circular resolutions dated October 5, 2012). Furthermore, with view to the implementation of the IPO, the supervisory board consented to the conclusion of an underwriting agreement and an indemnification agreement between the company and the underwriting banks by circular resolution dated October 15, 2012, and by circular resolution dated October 29, 2012, to the conclusion of a pricing agreement with the underwriting banks. Finally, by circular resolution dated October 31/November 5, 2012, the supervisory board adopted the Declaration of Compliance pursuant to section 161 of the German Stock Corporation Act, having beforehand thoroughly studied the German Corporate Governance Code.

Committees of the supervisory board

Already prior to the admission of its shares to trading on the Frankfurt Stock Exchange and prior to its meeting on December 5, 2012, the supervisory board formed a nomination and an audit committee by way of circular resolution dated October 5, 2012.

The audit committee is responsible for the preparation of advice on, as well as the resolution of, accounting matters. This includes questions relating to accounting and risk management, the requisite independence of the external auditor and coordination with the external auditor. The committee comprises four members. The chairperson of the committee is Michael Hoffmann. The other members are María Pilar López Álvarez, Patricia Cobián González and Angel Vilá Boix.

In 2012, the audit committee met twice with participation of all its members. At the meeting on November 28, 2012, the audit committee discussed the quarterly results as of September 30, 2012 with the management board pursuant to section 7 paragraph 2 c) of the by-laws of the supervisory board. At the meeting on December 5, 2012 the audit committee discussed and reviewed inter alia the internal control system, risk management and audit activities.

The nomination committee is responsible for proposing to the supervisory board suitable candidates for recommendation to the general shareholders' meeting for election. Patricia Cobián González was elected chairperson of the nomination committee. The other members are María Pilar López Álvarez and Enrique Medina Malo.

Corporate Governance

The supervisory board and the management board are aware that good corporate governance is essential for corporate success and is therefore in the interest of the company's shareholders. Details on the corporate governance of Telefónica Deutschland Holding AG can be found in the management declaration according to section 289a of the German Commercial Code (Erklärung zur Unternehmensführung) on pages 56-59 of the annual report (or on the company's website under www.telefonica.de/management-declaration) and in the boards' joint corporate governance report on pages 54-57 of the annual report (or on the company's website under www.telefonica.de/corporate-governance-report).
Based on a circular resolution dated October 31/November 5, 2012, the boards issued a joint Declaration of Compliance pursuant to section 161 of the German Stock Corporation Act. On February 28, 2013, the supervisory board and the management board issued an updated Declaration of Compliance. Both declarations, i.e. both the updated and the previous one, are available on the company's website.

Five members of the supervisory board hold positions in administrative, management and supervisory bodies of the company's major shareholder and its affiliated companies. Both the supervisory board members and the management board members disclose possible conflict of interests promptly to the supervisory board. With regard to the reporting period, no conflicts of interest within the meaning of the German Corporate Governance Code on the part of the members of the supervisory board arose.

Review of the Annual Financial Statements 2012

The 2012 annual financial statements for Telefónica Deutschland Holding AG and the consolidated financial statements along with the management report for Telefónica Deutschland Holding AG and the group each presented by the management board were audited by the auditing company Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft with its seat in Stuttgart, branch Munich. Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft had been appointed auditor for the financial year 2012 by resolution of the shareholders' meeting that also resolved on the conversion of the company into a stock corporation as on September 18, 2012.

The Telefónica Deutschland Holding AG's financial statements and the management report were prepared in accordance with the legal requirements of the German Commercial Code (HGB). The consolidated financial statements along with the corresponding group management report were prepared in accordance with section 315a of the German Commercial Code (HGB) and Regulation (EC) no. 1606/2002 on the basis of the International Financial Reporting Standards (IFRS) as applicable in the European Union.

The auditor performed his audit on the basis of German generally accepted auditing principles as promulgated by the Institut der Wirtschaftsprüfer (IDW). The auditor issued an unqualified opinion (uneingeschränkter Bestätigungsvermerk) for the 2012 annual financial statements of Telefónica Deutschland Holding AG with management report and the consolidated financial statements and the group management report.

All documents relating to the financial statements the management board's proposal for the appropriation of profit and the respective auditor's reports were submitted to the supervisory board's audit committee and to the other members of the supervisory board in due time prior to the respective meetings. The audit committee and the supervisory board in its entirety thoroughly examined the reports and discussed and scrutinised them in detail together with the auditor in their meetings. The supervisory board noted and approved of the auditor's findings in the audit reports and had no objections.

At its meeting on March 22, 2013, the supervisory board therefore approved the annual financial statements of Telefónica Deutschland Holding AG and the 2012 consolidated financial statements together with their respective management reports; the financial statements were thereby adopted (festgestellt).

Relations to affiliated companies

The report on relations to affiliated companies (dependency report) as prepared by the management board pursuant to section 312 of the German Stock Corporation Act was also audited by the auditor. With respect thereto, the auditor issued the following unqualified opinion (uneingeschränkter Bestätigungsvermerk):

"Based on our audit and assessment, which were carried out in accordance with professional standards, we confirm that

1. the factual statements made in the report are correct,
2. the payments made by the company in connection with legal transactions detailed in the report were not unreasonably high,
3. there are no circumstances that would require a materially different assessment of the measures listed in the report than that of the management board."

The dependency report as prepared by the management board and audited by the auditor as well as the audit report on the dependency report were submitted to the supervisory board in due time. Having examined the dependency report and the corresponding audit report in accordance with section 314 of the German Stock Corporation Act, the supervisory board had no objections against the dependency report and the management board's declaration on the relations to affiliated companies contained therein and agrees with the auditor's findings.

The supervisory board would like to thank the members of the management board and all employees of Telefónica Deutschland for their dedication and excellent work in the past year. Our encouraging performance would not have been possible without the commitment of all our employees. The supervisory board sees this as motivation for all employees to remain committed to the course in 2013 and contribute profitable growth.

Munich, March 22, 2013

On behalf of the supervisory board

Eva Castillo Sanz
Chairperson and Chief Executive Officer of Telefónica Europe and member of the board of Telefónica S.A.

Corporate Governance Report

The German Corporate Governance Code establishes a standard for transparent control and management of companies. Many of the principles contained in the German Corporate Governance Code have been standard practices at Telefónica Deutschland for some time. In the following management board and supervisory board of Telefónica Deutschland Holding AG inform according to 3.10 of the German Corporate Governance Code as follows about Corporate Governance. This Corporate Governance Report is also published together with the Management Declaration in accordance with §289a German Commercial Code (HGB) on our website (corporate-governance-report).

Declaration of Compliance with the German Corporate Governance Code

Telefónica Deutschland Holding AG's management and supervisory boards have thoroughly studied the German Corporate Governance Code to determine which of its recommendations Telefónica Deutschland Holding AG complies with and which guidelines the company may deviate from, as well as the main reasons for these deviations and have agreed on a Declaration of Compliance.

The full wording of the Declaration of Compliance can be found on the Telefónica Deutschland website: www.telefonica.de/declaration-of-compliance.

The company's governing bodies

As a German stock corporation, Telefónica Deutschland Holding AG has three governing bodies: the general shareholders' meeting, the supervisory board and the management board. Their tasks and powers are substantially determined by the German Stock Corporation Act, the Articles of Association and the by-laws of both the management board and the supervisory board.

German corporate law provides for a clear separation of personnel between management and controlling bodies.

The managing body is the management board. It manages the company in own responsibility in the interest of the company with the object of sustainable value creation.

The management board is controlled and advised by the supervisory board. Management board and supervisory board work together closely and in the interest of the welfare of the company. All transactions and decisions that are of fundamental or material importance to the company are carried out in close coordination between the management board and the supervisory board.

The management board informs the supervisory board regularly, promptly and comprehensively on all material questions regarding the company, especially regarding planning, business development, strategy, situation and management of risks as well as compliance. Furthermore, the management board provides the supervisory board with information in case during the course of business deviations of plans or objects may occur and what the reasons therefore are.

Details regarding the composition and the working procedures of the management board, the supervisory board and the supervisory board's committees can be found in the management declaration in accordance with section 289a of the German Commercial Code (HGB) (Erklärung zur Unternehmensführung) on pages 56-57 of the annual report or on the Telefónica Deutschland website under www.telefonica.de/management-declaration.

The supervisory board has specified concrete objectives regarding its composition (5.4.1, 2nd paragraph of the German Corporate Governance Code) considering the specifics of the enterprise, its shareholders' group and the international activities of the enterprise and taking into account that half of the members of the supervisory board are to be elected by the employees pursuant to German Co-Determination law. In this context, the supervisory board has set the following objectives regarding its composition:

- The supervisory board has at least one independent member within the meaning of section 100 paragraph 5 of German Stock Corporation Act (AktG) and 5.4.2 sentence 2 German Corporate Governance Code and should not include any persons who hold an office (e.g. at a significant competitor) which may create a material and not only temporary conflict of interest.
- One third of the members of the supervisory board, however in any event at least one third of the supervisory board members to be elected by the general meeting, should be female.
- At least one third of the supervisory board members to be elected by the general meeting should have experience of business operations abroad, knowledge of the English language as well as an understanding of global economic relationships ("internationality").

The supervisory board considers these concrete objectives as currently fulfilled and assumes these concrete objectives will continue to be complied with in the future composition with the additional six employees' representatives being elected.

The supervisory board has refrained from implementing a concrete objective regarding an age limit and has in this regard made a declaration of deviation in the Declaration of Compliance.

Relation to shareholders and annual general meeting

The shareholders are generally informed four times a year about the financial and earnings situation and business development (quarterly financial reports). The company provides for further information on its website (www.telefonica.de/investor-relations), especially the financial calendar. Furthermore, analyst conferences and meetings take place.

The shareholders exercise their rights according to law and the articles of association before and during the annual general meeting, especially by exercising their voting rights.

The annual general meeting resolves amongst others about profit distribution, discharge of the members of the supervisory and management board and the election of the auditor.

Compliance

Telefónica Deutschland's credibility, integrity and reputation play a vital role in the success of the company. Telefónica Deutschland is committed to complying with all applicable laws, policies, procedures, rules, and regulations pertaining to its operation. Therefore, the company has a group-wide compliance organization that is continuously improved.

The compliance programme focuses on antitrust, anti-corruption and ethically appropriate behavior. These topics are covered by mandatory online trainings, as are the areas of data protection, anti-discrimination and information security. Each employee is regularly required to complete certain mandatory training sessions based on his or her job responsibilities. At the end of each year, a Compliance Certificate in respect of the success of training and compliance activities is produced and processed as part of the Corporate Responsibility Report.

The company has a compliance officer, appointed by the management board. She deals with the maintenance and enhancement of the compliance organization in the company and regularly reports to the management board. To ensure constant monitoring, awareness, prevention and detection of potential issues the major units responsible for executing controls such as compliance, internal audit (incl. risk management), fraud, physical and information security, SOX compliance, intervention and data protection meet on a regular basis as compliance forum and are in constant exchange concerning potential failures or risk factors.

The management board – as well as the supervisory board – regularly occupy themselves with the topic "compliance".

In this whole context, the company maintains insider lists wherein any persons who act for the company and have intended access to insider information are enlisted (following respective instructions regarding their duties by insider law).

Transparent communication

On Telefónica Deutschland website the shareholders may inform themselves about the company. Press releases and ad-hoc news as well as the articles of the association are published on our homepage.

Relevant shareholdings of management and supervisory boards

None of the members of the management board holds shares in Telefónica Deutschland Holding AG or options on shares.

As per December 31, 2012, the supervisory board held approximately 0.0018% of the shares of Telefónica Deutschland Holding AG. These shareholdings were obtained through the stock market listed below as directors' dealings.

Directors' dealings

According to section 15a of the German Securities Trading Act (WpHG), members of the management and supervisory boards and related parties are obliged to disclose directors' dealings in Telefónica Deutschland shares if the value of these transactions reaches 5,000 euro within a calendar year.

Further information can be found on the Telefónica Deutschland website www.telefonica.de/directorsdealings.

Accounting and audit

Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft with seat in Stuttgart, branch Munich, has been appointed auditor for the financial year 2012 by resolution of the shareholders' meeting on September 18, 2012.

Management Declaration

in accordance with section 289a of the German Commercial Code (HGB)

1. Declaration of Compliance in accordance with section 161 German Stock Corporation Act (AktG)

Under section 161 of the German Stock Corporation Act (AktG), the management board and the supervisory board of a listed stock corporation are required to declare every year that the company has complied and is complying with the recommendations of the "Government Commission for the German Corporate Governance Code", as published in the official part of the Federal Gazette by the Federal Ministry of Justice, or, alternatively, are to declare which recommendations the company has not followed or does not follow and why not. The declaration shall be published permanently on the company's website.

In February 2013, the management board and the supervisory board issued a joint declaration of compliance pursuant to section 161 of the German Stock Corporation Act. Such declaration is as follows:

"The management board and supervisory board of Telefónica Deutschland Holding AG hereby confirms pursuant to § 161 (1) of the German Stock Corporation Act that since the issuance of the last compliance declaration Telefónica Deutschland Holding AG has complied, and will in the future comply, with the recommendations of the German Corporate Governance Code in the version dated May 15, 2012 ("GCGC") with the following exceptions:

1. The GCGC recommends in 3.4, 2nd paragraph, that the supervisory board shall specify the information and reporting duties of the management board in more detail. As the company was only created through a transformation of form on September 26, 2012, the supervisory board first wished to discuss which particular reports it required, in addition to the reports required by statute, in order to complete its advisory and supervisory tasks. By resolution dated February 28, 2013 the supervisory board amended the by-laws for the management board and detailed the requirements for the standard reports under § 90 (1) sentence 1 no. 1 Stock Corporation Act as well as determining further reporting obligations, so that the recommendation will be fully complied with in the future.

2. The recommendation in 4.2.3, 2nd paragraph, sentence 4 GCGC that both positive and negative developments be taken into account with respect to the structure of the variable remuneration components has not been and will not be followed. The management board and the supervisory board are of the opinion that the remuneration of the management board is oriented towards a sustainable company development. The remuneration consists of fixed as well as of short- and long-term components. The relevant parameters for the determination of the annual bonus are overall oriented towards sustainable development and structured in a way that they, as a whole, do not provide incentives for business decisions which are opposed to the interests of the company.

3. In 4.2.3, 3rd paragraph, sentence 2, the GCGC recommends that share-based and performance-based remuneration components shall relate to rigorous and relevant comparison parameters. A partial derogation from such recommendation has been and will be made. The amount of the annual bonus depends to a small extent also on parameters regarding Telefónica Europe and Telefónica S.A. In addition, a part of the long-term remuneration components is dependent on the Total Shareholder Return of the Telefónica S.A. shares. The management board and the supervisory board are of the opinion that no misdirected incentives are created thereby.

4. The recommendation in 4.2.3, 3rd paragraph, sentence 3 GCGC that forbids a retroactive change of performance objectives or comparison parameters has not been and will not be followed. The service contracts allow a retroactive change of the criteria for the variable remuneration. From the management board's and the supervisory board's view, this is necessary because the company is active in an extremely volatile and innovative market environment, and a change of corporate strategy in the interest of a sustainable company development must also be possible within the calculation period for the variable remuneration components. Such changes of corporate strategy necessary with a view to reasonable company interests shall not be hindered or delayed as a result of monetary interests of the members of the management board. Thus, in particular the supervisory board is of the opinion that flexibility is required as to performance objectives and comparison parameters.

5. In deviation from the recommendation in 4.2.3, 4th paragraph GCGC, no formal severance payment cap in the event of premature termination of the management board mandate is agreed in the service contracts. A combination of various mechanisms in the service contracts ensures that a member of the management board in the event of premature termination of the mandate as a general rule receives less, and in no event more than the amount that is recommended by the GCGC as a severance payment cap.

6. The recommendation in 4.2.5, 2nd paragraph GCGC that the compensation report shall also include information on the nature of fringe benefits provided by the company has only been followed in part. The general meeting on October 5, 2012 resolved pursuant to § 286 (5) German Commercial Code, to dispense with disclosure of the compensation of individual management board members for the period of 5 years. Therefore the fringe benefits provided by the company are only disclosed to the extent they are provided to all management board members. Where fringe benefits are only provided to individual management board members, these are not shown. The management board and supervisory board take the view that the individualization involved in the disclosure of these individual benefits would contradict the resolution of the general meeting and anyway would represent too large an intrusion on the private sphere of the relevant management board members.

7. Contrary to the recommendation in 5.1.2, 2nd paragraph, sentence 3 GCGC, the company has not determined any age limit for management board members. A fixed age limit for management board members is not appropriate in the view of Telefónica Deutschland Holding AG, since the ability to successfully run a company is not necessarily restricted by reaching a certain age. Rather it may be necessary where appropriate in the interest of the company to appoint persons of advanced age with extensive experience even after they reach a particular age limit. In addition the setting of a fixed age limit could also constitute discrimination.

8. Pursuant to 5.4.1, 2nd paragraph GCGC the supervisory board shall specify concrete objectives regarding its composition. The current members of the supervisory board elected by the general meeting have been elected until the end of the ordinary general meeting in the year 2017, which resolves on the discharge for the financial year 2016. Under these circumstances there is currently no pressing need to determine the objectives for the composition of the supervisory board. Nevertheless the supervisory board has on February 28, 2013 resolved on concrete objectives regarding its composition, however without specifying a concrete objective regarding an age limit for supervisory board members. Just as for management board members, a fixed age limit for supervisory board members is not appropriate in the view of Telefónica Deutschland Holding AG, since the ability to control and supervise the management board is not necessarily restricted by reaching a certain age. Rather it may be necessary where appropriate in the interest of the company to appoint persons of advanced age with extensive experience even after they reach a particular age limit. In addition the setting of a fixed age limit could also constitute discrimination.

9. Notwithstanding the recommendation in 5.4.6, 1st paragraph, sentence 3 GCGC that the chair and membership in committees is also to be taken into account in the compensation of the supervisory board members, only the chair of the audit committee receives an additional compensation. The company takes the view that this reasonably takes into account the current composition of the supervisory board.

10. 7.1.2 sentence 4 GCGC provides that interim reports shall be publicly accessible within 45 days of the end of the reporting period. In addition quarterly financial reports shall be discussed with the supervisory board or its audit committee prior to publication pursuant to 7.1.2 sentence 2 GCGC. These recommendations were not followed in the publication of the report for the third quarter 2012. A prior discussion with the audit committee of the supervisory board was not possible for lack of time. The publication deadline could not be complied with due to the public tender of the company's shares and the admission to listing on the stock exchange which took place on October 30, 2012 and the amount of work involved therewith. It is intended that this recommendation shall be complied with in the future."

The previous declaration of compliance that is no longer applicable is available on the company's website under www.telefonica.de/declaration-of-compliance.

2. Significant disclosures about management practices

Telefónica Deutschland Holding AG and its administrative bodies are committed to an efficient, sustainable and transparent corporate management as well as to values that form the basis of common business principles as set out in the company's ethical code called "Our business principles". Such code assembles a series of fundamental principles and guidelines aimed at leading both the management as well as the employees through their daily activities. It provides valuable help in particular with respect to business situations in which legal and/or ethical conflicts of interest arise so that decisions can be taken with integrity and professionalism, both in the design and implementation of work processes and in the manner in which the company interacts with customers, shareholders, employees, suppliers and other stakeholders.

The company's business principles are available on the company's website under www.telefonica.de/geschaeftsgrundsaetze.

Compliance with Telefónica's business principles is of eminent significance since Telefónica's reputation is built and affected by decisions and actions taken by its administrative bodies and employees, and is therefore carefully monitored by way of close cooperation between the compliance officer, HR management, internal audit, fraud and legal affairs.

The company's compliance programme includes the main areas of anti-corruption with clear guidelines and procedures and an external whistleblower system (www.telefonica.de/ombudsmann), competition law and ethical behaviour. The company's group data protection officer ensures compliance with data protection legislation which is of utmost importance for the company. Group compliance, data protection, the internal audit function and the legal department report directly to the management board.

Further details regarding the compliance organization of the company are explained in the Corporate Governance Report which forms a part of the Annual Report (see pages 54-57) and can also be found on the company's website under www.telefonica.de/corporate-governance-report.

3. Composition and working procedures of the management board, supervisory board and the supervisory board's committees

The **management board** of Telefónica Deutschland Holding AG consists of three members, the Chairperson René Schuster as well as Rachel Empey and Markus Haas. The management board has sole responsibility for managing the business of the company with the objective of creating sustainable value in the interest of the company with consideration to the concerns of its shareholders, employees and other stakeholders of the company. The work of the management board is governed, in particular, by the by-laws for the management board that were adopted by the supervisory board. The management board is responsible for the corporate strategy of the company, coordinates in this respect with the supervisory board on a regular basis, and also provides for its implementation.

The current three members of the management board share responsibilities as provided for in the schedule of responsibilities as attached as annex to the by-laws for the management board and as amended from time to time by resolution of the management board. Each member of the management board is responsible for managing the area of business allocated to him in the schedule of responsibilities, however without prejudice to their joint responsibility for the management of the company as a whole. All matters of fundamental or material importance for the company and/or its affiliates, in particular matters regarding organization, company policy, investment and financial planning as well as all investments exceeding the annual budget approved by the supervisory board are therefore decided by the entire management board. Furthermore, every board member can submit matters to the entire management board for decision. Transactions and measures of particular significance are, in addition, subject to the prior consent by the supervisory board.

Meetings of the management board are held regularly, generally once per week, and are convened and chaired by the chairperson of the management board. Meetings may also be held by telephone or video conference and resolutions by the management board may also be passed outside of meetings, in particular in writing, by fax or e-mail.

The management board reports to the supervisory board on the company's course of business on a regular basis by inter alia providing the supervisory board monthly with written reports that cover relevant key performance indicators regarding the company's business. Furthermore, the management board is obligated to report to the supervisory board any transactions that may be of material significance to the profitability or liquidity of the company. Finally, the management board must report to the supervisory board any important events or affairs within the meaning of section 90 (1) sentence 3 of the German Stock Corporation Act.

The **supervisory board** of the company currently consists of six members, but will consist in due time of twelve members (six shareholder representatives and six employee representatives). The current members of supervisory board, all being elected by the general meeting of the company, are the Chairperson Eva Castillo Sanz, María Pilar López Álvarez (deputy chairperson), Angel Vilá Boix, Patricia Cobián González, Enrique Medina Malo and Michael Hoffmann.

The election of the employee representatives to the supervisory board will take place in accordance with the provisions of the German Co-Determination Act (Mitbestimmungsgesetz) following completion of the mandatory status proceedings which were initiated on October 5, 2012. The central election committee was constituted in December. Regional election committees were constituted additionally in January 2013. By February the regional committees evaluated and decided about the voters' registers. The process has continued with the period of candidate proposals. Candidates may be employees and representatives of workers' unions. Two of the six employee representatives will be representatives of workers' unions. The election is expected to take place in spring 2013.

The supervisory board advises and supervises the management board in the management of the company on a regular basis and must be consulted with respect to all matters outside the ordinary course of business which are of particular importance for the company. The supervisory board appoints and dismisses the members of the management board and determines the remuneration of the management board. The chairperson of the supervisory board coordinates the activities of the supervisory board and the cooperation with the management board. The principles governing the work of the supervisory board and its cooperation with the management board are set out in the by-laws for the supervisory board.

The supervisory board holds at least two meetings in a calendar half-year. Meetings of the supervisory board may also be held by telephone or video conference, and resolutions by the supervisory board may also be passed outside of meetings, in particular in writing, by telefax or e-mail.

Composition and work of the committees of the supervisory board

In order for the supervisory board to carry out its tasks in an optimal manner, the by-laws for the supervisory board provide for three fixed committees, two of which are already established. The supervisory board receives regular reports on the work of the committees.

The **audit committee** is responsible e.g. for preparing the decision of the supervisory board regarding the approval of the financial statements, discussing the quarterly reports with the management board, monitoring the accounting processes and internal control systems (including compliance, risk management and internal audit systems) and the auditor's review and coordination with the auditor for the audit of the financial statements. The audit committee is chaired by independent financial expert Michael Hoffmann. The other members are María Pilar López Álvarez, Patricia Cobián González and Angel Vilá Boix.

The **nomination committee** is responsible for proposing to the supervisory board suitable candidates for recommendation to the general shareholders' meeting for election. Patricia Cobián González was elected chairperson of the nomination committee. The other members are María Pilar López Álvarez and Enrique Medina Malo.

The **mediation committee** will be established immediately after the election of the employee representatives and shall assume the legal responsibilities as set forth in section 31 (3) of the German Co-Determination Act (Mitbestimmungsgesetz). Pursuant to statutory provisions, it will consist of the chairperson of the supervisory board who will also be chairperson of the mediation committee, of the deputy chairperson of the supervisory board, as well as of each one member elected on proposal of the employee representatives and one member elected on proposal of the shareholder representatives.

Group Management Report

for the financial year ended December 31, 2012

Management Report of Telefónica Deutschland Group

for the financial year ended December 31, 2012

Overview of the financial year 2012

- Strong financial performance in a competitive market environment
- Solid increase of wireless postpaid base of 9.5% year-on-year to account for 52.4% of the total wireless base
- Sound wireless service revenue performance at 7.0% year-on-year with non-SMS data revenues improving by 30.7% year-on-year
- Total revenue growth of 3.5%
- Strong year-on-year performance of blended ARPU (average revenue per user) at 0.9%
- Significant OIBDA growth of 11.3% and margin progression to 24.5% (plus 1.7 percentage points year-on-year)
- Increased investments in the network, improving 3G data capacity and accelerating LTE network rollout
- Strong Operating Cash Flow generation of EUR 670m translated into Free Cash Flow of EUR 674m and net debt position of EUR 842m

Contents

The figures were subject to rounding adjustments that were carried out according to established commercial standards. As a result, the figures stated in a table may not exactly add up to the total values that may also be stated in the table.

1. Business and operating environment

1.1. Economic and legal environment

1.1.1. Economic environment

German macro environment
Germany is Europe's largest economy and has been relatively resilient throughout the recent economic crisis, experiencing consistent GDP growth over the last few years. Real GDP growth in 2011 was 3.0% compared to 1.4% across the EU. In 2012, real GDP growth slowed down to 0.7% for Germany, still significantly higher than the EU average of minus 0.4% in 2012. Germany is one of the wealthiest countries in the EU with GDP per capita at EUR 31,662 in 2011 rising to EUR 32,584 in 2012, higher than the EU average of EUR 28,537 in 2011 and EUR 29,039 for 2012.

(Source: Federal Statistical Office, FocusEconomics Consensus Forecast Euro Area, February 2013; German Federal Bank Monthly Report, January 2013)

Real GDP growth

	2010	2011	2012
Germany	4.2	3.0	0.7
EU Average	2.0	1.4	(0.4)

General trend in the German telecommunications market
The German telecommunications sector is experiencing a number of clear trends which are set to extend into the future. First, there is a strong movement towards convergence. Second, there is a strong push by all four mobile network operators to monetize wireless data. The symbiotic growth in wireless data usage and smartphone penetration presents upside opportunities for mobile network operators. Third, it is expected that there will be a move to cloud services, where services such as Customer Relationship Management systems and e-mail are hosted remotely rather than on dedicated servers within enterprises. Finally, the market for machine-to-machine (M2M) communication is growing.

(Source: Yankee Group Research, Global ConnectedView Forecast, December 2012)

German wireless market
Germany is the EU's largest wireless market by number of subscribers slightly growing from 114.1 million accesses in 2011 to 114.2 million accesses (i.e. SIM cards) as of September 2012. The penetration rate compared to 2011 remained stable at 140% as of September 2012. In 2012, market customer growth was mainly driven by postpaid, with postpaid customers representing 46% of total accesses at the end of September 2012 up from 44% end of 2011.

(Source: Company data. Yankee Group Research, Global ConnectedView Forecasts, December 2012)

The German wireless market was very competitive in 2012 driven by a strong push of smartphones and smartphone tariffs. According to Yankee Group Research, smartphone penetration increased from the end of 2011 by more than 11 percentage points to 45.7% at the end of 2012.

Wireless service revenue growth on the German market continued in 2012, up around 2% compared to 2011. This increase in wireless services revenues is mainly driven by an increased penetration of smartphones and small screen devices such as tablets, as well as consumption of wireless data services.

The German wireless market is well developed, with four wireless network operators. Telefónica Deutschland Group recorded 19.1 million accesses, giving it a market share of 16.7% as of September 30, 2012 compared to a market share of 16.2% as of September 30, 2011 counting 18.1 million accesses.

(Source: Company data. Yankee Group Research, Global ConnectedView Forecasts, December 2012)

German wireline market
The wireline broadband services market in Germany remained competitive. Market customer base grew around 1.5% compared to 2011 and reached a customer base of approximately 26.3 million at the end of September 2012. The major DSL service provider in Germany is Deutsche Telekom AG in Bonn, the incumbent telecommunications service provider. Other major competitors in the broadband internet market rent the unbundled local loop (ULL) from Deutsche Telekom AG, as does Telefónica Deutschland Group.

(Source: Global Comms Database German broadband 2012)

Economic environment of the segment Global Services
Growth in Europe and Latin America is particularly relevant for the Global Services segment due to its geographic focus. Latin America's and the Carribean's GDP growth rates for 2011 were 4.5% and for 2012 growth was solid as well, coming in at 3.0%. However, there are some signs of a slowdown in economic growth. This is mainly due to the weaker economic outlook of the major economies and the slowdown in growth in China. The variance between the individual countries is very large. Growth scenarios in countries such as Chile, Colombia, Peru and Venezuela are evaluated as satisfactory to positive while other countries are facing a difficult situation (Brazil, Argentina, Mexico). The Global Services segment was sold on October 1, 2012 and is reported under discontinued operations in the Consolidated Financial Statements for the year ended December 31, 2012.

(Source: International Monetary Fund, Overview of the World Economic Outlook Projections, January 2013)

1.1.2. Regulatory influences on Telefónica Deutschland Group

Telecommunications services and the operation of telecommunication networks are subject to the regulatory regime of the German Telecommunications Act (Telekommunikationsgesetz) of June 22, 2004 as amended on May 3, 2012 and certain regulations that supplement the Telecommunications Act.

The Telecommunications Act implements the European Regulatory Framework for Electronic Communications Networks and Services which was amended in November 2009 (the “Framework”). The Framework consists of, amongst other provisions, the Framework Directive (2002/21/EC), the Authorization Directive (2002/20/EC), the Access Directive (2002/19/EC), the Universal Service Directive (2002/22/EC) and the Directive on Privacy and Electronic Communications (2002/58/EC).

The Telecommunications Act contains provisions regarding, among other things: (i) the establishment and powers of the regulatory body; (ii) notification requirements; (iii) the granting of rights of way; (iv) the allocation of frequencies; (v) access obligations; (vi) the regulation of rates; (vii) abusive behavior; (viii) consumer protection; and (ix) data protection and public safety. Some of these obligations only apply to providers that have significant market power in their respective markets. Other obligations apply or might be imposed by the German Federal Network Agency (FNA) even if those operators do not have significant market strength.

In November 2009, the European Parliament, following a proposal by the European Commission, passed legislation amending certain directives within the framework in order to strengthen competition and consumer rights in Europe’s telecom markets and to facilitate access to high-speed broadband internet connections. The changes to the existing framework came into effect on December 19, 2009, and had to be transposed into national law. This led to an amendment of the Telecommunications Act which entered into force in May 2012.

While most of the new regulations entered into force in May 2012, transition periods existed for some of them. Worth mentioning are the rules concerning the free-of-charge-waiting-loop and some of the rules concerning the change of the provider.

Telekom Deutschland GmbH Contingent Model for VDSL
In April 2012, the Federal Network Agency (FNA) rejected Telekom Deutschland GmbH’s application for a “contingent model”. Telekom Deutschland GmbH had planned to grant its competitors bitstream access via the VDSL access product on the basis of agreed contingent accesses. After Telekom Deutschland GmbH managed to allay FNA’s concerns, FNA approved the contingent model in July 2012 and forwarded it to the European Commission for review. The changes addressed the ability to migrate the accesses to alternative infrastructures, lower minimum commitments and higher monthly fees.

FNA expects that implementing the contingent model will boost the distribution of high-end broadband accesses and that it will incentivize the roll-out of new infrastructure (e.g. through expanded alliances).

Telefónica Germany GmbH & Co. OHG signed such a contingent model agreement with Telekom Deutschland GmbH in December 2012 and promotes VDSL accesses on this basis. Telefónica Deutschland Group gains access to about 11million households through VDSL and thus promotes another form of competitive wireline infrastructure.

Roaming III
On May 30, 2012, the Council of the European Union adopted a new, revised roaming regulation, which replaced the 2009 regulation (“Roaming III”). This new roaming regulation entered into force on July 1, 2012 and will apply until June 30, 2022. Under Roaming III, the current retail price caps on voice calls and SMS have again been reduced and a new retail cap on data services has been introduced. Wholesale price caps will also be progressively reduced and new structural measures are being introduced with the aim of improving competition amongst operators. From July 1, 2014, customers will be able to buy their domestic and roaming services separately from different operators, while keeping the same phone number. In addition, since July 1, 2012 mobile virtual network operators (MVNO) have the right to access other operators’ networks at wholesale prices in order to provide roaming services.

The regulation also lays down rules aimed at increasing price transparency and improving the provision of information on charges to roaming customers.

With respect to retail prices, the new rules pursuant to Roaming III which entered into force on July 1, 2012 are, among others, as follows:

- 29 cents per minute to make a call;
- 8 cents per minute to receive a call;
- 9 cents to send a text message; and
- 70 cents per megabyte (MB) to download data or browse the internet while travelling abroad (charged per kilobyte used).

Decisions concerning mobile and fixed termination rates (MTR/FTR)

MTR
Telefónica Deutschland Group’s most recently approved MTRs (EUR 0.0339/min) expired on November 30, 2012. On November 16, 2012, the FNA reached a preliminary decision on new MTRs as follows: EUR 0.0185/min as of December 1, 2012, and at EUR 0.0179/min as of December 1, 2013.
The European Commission has been notified of the preliminary decision. Telefónica Germany GmbH & Co. OHG filed an objection to the decision on December 19, 2012, with the aim of increasing termination rates.

FTR
On November 30, 2012 the FNA released its preliminary decision on the fixed termination rate (FTR) for Telekom Deutschland GmbH. The local FTR will decrease by about 20%. Because of regulatory obligations, the Telekom Deutschland GmbH's FTR will also have an impact on the FTR for traffic exchanged with alternative network operators. The final decision is expected in the first or second quarter of 2013.

The FNA drafted a decision for the ex-ante regulation of the alternative network operators' FTR in 2012. The current ex-post regulation will be in effect until approval of the draft decision has been received from the EU, which is expected in the first or second quarter of 2013.

Future development of GSM licenses
The GSM licenses that grant the right to use the 900 MHz and 1,800 MHz band of the frequency spectrum expire at the end of 2016. The FNA is currently deciding on the future of these frequencies. In November 2012 the FNA published a paper containing four potential scenarios regarding the future of the spectrum. The scenarios range from prolongation over an isolated awarding scenario of the GSM licenses to scenarios that contain the allocation of the GSM spectrum together with an additional spectrum that is expected to be available within the next few years. The scenario paper is open for discussion. Input is called for until January 31, 2013. The FNA stated that it plans to publish a draft decision based on the input on the scenario paper.

1.2. Group organization, business activities and strategy

1.2.1. Structure of Telefónica Deutschland Group

Telefónica Deutschland Holding AG ("Telefónica Deutschland") is a German stock corporation (Aktiengesellschaft) organized and operating under German law. The company's change of legal form from a German limited liability company (Gesellschaft mit beschränkter Haftung) into a German stock corporation was approved by a resolution at the general shareholders' meeting of September 18, 2012 and was registered in the commercial register on September 26, 2012. Ever since, the company has been a German stock corporation.

The legal and business name (Firma) is "Telefónica Deutschland Holding AG". The registered office (Satzungssitz) is in Munich, Germany. Telefónica Deutschland Holding AG is registered in the commercial register (Handelsregister) of the local court (Amtsgericht) in Munich under registration number HRB 201055. The company has its business address at Georg-Brauchle-Ring 23–25, 80992 Munich, Germany (telephone number: +49 (0) 89 2442–0; www.telefonica.de). Its financial year is the calendar year (January 1 through December 31). Telefónica Deutschland Holding AG was established for an unlimited period of time.

The initial public offering on the regulated market of the Frankfurt Stock Exchange was successfully concluded on the first day of trading on October 30, 2012 at an initial share price of EUR 5.60. The WKN is A1J5RX; the ISIN DE000A1J5RX9. The registered share capital of Telefónica Deutschland Holding AG amounts to EUR 1,116,945,400. It is divided into 1,116,945,400 registered shares with no-par value each representing a notional amount of EUR 1.00 in the registered share capital. While 23.17% of the shares are in free float, the remaining 76.83% are held by Telefónica Germany Holdings Limited. Each share confers one vote at the company's general shareholders' meeting. There are no restrictions on voting rights. The major shareholder, Telefónica Germany Holdings Limited, does not have any alternate voting rights.

Telefónica Deutschland Holding AG has authorized capital allowing the management board of the company to increase the registered share capital until September 17, 2017 by a total amount of up to EUR 558,472,700 by issuing new non-par value registered shares. Furthermore, Telefónica Deutschland Holding AG's registered share capital is conditionally increased for granting stock upon the exercise of option or conversion rights or for the fulfillment of conversion obligations.

Telefónica Deutschland Group is incorporated in the Consolidated Financial Statements of its ultimate parent, Telefónica S.A., Madrid, Spain ("Telefónica Group") as of December 31, 2012.

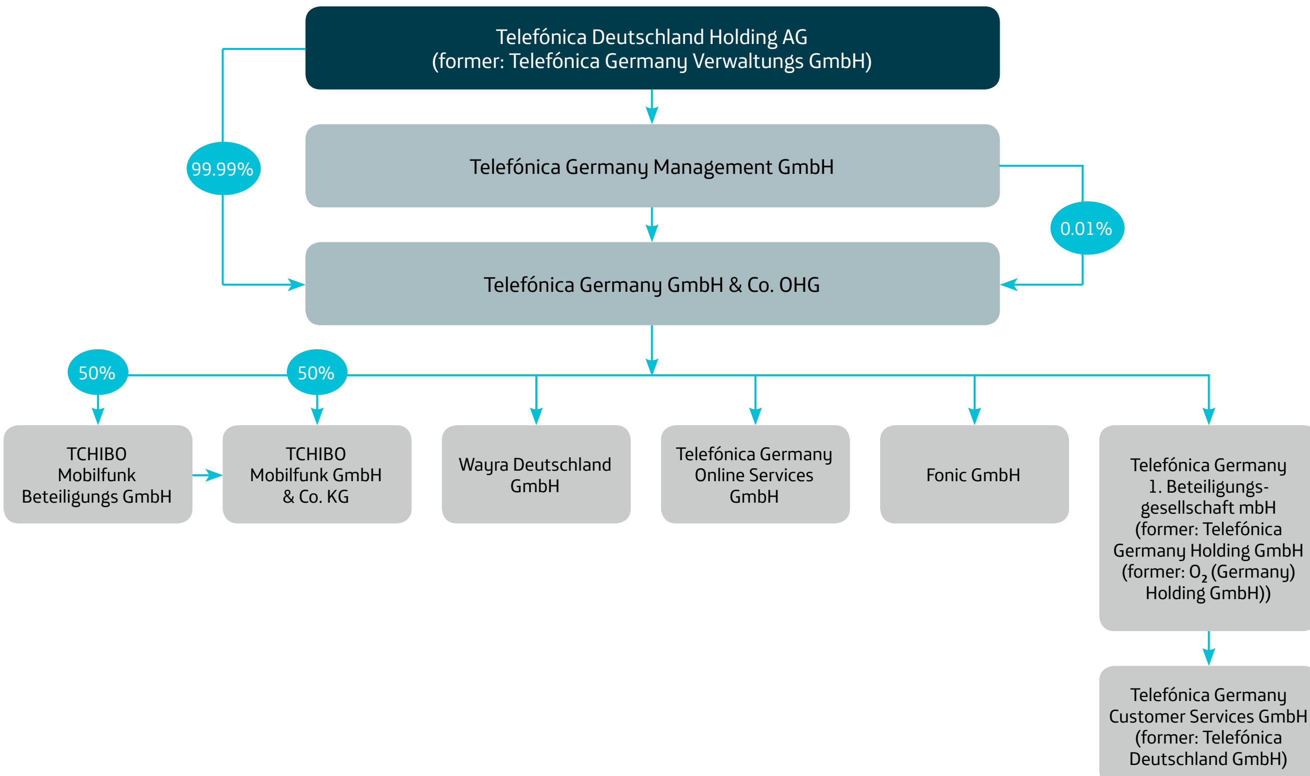
The legal structure of Telefónica Deutschland Group as of December 31, 2012 is shown on the next page.

Until October 1, 2012 Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, together with its subsidiaries Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. and the indirectly held 40% interest in Adquira España S.A., were part of Telefónica Deutschland Group.

All shares of these companies were held by Telefónica Global Activities Holdings B.V. (former Telefónica Chile Holding B.V.) Prior to the IPO, Telefónica Deutschland Holding AG sold all shares in Telefónica Deutschland Global Activities Holdings B.V. to Telfisa Global B.V., a Telefónica Group entity. After the sale, Telefónica Global Activities Holdings B.V. and all of the aforementioned entities ceased to be members of the group.

Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. and Adquira España S.A. together formed the segment Global Services. As of December 31, 2012, Telefónica Deutschland Group comprises one segment (telecommunications).

Management and governing bodies
The company's governing bodies are the management board, the supervisory board and the general shareholders' meeting. The power of these governing bodies is determined by the German Stock Corporation Act (AktG), the company's articles of association and the by-laws of both the management board and the supervisory board.



Management board
Members of the management board are appointed by the supervisory board for a maximum term of five years and may be re-appointed an unlimited number of times, in each case for a maximum of five years. The supervisory board may revoke the appointment of a management board member prior to the expiration of his or her term for good reason, such as for gross breach of fiduciary duties or if the general shareholders' meeting adopts a no-confidence resolution in relation to the management board member in question. The supervisory board may appoint one management board member as chairperson or spokesman and another member as deputy chairperson or spokesman. The members of the management board of the company have been appointed until September 17, 2015.

The management board of the company currently comprises three members:
- René Schuster CEO (Chief Executive Officer)
- Rachel Empey CFO (Chief Financial Officer)
- Markus Haas CSO (Chief Strategy Officer)

Supervisory board
In accordance with the company's articles of association sections 95 and 96 of the German Stock Corporation Act and section 7 of the German Co-Determination Act (Mitbestimmungsgesetz – MitbestG), the supervisory board consists of twelve members, six of which are shareholder representatives and – upon completion of the election process already initiated within Telefónica Deutschland Holding AG – six of which are employee representatives. Unless the general shareholders' meeting has set a shorter term, the term of each supervisory board member, as well as the term of each substitute member, if elected, expires at the end of the general shareholders' meeting discharging the members of the supervisory board for the fourth fiscal year following the commencement of the member's term of office, not including the fiscal year in which the term commences. All members of the supervisory board of the company have been appointed until the end of the ordinary general shareholders' meeting held in 2017 for the year ending December 31, 2016.

1.2.2. Business activities

Telecommunications
Telefónica Deutschland Group offers wireless and wireline services providing voice, data and value-added services to consumer and business customers. In addition, we are one of the leading wholesale providers in Germany, offering our wholesale partners access to our infrastructure and service capabilities.

We operate a nationwide mobile network with GSM coverage exceeding 99% of the German population, and a nationwide wireline network with DSL access covering approximately 67% of German households. Our mobile network operates on the technology standards GSM, UMTS, and, more recently, LTE.

We market our products under a multi-brand strategy, offering the majority of our postpaid and prepaid wireless and wireline products and converged services through our core premium O_2 brand. We constantly seek to improve the positioning of O_2 to attract premium consumers and businesses. Our aspiration is to be one of the most popular brands with the most satisfied customers in the German telecommunications market.

Through our "O_2 My Handy" model launched in May 2009, we sell handsets and other hardware to our customers for a fixed price either for immediate payment of the total purchase price or for an up-front payment of part of the total purchase price and 12 or 24 subsequent monthly installments. This provides the customer with price transparency with respect to the costs of the handset and the costs of the wireless services. Customers are able to acquire a wide range of mobile phones, including premium handsets, based on attractive payment terms. Our main suppliers of handsets are Samsung, Apple, Nokia, HTC and Sony Mobile Communications. Our focus for the "O_2 My Handy" model has been and continues to be on smartphones, which comprise more than 90% of the handsets we sold in the financial year ended December 31, 2012. The "O_2 My Handy" model is also used for our secondary brands, especially for a portfolio of low-budget smartphones, in order to meet the increasing demand for data services in these customer segments as well as, in part, for our wholesale partners.

We access additional customer groups through our secondary and partner brands as well as our wholesale channels. Secondary brands are fully-controlled brands, such as FONIC and netzclub or brands held through joint ventures and strategic partnerships, such as Tchibo mobil and Türk Telekom Mobile. We market high-speed internet access and wireline telephony via DSL. Our multi-brand approach enables us to target a broad range of consumers and to maximize our sales reach through tailored product offerings, marketing and distribution. We also provide wholesale wireless, wireline network and value-added services to customers such as 1&1, mobilcom/debitel, Drillisch and the two major German cable operators. We provide our wireline wholesale partners with a range of ULL services, including wireline telephony and high-speed internet access, as well as other add-on services, such as billing, the management of phone numbers and SIP-accounts. The extensive portfolio we offer to our wholesale partners which enables them to service their end-customers allows us to increase our reach and leverage scale.

We target our small and home offices (SoHos), small and medium sized enterprises (SMEs) customers, and large, national companies through our O_2 brand and multinational corporations with our "Telefónica Multinational Solutions". We offer our products through a diversified distribution platform, including both direct sales channels, comprising our nationwide network of self-operated and franchised O_2 shops and premium partner shops, online and telesales, and indirect sales channels, such as retail/e-retail partnerships and dealers/cooperations.

Global Services
All global procurement activities of the operating units of Telefónica Group including the activities of Telefónica Deutschland Group are coordinated and managed by the Global Services segment. Global Services acts as a central contact point for the suppliers of the whole Telefónica Group by consolidating the needs of the individual companies and negotiating with suppliers on a global scale in order to achieve economies of scale for Telefónica Group.

Global Services also acts as an agent in negotiating integrated wireline, wireless and IT services to Telefónica Group with the objective of optimizing these services for Telefónica Group and achieving economies of scale. Telefónica Global Roaming, on behalf of Telefónica Europe's operating businesses, negotiates discount agreements with Telefonica's international roaming partners, both to achieve favorable cost positions and secure inbound roaming revenues.

1.2.3. Group strategy

We aim to leverage our existing assets to capture market share in the wireless services market and drive growth through the following strategic priorities:

Capitalize on multi-brand portfolio and superior customer satisfaction
We aim to use our core O_2 brand and our strong portfolio of secondary brands and partner brands to build on our position in the German telecommunications market. We also intend to continuously explore strategic partnerships to add brands that target specific niches or consumer segments.

The aim of our customer service, retention and satisfaction programs is to continue to provide our customers with consistently high-quality service and maintain transparency, thereby earning our customers' trust. We believe that our high levels of customer satisfaction decrease churn and increase the rate at which our current customers recommend us to new potential customers. We intend to increase the use of direct distribution channels to optimize our acquisition process and costs.

Monetize data opportunities through innovative products and digital services
We aim to leverage the current strength of our core O_2 brand and to monetize the rise in data usage and smartphone users, especially through the ongoing roll-out of our LTE network and through increased convergence.

Expand our convergence strategy to increase share of customer spending and reduce churn
We intend to continue to focus on converged wireless and wireline service bundles in order to increase our share of customer spending, reduce wireless churn and reduce subscriber acquisition costs. One

of our strategic aims is to cross-sell products and services to customers who currently use only wireless or wireline services, because this increases our share of customers' spending. We believe it also reduces our risk of churn. In addition, cross-selling allows for the acquisition of new accesses at comparatively low customer acquisition costs. To utilize the cross-selling potential in our customer base, we offer discounts to customers who purchase both wireless and wireline services.

(Source: Convergence study)*

Seize the opportunity in the SoHo, SME and wholesale markets
We target small, medium-sized and large national business customers with our core O_2 brand and larger international companies with our "Telefónica Multinational Solutions" in partnership with Telefónica Group. We intend to raise customers' perception of our core O_2 brand as a business brand. We aim to increase our market share by differentiating ourselves from our competitors by providing good value for money, tailored propositions and bundled benefits and focusing on customer service.

We aim to use innovation to improve services, profitability and competitiveness in our wholesale business to maintain and increase our market share.

Maintain competitive 3G and LTE networks
We believe demand for LTE technology in Germany will increase significantly in 2013 and 2014. During the initial roll-out, the German regulator FNA required certain towns and districts with little or no broadband coverage (also known as "white spots") to be prioritized. This requirement has been fulfilled in all of the 16 federal states. As a result, we are now able to develop our LTE network strategy based primarily on commercial considerations.

Drive profitable growth and efficiency to generate enhanced cash flow
We intend to drive profitable growth by maximizing operating efficiencies. This will entail actively managing our customer base and our ARPU levels, with a focus on data usage, including increasing our share of direct distribution channels, online and digital customer care. Efficiency initiatives to optimize processes, realize network efficiencies, and streamline our IT systems are also on the agenda.

* The company commissioned mm customer strategy GmbH to regularly produce a market study of our business and market position ("Convergence Study"), the key findings of which were published on September 19, 2012 at www.mm-strategy.com, and which we also cite in this Management Report. All statistics and market data in this study are derived from third-party sources or are produced by mm customer strategy GmbH. We did not verify or modify any of the third-party statistics or other statistics provided by mm customer strategy GmbH.

1.2.4. Management of the Group

Telefónica Deutschland Group is centrally managed by the members of the management board with the objective of growing the company profitably.

Clear end-to-end profit and loss responsibilities have been defined to reward entrepreneurial behavior, which is one of the company's key maxims. Management is passionate about increasing shareholder value and strongly believes that delivering superior customer and employee experiences is the key to achieving this objective.

Telefónica Deutschland Group's management has implemented a comprehensive internal management system to steer the group, primarily consisting of the following elements:

- A strategic setting process
- An integrated budgeting and planning system
- Key financial and operational performance indicators
- Monthly reporting to the management board and supervisory board
- Ongoing risk and opportunity management
- Management by objectives at all levels of the company

1.2.4.1. Strategic setting process

Telefónica Deutschland Group's management board reviews corporate strategy based on its vision for the company using an annually recurring planning process. This process entails developing the long-term strategic targets for the company's German market share and usually a three-year financial plan. Decisions are based on current market and competition analyses, market forecasts, the company's vision and long-term strategic goals.

New growth opportunities are systematically identified and investment decisions made accordingly. The overall corporate strategy and goals are then broken down into business unit strategies in close cooperation with each business unit. This step includes implementing an operational model of the strategy at the business unit level by defining specific financial targets, key performance indicators (KPI) to measure the degree of success implementing the strategy and establishing levers to achieve the targets. A detailed budget planning round for the next fiscal year is conducted based on the agreed three-year targets and short term strategic priorities are defined in parallel.

1.2.4.2. Management system and value management

We have defined performance figures to steer our strategic and operational targets so that we reach our goals. The following KPIs are an integral part of Telefónica Deutschland Group's management system and value management and reflect the interests of our different stakeholders.

Profitability
Revenue growth is a key indicator of the success of our business. The OIBDA and the OIBDA margins facilitate operating performance

comparisons from period to period and company to company by eliminating potential differences caused by variations in tax positions (such as the impact of changes in effective tax rates or deferred taxes on periods or companies), depreciation and amortization and certain other items. OIBDA and the OIBDA margin are commonly used in terms to compare the operating activities of telecommunications operators. However, because other companies may not calculate OIBDA and the OIBDA margin exactly as we do, our presentation of OIBDA and the OIBDA margin may not be comparable to that of other companies.

Financial planning
We are driving enhanced Free Cash Flow generation to meet our capital expenditure needs. Main focus is on the investments in growth as well as the ability to pay a dividend.

Furthermore, the company's leverage ratio (calculated by dividing net financial debt by OIBDA) is managed at the Telefónica Deutschland Group level.

Capital management
We are monitoring cost of capital and the equity ratio with a goal of optimizing capital structure.

Shareholder remuneration
In line with its shareholder remuneration policy, the company intends to pay a dividend.

The payment of dividends, if any, and the amounts and timing thereof, depend on a number of factors, including future revenues, profits, financial conditions, general economic and business conditions, the company's future prospects, applicable legal and regulatory requirements and such other factors as the management board may deem relevant.

The company aims to remain solvent by refraining from paying dividends, distributing capital or capital reserves in cash or buying back shares, if the ratio of net financial debt/OIBDA materially and consistently exceeds the target leverage, and restricting the use of new debt to pay dividends, allowing it only if the ratio of net financial debt/OIBDA complies with the target leverage (as defined below in chapter 2.3.1. Principles and objectives of financial management).

Customer satisfaction
Customer satisfaction is a key priority for our company and we continuously seek to improve the positioning of O_2, our core premium brand, to attract premium consumer and business customers for postpaid wireless, wireline and converged services. Our aspiration is to be the most popular brand with the most satisfied customers in the German telecommunications market. This includes offering customer insight driven propositions and providing outstanding service through all customer touch points. We believe our high levels of customer satisfaction decrease churn and increase the rate at which our current customers recommend us to new potential customers.

Customer satisfaction is measured regularly, and the impact of all decisions on customer satisfaction is taken into account.

Employee satisfaction
A company cannot be successful without its employees. Our employees contributed substantially to our success. Their confidence, dedication and commitment make us what we are today.

We measure the satisfaction of our employees regularly and take their feedback seriously to further improve the company.

1.2.4.3. Budgeting and planning system

The integrated planning system is based on a combination of strategic and operational targets. Telefónica Deutschland Group defines internal targets for the company and the group for all relevant key performance indicators, as described in chapter 1.2.4.2. Both the expected market development and internal expectations for growth and efficiency evolution are discussed once a year to generate a long-term plan for the next three years. The first year is ultimately broken down into a monthly plan to reflect the detailed budget for the first year. For control purposes, the budget is updated twice a year taking into account as is results as analyzed in conjunction with the monthly reporting process, an update on market trends and currently recognized additional opportunities or risks. The revised forecast is then used to make operational corrections or to seize new opportunities for the company and group.

1.3. Product development and innovations

Product development
We are building a solid basis for sustainable growth in revenues and earnings with our range of flexible, competitive and customer-oriented products, which we continually improve and expand. For example, we added various data flat rates to our portfolio of "O_2 Blue" packages in early 2012. These are specifically tailored to address the way our customers' use of the internet has changed due to the ever-increasing spread of smartphones. They serve our customers' need for an integrated voice telephony and data transmission service perfectly. Telefónica Deutschland Group has been offering LTE for smartphones since July 2012. Apart from the mobile rates, our portfolio includes a great variety of state-of-the-art smartphones by almost all quality manufacturers. With our "O_2 My Handy" plan, the devices can also be bought without a mobile phone contract.

Our portfolio also comprises new offers for our DSL customers. "Speed", an additional VDSL option for the O_2 DSL offerings has been available since late 2012. It allows our customers to surf the internet up to three times faster than with a traditional DSL connection. In recent years, Telekom Deutschland GmbH in particular has invested heavily in VDSL infrastructure, a network that so far has grown to cover about 11 million households in 48 towns and cities across Germany. The long-term partnership with Telekom Deutschland GmbH, which we entered into in late 2012, enables us to use the VDSL contingent model, which gives us the opportunity to offer an extremely competitive high-speed DSL product in addition to our successful wireless solutions.

The different ways our customers now use mobile telephones and new technological developments are allowing us to tap new business areas. One example is mobile payment, an area in which the Telefónica Deutschland Group developed various products and services in 2012. Our customers can now pay for digital purchases such as games, digital currencies or apps with their mobile phone bill using "direct to bill". Our "mpass" payment service lets customers use their phones for payment: They can pay online and, thanks to NFC (near field communication), offline in many retail outlets. Our alliance with MasterCard makes easy, secure and contact-free payment possible at all outlets that have installed the PayPass infrastructure. Finally, we added the O_2 credit card to our financial services portfolio in November 2012. The O_2 credit card is issued by our partner Barclaycard and is accepted at more than 30 million outlets that accept Visa.

New rates and products for business customers

Over the course of 2012 we restructured the "O_2 on Business" offering. The new rates vary by volume of data allowed to be transferred at maximum speed, the abroad call time included and the number of text messages included. An option for LTE-compatible devices is also available.

In addition, Telefónica Deutschland Group has been offering all freelancers, self-employed customers and small businesses a discount when they combine their wireless and wireline connections and book a DSL contract in addition to their mobile phone contract.

Apart from attractive rates, we offer our business customers a great variety of services. For example, we have been offering a comprehensive cloud-based solution for business telephony as part of our product portfolio since October 2012: The Office Voice Cloud connects wireline and wireless systems so that the functions of the wireline can also be used from the mobile phone while on the go. Telefónica Deutschland Group offers this product in cooperation with nfon AG, one of the leading providers of off-premises telephone exchanges (IP Centrex) in Germany.

The portfolio of M2M products for business customers was also expanded in 2012. For example, a new solution package for fleet monitoring has been available since March 2012: The O_2 Fleet Store is offered in cooperation with Masternaut, the leading telematics services provider. Medium-sized or large companies and multinationals use it to more efficiently manage their fleets, reduce costs and improve customer satisfaction. The O_2 Fleet Store's core component is a tiny GPS box. It can be installed in any vehicle and connects to the Masternaut servers via the O_2 mobile communications network. While moving, it continually transmits vehicle data such as location, direction of movement, speed and the temperature in the cargo space. The movements of individual commercial vehicles can be tracked on a map featured on a password-protected website, which provides additional information about any available vehicle.

Innovation management

A crucial success factor for further growth is our ability to identify trends and new technological developments early on, to turn them into customer-driven products and bring them to market quickly. In doing so, we draw on the global innovation network of Telefónica Group, refine the respective global products and also develop strategically specific services for the German market. Our innovation management always follows the principle of "open innovation" in order to tap the maximum innovation potential for our company. This means that we involve employees as well as customers, start-ups, business partners and other drivers of innovation in our innovation activities.

We apply "smartidee", our employee suggestion scheme, as a platform for staff to share their ideas and, consequently, to help take our company to the next level. Since its inauguration in 2003, more than 13,000 suggestions have generated a financial benefit for our company accounting to over EUR 15m.

Launched in 2010, the "O_2 Ideenforum" gives customers a chance to send their suggestions regarding new products and services to the Telefónica Deutschland Group; submitted ideas are then discussed and prioritized by other customers on the o2.de portal. About 150,000 registered customers have participated in the process already. By implementing selected ideas, we both improve our products and give credible proof of our supreme customer orientation.

Stepping up our customers' involvement in product development and reducing time-to-market are our top priorities. This is why we launched the "O_2 Ideenlabor" in November 2011. This initiative ensures a full innovation cycle where concepts developed in-house via an online survey are presented to customers who provide us with their instant feedback. As of today, a panel of about 1,500 customers and other interested users are registered for the ideas lab, enabling us to collect hundreds of data points within only a few hours in a highly cost-efficient way.

We also maintain close ties with leading research institutes and are actively involved in an exchange of ideas on innovation through symposia, panel discussions and the annual DLD (Digital-Life-Design) Conference in Munich, which brings together the pioneers of the IT and telecommunications industries.

2. Analysis of the group's business performance

2.1. Statement of the board of management on business development

The management board is pleased with the development of its telecommunications' business as Telefónica Deutschland Group extended its positive financial and operating performance trend throughout the year outperforming the market with trading momentum in the postpaid sector and successfully monetizing wireless data. After the initial public offering in 2012, we are convinced that we have further raised our profile and will continue the successful Telefónica Deutschland Group growth story in the long run. Wireless data has stimulated growth, as reflected in our continuous, strong financial performance in the financial year of 2012. Total revenue growth of 3.5% was especially driven by wireless service revenues due to a strong increase in accesses and a stable ARPU. Data revenues benefitted from increased smartphone penetration to improve by 16.1%. Additionally, the significant OIBDA growth of 11.3% resulted in an OIBDA margin of 24.5% in 2012 (2011: 22.8%), leveraging wireless data growth and increased efficiencies. Increased investments in the network, improving 3G data capacity and accelerating the LTE network rollout will give essential support to our wireless service revenue growth.

We are also pleased with the development of the Global Services segment, whose companies were part of Telefónica Deutschland Group until September 30, 2012. We succeeded in reinforcing the business model and obtaining general acceptance among suppliers. Recently the focus shifted to improving operational procedures and the extending the scope of activities. The adjusted OIBDA margin remained stable for the prior financial year.

We are pleased with our first "BBB" rating from FitchRatings and the associated positive signal to the capital market. The rating reflects our strong position in a highly competitive market and the financial stability of Telefónica Deutschland Group. The business development is discussed in more detail in the following sections.

2.2. Results of operations and earnings position

Consolidated Income Statement

Euros in millions

	January - December			
	2012	2011	Change	% Chg
Revenues	**5,213**	**5,036**	**177**	**3.5**
Other income	61	61	–	(0.3)
Operating expenses	(3,995)	(3,947)	(47)	1.2
Supplies	(2,131)	(2,047)	(84)	4.1
Personnel expenses	(465)	(438)	(27)	6.1
Other expenses	(1,399)	(1,462)	63	(4.3)
Operating income before depreciation and amortization (OIBDA)	**1,279**	**1,149**	**130**	**11.3**
OIBDA margin	**24.5%**	**22.8%**	**n.m.**	**1.7%-p.**
Depreciation and amortization	(1,133)	(1,082)	(51)	4.7
Operating income (OI)	**146**	**67**	**79**	**>100**
Net financial result	(6)	6	(12)	>100
Profit before tax from continuing operations	**140**	**73**	**67**	**91.3**
Income tax	168	(2)	169	>100
Profit for the year from continuing operations	**308**	**71**	**236**	**>100**
Profit after taxes from discontinued operations	**1,027**	**483**	**544**	**>100**
Total profit for the year	**1,335**	**554**	**781**	**>100**

Revenue breakdown

Euros in millions

	January - December			
	2012	2011	Change	% Chg
Revenues	**5,213**	**5,036**	**177**	**3.5**
Wireless business	**3,845**	**3,606**	**239**	**6.6**
Wireless service revenues	3,152	2,946	205	7.0
Handset revenues	693	659	34	5.1
Wireline business	**1,363**	**1,426**	**(63)**	**(4.4)**
Other	**5**	**4**	**1**	**12.7**

2.2.1. Revenues

Revenues were EUR 5,213m for the year ended December 31, 2012, an increase of EUR 177m or 3.5% from EUR 5,036m for the year ended December 31, 2011. The increase is mainly driven by our wireless business, which benefitted from the company's clear focus on the data opportunity reflected by an integrated tariff portfolio ("O_2 Blue") and attractive smartphone offers through the "O_2 My Handy" model.

Wireless business

Wireless business including wireless service revenues and handset revenues reached EUR 3,845m for the year ended December 31, 2012, an increase of EUR 239m or 6.6% from EUR 3,606m for the year ended December 31, 2011.

The vast majority of wireless service revenues comprise customer base and tariff fees charged for voice (including incoming and outgoing calls), messaging (including SMS and MMS) and wireless data services and revenues from service contracts. Access and interconnection fees paid by other operators for calls and SMS terminated on our network are also included in wireless service revenues, as well as visitor roaming revenues.

Wireless service revenues increased by EUR 205m or 7.0% from EUR 2,946m for the year ended December 31, 2011 to EUR 3,152m for the year ended December 31, 2012. A solid rise in wireless postpaid accesses in the year ended December 31, 2012 stimulated revenue growth as wireless postpaid accesses had a significant leverage on trading momentum across all segments. Revenue development was supported by a stable year-on-year ARPU performance as a result of the improved customer mix and successful data monetization. In line with the steadily rising demand for data services such as wireless internet, service applications and other data content, wireless data revenue climbed 16.1% reaching 44.1% of wireless service revenue for the year ended December 31, 2012, an increase of 3.5%-p. compared to the year ended December 31, 2011. The company continued monetizing the data opportunity by leveraging the integrated tariff portfolio (mainly the enhanced "O_2 Blue" portfolio with "O_2 Blue Select" and "O_2 Nxt"") driving non-SMS data revenues growth of 30.7% for the year ended December 31, 2012 (2011: 48.9%).

Handset revenues reached EUR 693m for the year ended December 31, 2012, an increase of EUR 34m or 5.1% from EUR 659m for the year ended December 31, 2011 driven by the continued success of the "O_2 My Handy" model that meets the current high demand for smartphones. Handset sales were especially strong during the Christmas season. Handset revenues comprise the sale of wireless devices under the "O_2 My Handy" model as well as cash sales. Furthermore, one-time revenue payments for the wireless business (primarily for postpaid), hardware for bundled prepaid SIM and handset packages or postpaid contracts as well as accessories are included.

Wireline business

Wireline business revenues primarily comprise retail DSL service revenues, wireline telephony revenues, retail DSL activation fees and revenue for DSL-related hardware. Wireline revenues also refer to revenues generated from wholesale DSL services, carrier traffic trades and hosting services. We generated wireline business revenues of EUR 1,363m for the year ended December 31, 2012. This represents a decrease of EUR 63m or 4.4% from EUR 1,426m for the year ended December 31, 2011 driven by a lower customer base resulting from overall difficult market conditions.

Other revenues

Other revenues refer to new business such as advertising services, financial services (e.g. mobile payment mpass), communication and cloud services, M2M and security. This position amounted to EUR 5m in the year ended December 31, 2012, an increase of EUR 1m or 12.7% from EUR 4m for the year ended December 31, 2011.

2.2.2. Profit for the year

2.2.2.1. Profit for the year from continuing operations

OIBDA amounted to EUR 1,279m as of December 31, 2012. This shows an increase of EUR 130m or 11.3% compared to EUR 1,149m in the previous year. The main drivers of the increase in profitability were the dynamically growing postpaid sector, and the monetization of the data opportunity. The OIBDA margin continued its positive performance, growing by 1.7 percentage points to reach 24.5% for the year ended December 31, 2012 compared to 22.8% for the year ended December 31, 2011. The strong performance of the OIBDA margin is the result of increasing contribution from wireless data to the business, coupled with additional efficiencies from the commercial area compensating higher infrastructure growth-related costs.

Corresponding to the increase of wireless business revenues, supplies represent the main driver of the increase in total **operating expenses** (EUR 47m or 1.2%) from EUR 3,947m for the year ended December 31, 2011 to EUR 3,995m for the year ended December 31, 2012.

Supplies mainly include interconnection costs relating to costs incurred when connecting our subscribers to other mobile networks and costs for sold devices, especially under the "O_2 My Handy" model. Furthermore, they consist of costs for leased lines and purchases of ULL as well as costs associated with housing rental for network equipment. Supplies amounted to EUR 2,131m for the year ended December 31, 2012, an increase of EUR 84m or 4.1% compared to EUR 2,047m in the previous year. The rise was mainly due to strong demand for smartphones and increased wireless interconnection expenses due to higher usage of voice services.

Personnel expenses were EUR 465m for the year ended December 31, 2012, an increase of EUR 27m or 6.1% from EUR 438m for the year ended December 31, 2011 mainly reflecting the general pay rise from July 1, 2012 and the change in the mix of our employee base towards the commercial areas. Headcount, including permanent employees and temporary staff went down slightly and stood at 6,019 on December 31, 2012, a decrease of 262 compared to the year ended December 31, 2011 (6,281).

Other expenses primarily comprise commissions paid to dealers, marketing costs, customer service and administrative outsourcing, hardware and IT maintenance, equipment and premise lease expenses and energy costs. They were EUR 1,399m for the year ended December 31, 2012, down by EUR 63m or 4.3% from EUR 1,462m for the year ended December 31, 2011. The increased network costs were overcompensated by savings in other costs.

Depreciation and amortization increased by EUR 51m or 4.7% from EUR 1,082m for the year ended December 31, 2011 to EUR 1,133m for the year ended December 31, 2012, mainly driven by the amortization of LTE spectrum licenses that were acquired in 2010, but activated for commercial service from July 1, 2011. (For more information please refer to the explanation for intangible and fixed assets in chapter 2.4.)

Operating income amounted to EUR 146m in the January to December 2012 period, which is a significant improvement over the previous year's period at EUR 67m.

The net financial result was minus EUR 6m, from a positive income of EUR 6m in 2011. This was the result of the new capital structure of the company from September 2012 onwards.

Taxes
Due to deductible temporary differences, Telefónica Deutschland Group did not have positive taxable income for the year 2012 and therefore will not have to pay income tax. As a result, all income tax income included within the financial year ended December 31, 2012 relates to changes in deferred taxes.

Net profit from continuing operations for the financial year 2012 amounted to EUR 308m, a significant improvement over the previous year at EUR 71m.

2.2.2.2. Profit for the year from discontinued operations

Discontinued operations comprise the Global Services segment (Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L., and Adquira España S.A.) as well as Group 3G UMTS Holding GmbH and Quam GmbH. All of these entities were sold effective October 1, 2012. As a result, Telefónica Deutschland Group's discontinued operations have been reported for the first nine months in 2012.

The profit from discontinued operations amounting to EUR 1,027m (2011: EUR 483m) comprises the profit contribution from discontinued operations amounting to EUR 535m and the final consolidation result amounting to EUR 492m. The profit contribution is influenced by a positive tax income amounting to EUR 155m resulting from a reassessment of the realizability of deferred taxes of the discontinued operations in the new company structure. Furthermore, profit contribution is significantly impacted by the development of the Global Services segment. For this reason, further analyses are focused on the Global Services segment. Group 3G UMTS Holding GmbH and Quam GmbH are thus not considered in the following. The segment's year-on-year development is distorted because a 9-month-period (financial year 2012) is being compared to a 12-month-period (financial year 2011). Figures for 2012 have been extrapolated to a 12-month-period for a better comparison.

Global Services' **revenues** (before consolidation) for the first nine months of 2012 were at EUR 413m (extrapolated: EUR 550m), down EUR 122m (but up EUR 16m on an extrapolated basis). Extrapolated revenues for 2012 thus, rose 3.0% compared to the year ended December 31, 2011 reflecting the extended scope of activities.

Global Services' **OIBDA** was EUR 394m for the first nine months of 2012 (extrapolated: EUR 525m) versus EUR 507m for the financial year ended December 31, 2011, a drop of EUR 113m. On an extrapolated basis for 2012, OIBDA rose EUR 18m or 3.5% due to the reinforced business model, increased acceptance among suppliers and improved operational procedures.

Adjusted OIBDA (OIBDA before Telefónica group fees) was down EUR 75m or 15.4% from EUR 486m for the year ended December 31, 2011, to EUR 411m for the first nine months of 2012. On an extrapolated basis, adjusted OIBDA for 2012 was EUR 548m, up EUR 62m or 14.8% compared to the financial year ended December 31, 2011. Global Services' adjusted OIBDA margin remained stable, coming in at 95.4% for the first nine months of 2012 compared to 94.9% for the year ended December 31, 2011.

2.3. Financial position

2.3.1. Principles and objectives of financial management

Risk control and centralized management are key principles underpinning Telefónica Deutschland Group's financial management. The company aims to remain solvent by (a) refraining from paying dividends and buying back shares and neither paying back capital nor capital reserves and (b) restricting the use of new debt to pay dividends, allowing it only if the ratio of net financial debt/OIBDA complies with the target leverage.

The management board and supervisory board intend to maintain the company's leverage ratio (calculated by dividing net financial debt by OIBDA) below 1.0 over the medium term (the "target leverage").

2.3.2. Financing

Long-term financing arrangements

Our subsidiary Telefónica Germany GmbH & Co. OHG entered into a loan agreement dated September 12, 2012 with the Telefónica Group entity Telfisa Global B.V. (TGB.V.) as lender, pursuant to which TGB.V. has agreed to provide a loan facility (the "Facility") of EUR 1.25bn bearing interest at the rate of the 3–month EURIBOR plus a margin of 120 basis points, increasing by 40 basis points per year, accruing on a daily basis after drawdown of funds on the basis of a 360 day year. The Facility has a repayment schedule of 20% per year until 2017.

Telefónica Germany GmbH & Co. OHG has the right to prepay the Facility, in whole or in part in a minimum amount of EUR 100,000, on any interest payment date or subject to payment of a market-based breakage fee. The Facility is also subject to a mandatory prepayment in the event Telefónica Germany GmbH & Co. OHG obtains financing that matures after September 13, 2017 in the amount of 25% of the proceeds received from such financing which will be applied as a prepayment of the Facility. Default interest of an additional 2 percentage points on top of the applicable interest rate will apply in the event Telefónica Germany GmbH & Co. OHG fails to comply with any of its payment obligations under the loan agreement for any reason. The loan agreement contains certain restrictive covenants, including with respect to disposals of assets, creation of liens, and mergers and consolidations. In the event of default, the Facility will be accelerated and all amounts owed under the Facility will become immediately due for repayment. Events of default under the loan agreement include, among others, breach of the loan agreement, in particular a payment breach, an insolvency or similar event, a breach of payment obligations with respect to other indebtedness, and if Telefónica Germany GmbH & Co. OHG experiences a change of control.

As of December 31, 2012, the principal future payment obligations from our long-term financing arrangements, after giving effect to the EUR 1.25bn loan granted by TGB.V. on September 12, 2012 are as follows:

Long term financing arrangements

Euros in millions

	Payment due by period				
	2013	2014	2015	2016	2017
Senior credit facilities	250	250	250	250	250
Debt relating to finance leases	4	2	2	1	–
Total	**254**	**252**	**252**	**251**	**250**

Revolving credit facilities

In August and September 2012, Telefónica Germany GmbH & Co. OHG, as borrower, entered into revolving credit facility agreements with several banks. As a result, Telefónica Germany GmbH & Co. OHG has undrawn committed credit lines with maturity beyond one year in a total amount of EUR 710m.

Every agreement's calculation of interest is the percentage rate which is the aggregate of the margin and EURIBOR.

Cash pooling

We have been and will remain a party to the cash management system used by Telefónica Group. To this end, we entered into certain deposit and cash management agreements with TGB.V. Cash throughout the Telefónica Group is centralized through these arrangements, allowing us to benefit from the economies of scale from the overall Telefónica Group as well as, among other things, from the in-house liquidation of payables and receivables between us and the participating members of Telefónica Group. Under the cash pooling arrangements, the entire cash surplus available in our bank accounts included in the cash pool is automatically transferred on a daily basis to master bank accounts held by TGB.V. In addition, we are also able to use other ways to deposit funds to the cash pool account and settle receivables from, and payables to, Telefónica Group companies and third parties via the cash pool. We are able to draw from this pooled account certain amounts exceeding the amount of our cash contributions up to a maximum amount of EUR 40m, which helps us to satisfy our working capital requirements. The amount that may be included in the cash pool is capped at an amount equal to our 18-month free cash flow. In addition, we are entitled to make cash deposits for periods of between one and up to 12 months in separate accounts. For positive balances in the cash pool account, we are paid a rate of interest set by a reference rate (LIBOR or EURIBOR, depending on the relevant currency), plus/less a margin based on market prices. For deposits made in separate accounts for a period of between one and up to 12 months, we agree with Telefónica Group on the applicable interest rate in each individual case. Similarly, we will be charged interest when we borrow money from the pool exceeding our contributed cash amounts. The interest rate for borrowings is based on a reference rate (LIBOR or EURIBOR, depending on the relevant currency), plus a margin based on market prices. The deposit and cash management agreements are automatically renewed every calendar year unless terminated by either party prior to the end of a contractual year upon 30 business days' notice or immediately in certain circumstances, such as failure to make payments requested under the agreement or if we reasonably believe that our repayment claims under the arrangements are not fully recoverable. Subject only to the general legal rules for the set-off of claims, any claims for the repayment of deposits made under the deposit and cash management agreement can be offset against liabilities under loans granted to us by TGB.V., including, in the case of Telefónica Germany GmbH & Co. OHG, the existing loan facility of EUR 1.25bn granted by TGB.V. on September 12, 2012. In addition, we have significant information rights under the deposit and cash management agreements with regard to the financial condition of Telefónica Group and TGB.V.

This helps us to determine whether we may continue participating in the cash pooling or whether any termination rights have been triggered and should be exercised. Telefónica S.A. has guaranteed TGB.V.'s obligations under cash pool arrangements.

Silent factoring

In connection with the "O_2 My Handy" monthly payments, we negotiated factoring agreements with certain financial institutions for the sale of the associated accounts receivable to support our working capital. Thus, we receive immediate payment from "O_2 My Handy" contracts upon entering into a factoring agreement with the financial institutions for these receivables. We entered into our first factoring arrangement in November 2011 with a net cash contribution of EUR 229m for 2011, we entered into our second such arrangement in March 2012 with a net cash contribution of EUR 36m for 2012 and we entered into our third such arrangement in September 2012 with a net cash contribution of EUR 135m for 2012. In December 2012 we entered into another arrangement with a net contribution of EUR 131m. We plan on entering into additional factoring arrangements from time to time. Sold receivables have been derecognized except a small portion due to the continuing involvement. For more information on silent factoring please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 13).

2.3.3. Financing analysis

Net financial debt

The table below illustrates the components of net financial debt.

Consolidated net financial debt evolution

Euros in millions

	As of December 31,			
	2012	2011	Change	% Chg
Cash and cash equivalents [1]	324	1,351	(1,027)	(76.0)
A Liquidity	**324**	**1,351**	**(1,027)**	**(76.0)**
B Current financial assets [2]	**–**	**2,887**	**(2,887)**	**(100.0)**
Current interest-bearing debt	251	–	251	n.m.
Current other payables	4	5	(1)	(27.2)
C Current financial debt	**255**	**5**	**249**	**>100**
D=C-A-B Current net financial debt	**(69)**	**(4,232)**	**4,163**	**(98.4)**
E Non-current financial assets	**94**	**90**	**4**	**4.3**
Non-current interest-bearing debt	1,000	–	1,000	n.m.
Non-current other payables	5	6	(1)	(21.4)
F Non-current financial debt	**1,005**	**6**	**999**	**>100**
G=F-E Non-current net financial debt	**911**	**(84)**	**995**	**>100**
H=D+G Net financial debt [3]	**842**	**(4,316)**	**5,158**	**>100**

1 Including EUR 203m cash and cash equivalents of Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. in 2011.

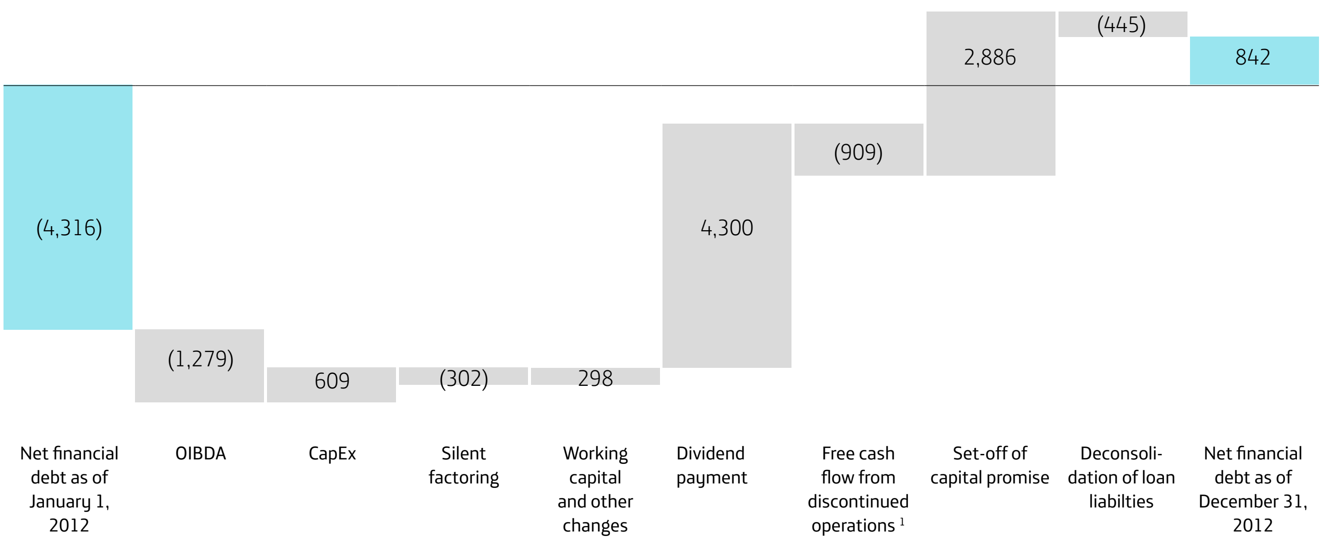
2 Including EUR 1m financial derivates of Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. in 2011.

3 Net financial debt includes current and non-current interest-bearing financial assets and liabilities which are immediately available for the group without any restrictions. Net financial debt is calculated as follows: Non-current interest-bearing debt + non-current other payables (EUR 4,985k in 2012 and EUR 6,342k in 2011) + current interest-bearing debt + other current payables (EUR 3,964k in 2012 and EUR 5,444k in 2011) - financial and other non-current assets (EUR 93,770k in 2012 and EUR 89,889k in 2011) - other current financial assets - cash and cash equivalents.

The following illustration explains the change in net financial debt during the 12-month period:

Reconciliation of net financial debt

Euros in millions



[1] Consists of Free cash flow pre dividends from the discontinued operations of EUR 351m plus cash inflow from sale of discontinued operations of EUR 703m minus existing cash of EUR 145m.

Off-balance sheet obligations
The following table summarizes our contractual obligations as of December 31, 2012. The information presented in this table reflects management's estimates of the contractual maturities of our obligations, which may differ significantly from the actual maturities of these obligations:

Operating lease obligations, purchase obligations and other contractual obligations

Euros in million

	Payment due by period			
	Less than 1 year	1 - 5 years	Over 5 years	Total
Operating lease obligations	300	822	829	1,951
Purchase obligations and other contractual obligations	126	–	–	126
Total	**426**	**822**	**829**	**2,077**

2.3.4. Liquidity analysis

Cash flow statement

The following analysis describes the development of the Group's liquidity during the financial years 2012 and 2011. Total cash flows from operating, investing and financing activities comprise cash flows from continuing and discontinued operations for each category. Cash flows from discontinued operations contain cash flow contributions from Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, Telefónica Global Roaming GmbH and Telefónica Compras Electronicas S.L. which were sold as per October 1, 2012 and thus were no longer part of Telefónica Deutschland Group.

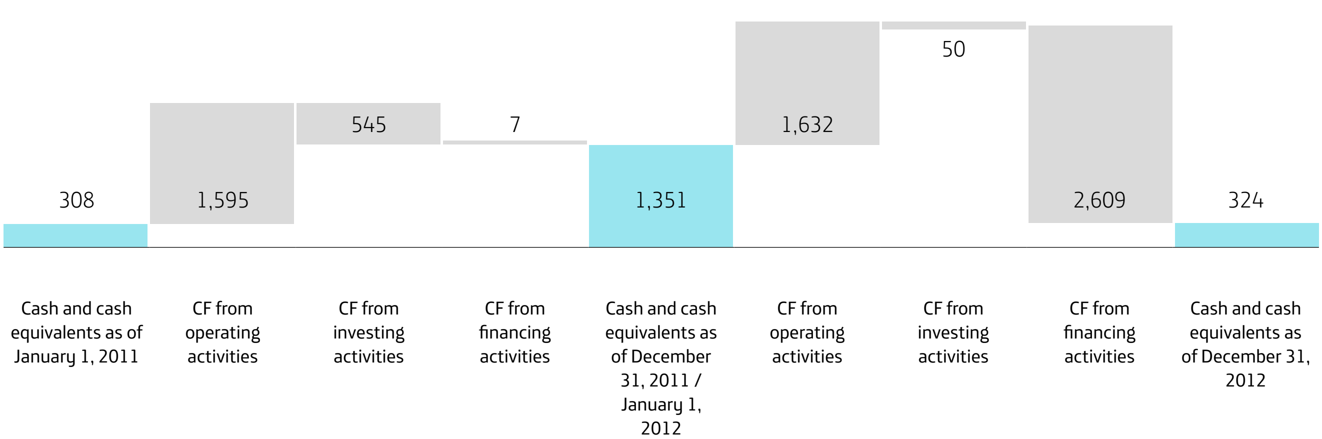
Consolidated statement of cash flows

Euros in millions

	January - December	
	2012	2011
Cash and cash equivalents at beginning of period	**1,351**	**308**
Cash flow from operating activities from continuing operations	1,283	1,240
Cash flow from operating activities from discontinued operations	349	355
Cash flow from operating activities	**1,632**	**1,595**
Cash flow from investing activities from continuing operations	(607)	(544)
Cash flow from investing activities from discontinued operations	557	(1)
Cash flow from investing activities	**(50)**	**(545)**
Cash flow from financing activities from continuing operations	(3,054)	(4)
Cash flow from financing activities from discontinued operations	445	(3)
Cash flow from financing activities	**(2,609)**	**(7)**
Net increase (decrease) in cash and cash equivalents	**(1,027)**	**1,043**
Cash and cash equivalents at end of period	**324**	**1,351**

Reconciliation of cash flow

Euros in millions



Cash flow from operating activities

In 2012, cash flow from operating activities amounted to EUR 1,632m in the financial year 2012 and increased compared to prior year figure by EUR 37m. The increase is driven by opposing effects: First, an increase in profitability driving OIBDA as a result of monetizing wireless data, coupled with additional efficiencies from the commercial area compensating higher infrastructure growth-related costs. Second, the operating cash flow is negatively affected by working capital* consumption of the revenues from the "O_2 My Handy" model. The working capital contribution from continued operations is positive due to the executed silent factoring agreements with financial institutions for "O_2 My Handy" receivables.

Cash flow from investing activities

Cash flow from investing activities totaled minus EUR 50m in the financial year 2012 implying a decrease of net outflows compared to the previous year of EUR 495m or 90.8%. (minus EUR 545m as of December 31, 2011).

CapEx** amounted to EUR 609m in the year 2012 (2011: EUR 558m), an increase of 9.1% on a year-to-year comparison with the goal of supporting future growth by accelerating investments in the development of the LTE network and increase of capacity in the 3G network and can be totally attributed to continuing operations.

The material decrease of cash outflows from investing activities mainly relates to net cash inflows from discontinued operations amounting to EUR 557m being net proceeds from the sold group companies (Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, Telefónica Global Roaming GmbH and Telefónica Compras Electronicas S.L). Net proceeds from the sale relate to cash inflows of EUR 703m (being the purchase price), compensated by outflows of cash-balances of sold companies summing up EUR 145m.

Cash flow from financing activities

In the financial year 2012 cash flow from financing activities amounted to minus EUR 2,609m which implies an increase of outflows of EUR 2,602m compared to prior year (minus EUR 7m). The cash flow is split up into financing activities from continuing operations (minus EUR 3,054m) and discontinued operations (EUR 445m).

Cash outflows from financing activities from continuing operations are largely due to the pre-IPO dividend to O2 (Europe) Limited amounting to EUR 7,186m, of which EUR 4,300m has been considered as cash payments and EUR 2,886m as cancellation of declarations of obligation. The pre-IPO dividend was partly financed by loan agreements between Telefónica Germany GmbH & Co. OHG and Telfisa Global B.V. as the lender in the amounts of EUR 1,250m and EUR 703m. The remaining part of the dividend has been financed by cash and cash equivalents. Further EUR 707m of cash outflows mainly relate to repayment of the loan towards Telfisa Global B.V. (EUR 703m).

Net cash inflows from financing activities from discontinued operations of EUR 445m relate to proceedings from borrowings (EUR 445m).

Cash and cash equivalents

The cash flows described above resulted in a decline of cash and cash equivalents by EUR 1,027m against the prior-year reporting date (2011: EUR 1,351). As of December 31, 2012 cash and cash equivalents amount to EUR 324m.

Free cash flow

For further illustration refer to the following table.

The free cash flow pre dividends from continuing operations declined by EUR 23m to EUR 674m in the financial year 2012 which is mainly driven by three factors. First, by a lower contribution from working capital of EUR 76m and second by lower net interest payments of EUR 9m due to the financing costs related to the arrangement of the external and internal credit facilities, which were partly offset by a higher cash contribution due to the improved profitability of the business as well as by the silent factoring transactions in 2012. The lower contribution from working capital is mainly affected by the strong incremental impact of the executed silent factoring transaction in the last quarter of 2011 with a net cash contribution of EUR 229m.

The free cash flow post dividends is mainly influenced by an equity movement of EUR minus 4,300m, which comprises the pre-IPO dividend payment to O2 (Europe) Limited. Free Cash Flow post dividends from discontinued operations increased by EUR 555m to EUR 909m in the financial year 2012, which is mainly driven by the sale of the discontinued operations with a sales price of EUR 703m and net proceeds of EUR 557m.

* Adjusted for vice versa corrections to CapEx (see footnote to CapEx)

** Payments on investments in property, plant and equipment and intangible assets (EUR 593m; 2011: EUR 547m) plus CapEx creditors (EUR 37m; 2011: minus EUR 9m) plus CapEx accruals (minus EUR 22m; 2011: minus EUR 3m) plus change in finance lease liabilities (EUR 1m; 2011: EUR 2m) add up to Capex (EUR 609m; 2011: EUR 558m) as of December 31, 2012

Reconciliation of Cash flow and OIBDA minus CapEx

Euros in millions

	January - December			
	2012	2011	Change	% Chg
OIBDA	**1,279**	**1,149**	**130**	**11.3**
- CapEx	(609)	(558)	(51)	9.2
= Cash contribution (OpCF)	**670**	**592**	**79**	**13.3**
+ Silent factoring [1]	302	229	73	31.9
+/- Working capital movements	(286)	(136)	(149)	>100
Change in working capital	**17**	**93**	**(76)**	**(82.1)**
+/- Gains/losses from sale of fixed assets and other effects	1	3	(2)	(59.4)
- Taxes paid	–	–	–	n.m.
+ Net interest payments	1	10	(9)	(92.9)
+ Payment on financial investments	(15)	–	(15)	n.m.
= Free cash flow pre dividends from continuing operations	**674**	**697**	**(23)**	**(3.3)**
+/- Equity movements [2]	(4,300)	(5)	(4,295)	>100
= Free cash flow post dividends from continuing operations	**(3,626)**	**693**	**(4,319)**	**>100**
+ Free cash flow post dividends from discontinued operations [3]	909	354	555	>100
= Total free cash flow post dividends	**(2,717)**	**1,047**	**(3,764)**	**>100**

[1] Full impact (YTD) of silent factoring transaction in the current year of EUR 302m (1st transaction in March 2012: EUR 36m, 2nd transaction in September 2012: EUR 135m, 3rd transaction in December 2012: EUR 131m); one silent factoring transaction in the 4th quarter 2011 with a net contribution of EUR 229m.
[2] Net payment as of December 2012 consists of the pre-IPO dividend of EUR 4.3bn.
[3] Free cash flow from discontinued operations of EUR 351m (2011: EUR 354m) plus net cash flow from the sale of discontinued operations of EUR 703m minus cash and cash equivalents of EUR 145m.

2.4. Analysis of assets and capital structure

The following analysis of assets and capital structure is based on the comparison of assets and liabilities as of December 31, 2012 with combined figures as of December 31, 2011 as presented in the IPO Prospectus dated October 16, 2012. This comparison serves for a better comparability regarding continued operations.

The difference between the 2011 combined and 2011 consolidated figures results from the inclusion of assets and liabilities of Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, together with its subsidiaries Telefónica Global Roaming GmbH and Telefónica Compras Electronicas S.L. in the consolidated figures. These assets and liabilities were not included in the combined financial statements as of December 31, 2011 as presented in the IPO Prospectus.

As per October 1, 2012 Group 3G UMTS Holding GmbH, Quam GmbH and Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. and the indirectly held 40% interest in Adquira España S.A., were sold, and thus the relating assets and liabilities were no longer part of Telefónica Deutschland Group.

Statement of financial position

Euros in millions

	As of December 31,					
	2012 Consolidated	2011 Consolidated	Change	% Chg	2011 Combined	Δ (2012 Cons. vs. 2011 Com.)
Intangible assets	3,983	4,368	(385)	(8.8)	4,364	(381)
Fixed assets	2,973	3,119	(146)	(4.7)	3,119	(146)
Trade and other receivables	1,009	1,349	(340)	(25.2)	1,010	(1)
Other assets	781	3,467	(2,686)	(77.5)	3,374	(2,593)
Cash and cash equivalents	324	1,351	(1,027)	(76.0)	1,149	(825)
Total assets = total equity and liabilities	**9,070**	**13,654**	**(4,585)**	**(33.6)**	**13,015**	**(3,945)**
Interest-bearing debt	1,251	–	1,251	n.m.	–	1,251
Provisions	89	111	(21)	(19.2)	111	(22)
Trade and other payables	1,147	1,086	60	5.6	979	168
Other financial liabilities	–	5	(5)	n.m.	–	–
Deferred income	154	170	(16)	(9.4)	170	(16)
Equity	6,429	12,283	(5,853)	(47.7)	11,756	(5,327)

As of December 31, 2012 total assets totaled EUR 9,070m (December 31, 2011, combined: EUR 13,015m) down 30.3% or EUR 3,945m.

Intangible assets
Intangible assets including goodwill declined by 8.7% or EUR 381m to EUR 3,983m as of December 31, 2012. The decline was due primarily to amortization of intangible assets with a finite useful life amounting to EUR 529m. This effect was partially offset by additions to software totaling EUR 155m in the financial year 2012.

Fixed assets
Compared with the previous year, combined figures for fixed assets were down 4.7% or EUR 146m from EUR 3,119m to EUR 2,973m as of December 31, 2012. Additions to property, plant and equipment totaled EUR 453m during the reporting period. The additions mainly relate to Telefónica Deutschland Group's investment (i.e. cell masts) made during the year to improve the capacity and coverage of the wireless networks. The impact of the additions on property, plant and equipment was offset by depreciation totaling EUR 604m.

Trade and other receivables
Trade and other receivables remained stable at EUR 1,009m as of December 31, 2012 (December 31, 2011, combined: EUR 1.010m).

Other assets
Other assets declined 76.9% or EUR 2,593m to EUR 781m as of December 31, 2012. Other assets comprise deferred tax assets, inventories and other financial assets. The drop is due primarily to other current financial assets, which were down considerably due to the cancellation of the capital promise of EUR 2,886m. Deferred tax assets, which increased EUR 169m to EUR 581m as of December 31, 2012, slightly offset the drop.

Cash and cash equivalents
Cash and cash equivalents totaled EUR 324m at the end of the year (December 31, 2011, combined: EUR 1,149m). The decline of 71.8% or EUR 825m is due to several factors. (For more information please refer to chapter 2.3.4 Liquidity Analysis)

Provisions
Compared with December 31, 2011, provisions were down 19.2% or EUR 21m to EUR 89m. The decrease was driven mainly by a considerable decline in restructuring provisions. Restructuring provisions fell EUR 26m from EUR 52m to EUR 26m as of December 31, 2012. The decline was partially offset by increased provisions for pensions as of December 31, 2012. For the year ended 2011, Telefónica Deutschland Group recognized net assets totaling kEUR 676 in its combined financial statements, whereas the company accounts for net provisions totaled EUR 8m as of December 31, 2012.

Trade and other payables
Trade and other payables rose 17.2% or EUR 168m from EUR 979m as of December 31, 2011 to EUR 1,147 at year-end 2012. Compared to the previous year, trade payables and other payables rose considerably. The increase of EUR 133m in trade payables to EUR 918m as of December 31, 2012 is due to the normal course of business. The increase in other payables to EUR 219m as of December 31, 2012 (2011: EUR 187m) refers to higher VAT prepayments as of December 31, 2011 (combined) compared to December 31, 2012. The further increase of the other current payables is due to the normal course of business.

Deferred income
Deferred income declined by 9.4% or EUR 16m to EUR 154m as of December 31, 2012. The change in deferred income primarily results from the "O_2 My Handy" business.

Interest bearing debt
Compared to December 31, 2011, interest bearing debt rose to EUR 1,251m. Telefónica Germany GmbH & Co. OHG has entered into loan agreements dated September 12, 2012 with the Telefónica financing entity (TGB.V.) as the lender in the amount of EUR 1,250m.

Equity
Shareholders' equity declined 45.3% or EUR 5,327m to EUR 6,429m as of December 31, 2012 compared to combined prior year equity amounting to EUR 11,756m. The decrease in equity was driven mainly by the pre-IPO dividend of EUR 7,186m, which was declared on September 14, 2012 to O2 (Europe) Limited, of which EUR 4,300m was reported as cash payments and EUR 2,886m as cancellation of declarations of obligation. The decrease due to the pre-IPO dividend was partly offset by the profit of the year of EUR 1,335m.

3. Employees

The telecommunications market is changing rapidly, and the demands on our employees are changing accordingly. This is why we have specific programs aimed at giving our employees the requisite abilities and skills and updating them on an ongoing basis. We also give our employees the freedom to develop their own talents. This is how we ensure that the expertise and abilities available in the company always meet the requirements of the market. We foster a working environment that is open and based on equal opportunity and make sure that our employees are able to combine the demands of a career and a family. All of this makes Telefónica Deutschland Group one of Germany's most attractive employers, as documented by numerous surveys and awards.

Personnel management target areas:

- People for the Future
  This program aims to enable our employees to face the challenges of the fast-paced telecommunications market. We help our employees build and develop their skills and we keep these specific abilities in mind when we recruit new employees.

- Corporate Culture
  We also constantly develop our corporate culture in order to stay competitive in the telecommunications market. We use a viral approach, building on the behavior of selected change champions. As opinion leaders, these individuals shape the company. Their conduct is meant to encourage other employees to follow their example.

- Operational Excellence
  We use standardized methods to consistently optimize our personnel management processes and services in order to achieve the highest possible quality at the lowest cost. The goal is to have user-friendly electronic systems that function without a hitch and thus facilitate our employees' daily working lives. We want these systems to contribute to greater satisfaction and improved efficiency.

- Employee Commitment
  We want our employees to feel they are a part of the company, be motivated, and identify with our company. A regular employee survey demonstrates the success of our activities.

Headcount and workforce structure

As of 2012 year-end, 6,019 employees worked for Telefónica Deutschland Group. The personnel level thus decreased from the previous year by 4.2% (2011: 6,281 employees). On an annual average we employed 6,212 employees, or 1.8% fewer than the average for the previous year (2011: 6,325 employees). For the calculation basis please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 29).

We have always had a relatively young workforce right from the start. In 2012, the average age of our employees was approximately 37 (2011: 36). A total of 896 employees, i.e. around 14.6% of our workforce worked part-time in 2012 (2011: 967 employees; 15.6%).*

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* Figures including Telefónica Global Services GmbH/ Telefónica Global Roaming GmbH, excluding Tchibo Mobilfunk Beteiligungs GmbH, Tchibo Mobilfunk GmbH & Co. KG, Telefónica Germany 1. Beteiligungsgestellschaft mbH, Wayra Deutschland GmbH, Telefónica Compres Electronicas S.L. (TCE) and Adquira España S.A., Group 3G UMTS Holding GmbH, Quam GmbH.

Diversity management

As part of our corporate principles, we have expressly committed to fostering diversity and equal opportunity in our company. We also anchored this commitment in our organizational structure by appointing a Diversity Officer in 2010.

Women make up 36.2% of our workforce, nearly the same as in the previous year (2011: 36.5%).* Nine female executives were part of senior management as of 2012 year-end, giving them a share of 14.5% in senior management (2011: eight female executives; 13.8%).

At the end of 2012, Telefónica Deutschland Group employees comprised a total of 71 different nationalities. Persons with disabilities are also welcome at our company. We show that we take this commitment seriously by offering a barrier-free career portal, which went online at the end of 2012, and directly approaching qualified individuals as part of our employer branding. In addition, since 2009 we have also given disabled persons a career perspective via our cooperation with Stiftung Pfennigparade. As of 2012 year-end, 108 persons with disabilities were employed at our company, 12 more than in the previous year (+11.1%)*.

Employer attractiveness

We aim to be among the most attractive employers in Germany. After all, qualified and motivated employees are a key factor in achieving our strategic goals. This is why we offer our employees a number of additional benefits. These include health protection options along with flexible working hours, a volunteer program and extensive options for combining career and family in an optimum manner to attain a healthy work-life balance (for more information please refer to chapter 4. Corporate Responsibility).

Various external employer rankings and awards testify to the success of our efforts. For instance, we have held top spots in the “Great Place to Work” independent study since 2009 (for companies with more than 5,000 employees). In 2012, we were ranked third and in 2011 were number four. In connection with the “Great Place to Work” survey, 74% of our employees stated that they were proud to work at Telefónica Deutschland Group in 2012. All in all 77% feel fairly treated and 81% say that work is something special for them and is more than just a job.

We use the “berufundfamilie” (career and family) audit to optimize the programs we offer as a family-conscious employer. We started the analysis process in the first quarter of 2012, and received the corresponding audit at year end.

Our personnel managers have always paid close attention to combining career and family. Numerous programs are in place to support our employees before and during parental leaves and to facilitate their reentering the workforce. In addition, we offer extensive family services in cooperation with external partners, ranging from finding care for children or seniors and providing moving help and after-school tutoring all the way to help in the household.

All of these measures contribute to increasing our employees’ satisfaction with their employer and fostering their loyalty to our company as their employer of choice. This ensures that the company retains key expertise and motivation and willingness to take on tasks stay at a high level.

Training and continuing education

Continuously developing the skills of our employees is one of the most important objectives of our personnel management policies. In 2012, Telefónica Deutschland Group spent a total of EUR 5.5m for training and continuing education for employees, a decrease of approximately 12% less than the prior year (2011: EUR 6.3m). A total of 4,200 employees enrolled in one of our continuing education courses in 2012 (2011: 4,600 employees). The total number of course hours for all employees was 162,000 hours in 2012 (2011: 158,000).

We offer our employees both internal and external continuing education options in line with their individual qualifications and job. Our employees are also able to attend Telefónica University, which offers an extensive, internationally focused program of courses.

Our “Expert as Trainers” program, or EasT for short, takes advantage of our employees’ and executives’ knowledge who as experts train their colleagues and employees. We have had very good feedback regarding this initiative. In 2012 we trained 73 of our employees for this program. In addition to the strong motivational benefit, this also lowers training costs without sacrificing quality.

Vocational training and “dual study” programs

By training future employees, we secure our own future while at the same time taking social responsibility as an employer. Telefónica Deutschland Group offers vocational training positions in commercial and technical jobs in a variety of fields. In 2012, 108 young people prepared for their future careers at our company. We were able to offer a permanent position to 78% of those who completed their training in 2012 (2011: 102 trainees; 88% offered permanent positions).*

For students entering university, we also offer the option of combining their course of study with vocational training. These students can either take part in “dual study” programs at career academies or work-study programs at various universities. In 2012, 46 students took advantage of this opportunity compared to 44 students the previous year.*

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* Figures including Telefónica Global Services GmbH/ Telefónica Global Roaming GmbH, excluding Tchibo Mobilfunk Beteiligungs GmbH, Tchibo Mobilfunk GmbH & Co. KG, Telefónica Germany 1. Beteiligungsgestellschaft mbH, Wayra Deutschland GmbH, Telefónica Compres Electronicas S.L. (TCE) and Adquira España S.A., Group 3G UMTS Holding GmbH, Quam GmbH.

4. Corporate Responsibility

Taking responsibility for our employees, the environment, and society is anchored in our corporate culture. But even more important, this commitment creates the basis for our long-term business success. We consistently take action wherever we as a telecommunications firm can make the greatest impact and generate the highest value for our stakeholders. We maintain a continuous dialog with stakeholders to ensure that we focus our commitment in as targeted a manner as possible.

We have defined the following focal points in our corporate responsibility strategy:

- Think Big youth program
  With our Think Big initiative, we want to empower young people to use new media to implement their own projects and thus play an active role in shaping their environment.

- Access via Telecommunications
  We want to facilitate access via telecommunications services, particularly for disabled persons, and help them take part in society by using new communications technologies.

- Climate and Environment
  We contribute to climate protection by improving the energy efficiency of our operations and developing our range of environmentally friendly products and services.

Corporate responsibility management

With the help of clearly defined key ratios, we measure the success of our activities in the area of sustainability management. We use these ratios to manage our activities in the seven core areas of economy, suppliers, compliance, employees, customers, society, and the environment. The ratios also form the basis for global corporate responsibility reporting in the Telefónica Group.

Furthermore, from the reporting year 2012 on the German Corporate Responsibility data and information will be published within the Annual Report of Telefónica Deutschland. All data included in the Corporate Responsibility chapter of the annual report 2012 is calculated on the basis of the Global Reporting Initiative (3.0) criteria. Additional information on Corporate Responsibility activities and KPIs will be provided online.

To manage these key ratios, we have defined clear responsibilities. Activities are coordinated by a corporate responsibility team working on a cross-divisional basis. Each year, specific targets are agreed with the individual departments and subsequently approved at the management level.

Stakeholder dialog

Our business commitment is shaped by transparency and continuous dialog with our stakeholders. For example, we operate an internet platform called "diskutiere.de" with Unternehmen: Partner der Jugend (UPJ) e.V., a non-profit organization. We use this platform to exchange ideas with the public on socially relevant issues that ensue from our business activities. The most recent example was in November 2012, when we organized a panel discussion on the topic of "corporate partnerships and social entrepreneurship", which we followed online at "diskutiere.de". The event was held at our representative office in the capital city of Berlin, which acts as an interface between our company and policymakers, the economy, and associations.

Another important element in our stakeholder dialog is maintaining an open exchange with our employees. We use various formats to accomplish this, particularly regular surveys on employee satisfaction (for more information please refer to chapter 3. Employees).

Areas of corporate responsibility action

We want to shape the digital future, which is why we pay heed to all aspects of our responsibility. In addition to responsibility for our products and the environment, our areas of action include social responsibility toward our employees and to society. We also expect our suppliers to act responsibly and sustainably, just as we do.

Product responsibility
We aim for a long-term relationship with our customers. Their satisfaction and the service quality that we offer them are of the highest priority for us. We view this responsibility as all-encompassing. For us, product responsibility therefore includes effective data protection, barrier-free access to communication, responsible product offers for children and teenagers, and transparent consumer information on the effects of electromagnetic fields.

In addition, we received external awards for our activities in customer satisfaction in 2012. For example, nearly 1,800 readers of FOCUS MONEY rated their mobile phone providers for "fairness" in an independent study called "Bestens FAIRbunden". Of the providers with their own network, Telefónica Germany GmbH und Co. OHG received the highest rating of "very good" six times and was named the fairest mobile phone provider in Germany. Telefónica Germany GmbH und Co. OHG did especially well in the "fairness" categories of value for money, customer service, communications, sustainability, and responsibility.

We support children and teens in using our service by showing responsibility in the products we make available. The extent of our service offering is based on internal guidelines as well as external rules we have agreed to abide by. Since 2006, we have been a member of "Freiwillige Selbstkontrolle Multimedia-Diensteanbieter e.V." (FSM), a voluntary self-monitoring association for the protection of minors. Together with seven other major German companies, we have signed a code of conduct for mobile phone service providers for the protection of minors. The aim of the code is to ensure that children and teenagers are not able to view any content that could endanger their development. We also support the development and operation of the “fragFinn.de” search engine in our capacity as a founding member of the “Ein Netz für Kinder” initiative. This search engine responds to inquiries on the basis of a white list reviewed in accordance with pedagogical criteria and youth protection aspects.

We also facilitate access via telecommunications for disabled persons. For people who are hard of hearing, we have supported VerbaVoice, a speech-to-text interpreting service together with VerbaVoice GmbH. The application is also available for mobile devices. In 2012, we funded the continuing development of that service, which is now also available as an app for the iPhone and the iPad. Dealing with the environment and its resources in a responsible manner is an important management task for us. Our objective is to minimize the negative environmental effects of our activities to the greatest extent possible. In doing so, we focus on saving energy and reducing carbon emissions as well as dealing responsibly with raw materials.

Our environmental management system has been certified since 2005 in accordance with the globally applicable ISO 14001 environmental management standard, and our adherence to the standard was again confirmed in 2012.

At approximately 96% (2011: 94%), the major portion of our energy consumption is attributable to our network with its approximately 26,000 mobile network transmission stations and additional network facilities. We consistently endeavor to keep our energy consumption as low as possible by using technologies that are as energy efficient as possible. In past years, we have succeeded in keeping the rise in the energy we consume lower than the rise in the use of our network, despite more intensive use and an increasing number of customers. The situation is similar with respect to the rise in carbon emissions based on network use.

Environmental responsibility
Careful use of resources is an important aspect of our environmental management. We want to reduce the resources used in our own processes and make a contribution to increasing the number of cell phones being recycled.

Our mobile phone recycling program allows consumers to dispose of their old phones at no cost and in an environmentally friendly manner. The mobile phones sent in are checked by our recycling partner. Defective devices are disposed of and the raw materials they contain are reintroduced into the resource cycle. Devices that still function are resold after data deletion to allow them to be reused. We use all of the proceeds generated from the cell phones we receive to support non-profit environmental protection organizations in Germany. Moreover, in 2012 we provided active support as a partner in the “handy-clever-entsorgen” initiative of the Bavarian Ministry of the Environment (see www.handy-clever-entsorgen.de) as well as to the “Die Rohstoffexpedition” campaign of the Federal Ministry for Education and Research as part of Science Year 2012 (see www.die-rohstoff-expedition.de). Both initiatives aim to raise public awareness of the importance of recycling cell phones and the various disposal options. They focus in particular on children and teenagers.

Environment		2012 [1]	2011
CO_2 emissions from electricity consumption and vehicle fleet	Tons	214,473	214,067
CO_2 emissions from business travel	Tons	6,824	6,807
Total electricity consumption	MWh	484,853	484,117
Share of electricity consumption from renewable energies	Percent	70	60
No. of used cell phones returned to O_2	Number	18,196	10,126
Share of Eco Index-tested cell phones	Percent	78.72%	n.a.

[1] At the time of data collection, not all data for 2012 was available. Approximately 8% of the stated value is therefore partly based on extrapolations derived from data for the year 2011. Tchibo Mobilfunk Beteiligungs GmbH and Tchibo Mobilfunk GmbH & Co. KG are not included in these figures.

We also involve our customers in our environmental management by making them aware of environmental aspects and will in the future offer more products and services that will allow them to minimize their environmental footprint.

A specific example of this is the Eco Index, which we have been offering to customers since 2011 to help them in selecting a new mobile phone with the assistance of sustainability criteria. The Eco Index rating includes aspects such as energy efficiency and materials used as well as social aspects related to the manufacture of the devices. Our goal with regard to the Eco Index is to provide a transparent assessment system that indicates the degree of sustainability of a mobile phone and to give device manufacturers the right initiative for product innovation. The Eco Index was developed in cooperation with Forum for the Future (www.forumforthefuture.org), an NGO in the UK for sustainable development, and various device manufacturers.

Social responsibility

In the area of social responsibility, we see ourselves as having a duty to our employees as well as to society, which we work to fulfill together with our employees (for more information please refer to chapter 3. Employees).

In 2012, Telefónica Deutschland Group spent a total of EUR 986,739 on donations and non-profit projects, up 12.6% from the prior year (2011: EUR 876,503).

The focus of our social commitment is on fostering media competence and entrepreneurial thinking among young people. We are actively involved in a variety of projects in this area, above all the Think Big program. We also offer assistance with other social matters through donations or the corporate volunteer activities of our employees.

As in the previous year, our activities in 2012 centered around the Think Big youth program, which we are implementing jointly with Fundación Telefónica and the Deutsche Kinder-und Jugendstiftung (German Children and Youth Foundation). Our objective with this program is to enable young people to implement social projects in their environment and help them develop digital media competence in the process. Since the start of this long-term program in 2010, more than 27,000 young people have taken part and some 1,300 projects have been implemented with our assistance. In 2012, we received the “Politikaward” in the category of corporate responsibility for Think Big. This renowned award for political communication is bestowed each year by trade magazine politik&kommunikation in Berlin, with the winners being elected by a high-profile jury made up of scientists, journalists, and PR experts.

One of the reasons for the success of Think Big is the close involvement of our employees. During their working hours they act as project sponsors, mentor young people by providing their expertise and give online advice on specific issues.

Corporate volunteering has been a pillar of our social commitment since 2008. In 2012, 797 of our employees took part in the activities, providing 6,881 hours of volunteer work (2011: 914 employees, 5,998 hours).

We are continuously developing the spectrum of our social commitment in close cooperation with our stakeholders. Long-term partnerships and alliances, including those with the Deutsche Kinder- und Jugendstiftung (DKJS) and the JFF-Institut für Medienpädagogik (German Institute of media pedagogy), create a foundation that maximizes the effectiveness of our work.

Society		2012	2011
Total donations and expenses for non-profit projects	EUR	986,739	876,503
Think Big participants (teenagers) per year	Number	17,000	10,000
Corporate volunteer program participants (employees)	Number	797	914
Working hours for the Corporate volunteer program	Number	6,881	5,988

5. Risk and opportunity management

Telefónica Deutschland Group focuses on anticipating and recognizing new business opportunities so that it can successfully increase shareholder value in the long run and continue to grow its revenue. However, to maximize the opportunities and operate efficiently it is also necessary to handle certain risks our company is exposed to. Our risk management approach is to continuously detect, identify and actively manage these risks at an early stage.

5.1. Risk management and financial instruments

General

Telefónica Deutschland Group is exposed to various financial market risks as a result of its business. However, due to Telefónica Deutschland Group's regionally focused operations, foreign exchange risk is not affecting Telefónica Deutschland Group materially. Telefónica Deutschland Group is subject to credit risk from the operating business (trade receivables) as well as from receivables towards Telefónica Group.

Furthermore, Telefónica Deutschland Group is exposed to liquidity risks relating to its credit risks and market risks or a weakening of its operating business or financial market disturbances.

If these financial risks materialize, they could adversely affect Telefónica Deutschland Group's financial position, cash flows and profitability.

Telefónica Deutschland Group has guidelines in place for risk management procedures and for the use of financial instruments, including a clear segregation of duties with regard to financial activities, settlement, accounting and the related controlling. Derivative financial instruments are only contracted to hedge underlying risks from its commercial and treasury financing activities. However, these instruments are always contracted with Telefónica Group treasury and Telefónica Deutschland Group has established guidelines derived from best practice standards for risk assessment procedures and supervision concerning the use of financial derivatives.

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates and interest rates will affect the value of financial instruments or income of Telefónica Deutschland Group.

Foreign exchange risk

Telefónica Deutschland Group has determined the Euro as its financial reporting currency. All financial statements of Telefónica Deutschland Group's subsidiaries are prepared in Euro and therefore Telefónica Deutschland Group is not exposed to foreign exchange translation risks. Besides translation risks, foreign exchange transaction risks exist, mainly arising from Telefónica Deutschland Group's business relations with suppliers or business partners in countries that use currencies other than the Euro. Given its funding solely by self-generated cash and equity no exchange risk from debt denominated in currencies other than the Euro occurs. The net exposure on foreign currency risk on the balance sheet consists of Primary and derivative financial instruments in foreign currencies as well as planned positions in foreign currencies of the following year.

For material identified foreign currency risks, derivatives are contracted with Telefónica Group treasury.

Interest rate risk

Interest rate risks arise primarily from Telefónica Deutschland Group's cash pooling accounts and deposits and in 2012 additionally from a loan agreement as a borrower.

Telefónica Deutschland Group deposits cash surpluses in cash pooling accounts and deposit accounts with Telfisa Global B.V., Netherlands. These accounts as well as the bank accounts bear variable interest.

Credit risk

Credit risk is the risk of financial loss arising from counterparty's inability to repay or service debt in accordance with the contractual terms. Credit risk includes both the direct risk of default and the risk of a deterioration of creditworthiness as well as concentration risks. Telefónica Deutschland Group's maximum exposure to credit risk is initially represented by the carrying amounts of the financial assets (without consideration of guarantees or collateral, if available).

Telefónica Deutschland Group considers managing commercial credit risk as crucial to meet its sustainable business and customer base growth targets in a manner that is consistent with its risk management policy. Appropriate credit policies, procedures and authorization guidelines are established to manage and monitor credit risk.

This approach to managing credit risk is based on continuous monitoring of the risk assumed and the resources necessary. In particular, attention is given to clients who could have a material impact on Telefónica Deutschland Group's Consolidated Financial Statements for which depending on the segment and type of relation appropriate credit management instruments like credit insurance or collateral may be used to mitigate exposure to credit risk. In order to control credit risk, Telefónica Deutschland Group regularly performs an ageing analysis of trade accounts receivables and books allowances for doubtful accounts receivables with similar exposure to credit risk, only.

In case Telefónica Deutschland Group has entered into foreign currency derivatives, all trades have been conducted with Telefónica Group treasury according to Telefónica Group policy only.

With regard to its cash surpluses Telefónica Deutschland Group has entered into cash pooling agreements and deposit agreements with TGB.V. according to Telefónica Group policy and places most of its cash surpluses with these institutions.

Thus, most of Telefónica Deutschland Group's cash surpluses will be concentrated in these companies belonging to Telefónica Group which is rated by international rating agencies with an investment grade rating. The remaining cash surplus is spread out over several German banks which are rated by international rating agencies with an investment grade rating.

Liquidity risk

Liquidity risk comprises the risk that a company is unable to meet its financial obligations that are settled by delivering cash or another financial asset. Telefónica Deutschland Group's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its obligations when due, under both normal and stressed conditions. Telefónica Deutschland Group manages its liquidity in close coordination with Telefónica Group and has entered into cash pooling agreements and deposit agreements with TGB.V., according to Telefónica Group policy and places most of its cash surpluses with these institutions. The cash inflows generated by Telefónica Deutschland Groups' operating business as well as the possibility of factoring receivables and maintaining credit facilities are used to reduce Telefónica Deutschland Group's liquidity risk.

Capital management

Telefónica Deutschland Group aims to ensure sustainability of the business and maximize the value to shareholders. Telefónica Deutschland Group monitors its cost of capital with a goal of optimizing its capital structure. Telefónica Deutschland Group monitors the equity ratio and the OIBDA.

For further information on risk management and financial instruments please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 19).

5.2. Risk management and risk reporting

Our business operations face different risks arising from the business, legal, financial and regulatory environment. We provide our services as a result of our own organizational, strategic and financial decisions, and provisions made.

Risks are inextricably linked to each business activity and can negatively affect the process of goal setting and goal achievement. They result from the cause-related uncertainty of future events – incomplete information being a regular occurrence – and represent the possibility of negative deviations from a specified target. If risks are not recognized and addressed, they can compromise the successful development of the company. In response, management has introduced and supports a risk management process that ensures prompt and complete risk transparency and evaluates changes to existing business risks.

The risk management process is an integral element of the decision making process at Telefónica Deutschland Group, assuring that risk assessments are considered in decision making and that measures to reduce and manage risks are taken at an early stage. Assessing, communicating and managing risk is one of the responsibilities of every manager at the company. The risk management is responsible for maintaining the company's risk register, which includes all subsidiaries. The risk manager is in constant contact with all areas throughout the organization and with designated risk coordinators in order to continuously track and assess risk, its management and evolution. Individual training is provided to those responsible and furthermore, basic trainings are available to all employees in order to strengthen overall risk management awareness.

Risks are evaluated to assess their impact on business goals, both from an operational and a financial perspective. The risk register is based on a database containing all individual risks identified, their status and defined action plans. A formal, proactive report on the risk register of Telefónica Deutschland and it subsidiaries' total risk exposure is submitted to the management board on a quarterly basis. The audit committee is periodically informed about the risks and their evolution.

5.3. The risks

Of all risks identified, the following section examines these risks that could materially affect our financial or competitive position or the ability to meet the set targets. Our business might be impacted by other or additional risks that we are currently not aware of or we did not consider being significant. For internal purposes risks are clustered into business, operational and financial risks.

Recessionary conditions in the Eurozone

The Eurozone debt crisis and general economic slowdown in parts of Europe from, among other factors, lower consumer confidence, decreasing gross domestic product, rising unemployment and uncertainty, may adversely impact macroeconomic conditions in Germany. As we operate exclusively in Germany, the success of our business is closely tied to the market environment and stability of the German economy and cannot be offset by developments in other markets (business risk).

Macroeconomic factors may impair growth prospects in the German telecommunications market in terms of the penetration of new value-added services and traffic, ARPU and number of customers and, in particular, the volume of business customers (business risk). Recessionary conditions may also increase the number of defaults and/or delays in payments from our customers, increase churn and prevent us from attracting new customers (business risk). Reduced German consumer spending, including telecommunications services and products, could adversely affect our number of customers and revenues as customers may no longer deem critical the services we offer (business risk).

Highly competitive markets and changes in customer demand

We operate in markets that are highly competitive and subject to constant technological development. Our company is facing increasing competition from alternative telecommunications providers such as cable providers, MVNOs and consumer electronic companies as well as from alternative telecommunication services such as Over the Top (OTT). To effectively compete with these providers we need to successfully market and deliver our products and services. We need to respond to both commercial actions by competitors and anticipate technological changes, changes in consumer preferences and general economic, political and social conditions (business risk). We have to maintain and further develop our direct and indirect distribution channels anticipating and meeting the expectations and preferences of our customers. Failure to do so appropriately could have a negative impact on our ability to attract and maintain customers and might influence our financial position, operating results and cash flow (operational risk).

Regulatory risks

Our business environment is a highly regulated market where decisions by the regulatory authorities may directly influence services, products, and prices (business risk).

Mobile termination rates have decreased across Europe in the last several years, with considerable reductions in Germany (cuts of over 50% since December 2010), and various related reviews of such rates and court proceedings on regulatory measures which are still pending. The European Commission intends to further reduce mobile and fixed termination rates significantly and has issued a recommendation on the calculation of such rates by the respective National Regulatory Authority (NRA), which must be fully applied by 2013. The Commission has also recommended that rate asymmetry between network operators be eliminated. As a result the decision of the German FNA is subject to an approval by the European Commission (notification procedure). As the German FNA still not fully complies with the recommendation, the procedure inherits the risk of changes to the preliminary decisions of the FNA. Additionally, third parties are allowed to comment and able to place proceedings against the decisions. FNA's preliminary decision MTRs from November 16, 2012, having decreased the prices since December 1, 2012, might respectively be changed by the European Commission or third party actions and even lower rates might be decided (business risk).

In 2013, ex-ante price regulation for fixed termination rates will be imposed on alternative operators including Telefónica Deutschland Group. It has already been decided that the lowest possible termination rate (the so called 'local rate') will be the same as the one for Deutsche Telekom AG. It is still open how the FNA will decide on the question, if different interconnection structures in comparison to Deutsche Telekom AG will lead to different rates and if the structure will vary from operator to operator. This may influence interconnection revenue streams in a negative or positive way. Currently it is not clear when exactly this regulation will start (business risk).

Other services with regulated prices in Europe include international call roaming, short message service ("SMS") and data services. The European Parliament and Council have approved the Roaming III regulation, which aims to set ceilings on tariffs for voice calls and SMS retail and wholesale services between July 2012 and July 2014, with subsequent further reductions. Roaming III also regulates retail and wholesale data roaming charges and lays down rules to increase pricing transparency and improve the provision of information on charges to roaming customers. From July 1, 2012 MVNOs have had the right to access other operators' networks at wholesale prices in order to provide roaming services. From July 2014, mobile network operators (MNOs) will be required to separate the sale of roaming services from their domestic services, enabling customers to choose a different network operator for calls made in other member states. Currently it is not foreseeable how the customers and the competitors will react to this situation. The products created might threaten our margins on roaming services (business risk).

Regulators could at any time adopt measures to lower roaming tariffs and mobile or fixed termination rates or require us to provide third-party access to our networks at reduced prices. Any future decreases of such tariffs and charges could have a material adverse effect on our business, financial condition and result of operations (business risk).

Licenses and frequencies

As our licenses and assigned frequency usage rights have finite terms, any inability to renew or obtain new licenses and frequency usage rights necessary for our business as well as significant changes in the financial conditions for their usage could adversely affect our operations (business risk).

Delayed approvals of microwave frequency usage rights applications by the FNA could materially adversely affect the performance and expansion of our mobile networks (business risk).

Technology operations

Sustained or repeated disruptions or damage to our wireless or wireline networks and technical systems may lead to the loss of customers or a decrease in revenues and require costly repairs (operational risk).

Other business risks

The telecommunication industry has been, and will continue to be, affected by rapid technological change. Our business success depends on our ability to anticipate and adapt to these changes and customer preferences. Wrong interpretations or decisions might impact the market acceptance of our products and prevent us from reaching our revenue or growth targets. This also relates to our ability to ensure the constant availability of handsets and smartphones as well as those handsets and smartphones being compatible with our mobile network. Constraints or prohibitions imposed on handset supplies or incompatibilities with our network could negatively affect our ability to achieve the expected customer and revenue growth (business risk).

A termination or failure to renew existing agreements or partnerships with MVNOs and branded resellers could damage our reputation and negatively impact our ability to diversify and grow our customer base (business risk).

Legal risks

We may be subject to claims that we infringe the intellectual property rights of others and may be unable to adequately protect our own intellectual property rights (operational risk). We collect and process subscriber and other personal data as part of our business. Undue use or leakage of such data could breach laws and regulations which could result in fines, loss of reputation and customer churn (operational risk).

Insurance

Despite having a risk management process in place there is always a remote risk that unexpected events may result in financial damages if provisions taken or our insurance coverage turns out to be insufficient (business risk).

Supplier failures

As a wireless and wireline telephony operator and provider of telecommunications services and products, we, like other companies in the industry, depend upon a small number of major suppliers (e.g. Deutsche Telekom AG) for essential products and services, mainly IT and network infrastructure. If these suppliers fail to deliver products and services to us on a timely basis, it could jeopardize network deployment and expansion plans, which might have an adverse impact on our business and the results of its operations (operational risk). The same applies if vendors we contract for outsourcing and out tasking projects for efficiency reasons do not deliver the services in time or in the quality needed (operational risk).

Financial risks

Our business is capital intensive and requires significant amounts of investments. We have implemented an extensive capital expenditure program that will continue to require significant expenses in the foreseeable future, including the maintenance and optimization of our wireless and wireline network as well as further investments in the High-Speed Package Access (HSPA) coverage and LTE technology. In addition, costs associated with frequency usage rights needed in order to operate our existing networks and technologies, and costs and rental expenses related to their deployment as well as costs associated with our wireline network, are a significant portion of our cost base and subject to increases (also partly a business risk). We believe that we will be able to meet our financial obligations for the next twelve months. Currently, we have negotiated favorable payment and delivery terms with our suppliers and have in place cash pooling arrangements and factoring agreements to support our working capital. However, there can be no assurance that such arrangements or agreements will be available in the future or on satisfactory terms. Furthermore, we may not be able to generate sufficient cash flows in the future to meet our capital expenditure needs. Therefore, we may require additional sources of working capital in connection with our continued growth, our strategy, market developments or the development of new technologies. Consequently, we may need to raise additional debt or equity financing in amounts that could be substantial. Our ability to raise additional capital to fund our operations can be further influenced by factors such as changing market interest rates, restrictive covenants in our debt instruments or negative changes in our credit rating or the credit rating of our majority shareholder. Future debt agreements we may enter into may include provisions restricting our ability to raise financing or to make certain business changes. Our exposure to the credit risks of our customers could also make it difficult for us to collect accounts receivables and thus impact our working capital position.

Like every company we are regularly subject to tax audits which may result in higher tax payments for previous periods if the authority does apply a dissenting opinion on interpretations and figures underlying our tax declaration. In 2012 Telefónica Germany Management GmbH and Telefónica Germany GmbH & Co. OHG filed a correction of the wage tax declaration for the period from January 2008 to October 2012 for employee benefits. The effects for wage tax, VAT as well as corporate income and trade tax require final agreement with the tax authorities. Since December 2012 both subsidiaries are subject to a wage tax audit for the periods January 2008 to October 2012. There are no findings yet from such audit.

5.4. The opportunities

Growth of the German market

Germany is one of Europe's largest telecommunications markets, with revenues from telecommunications services up 1.4% from EUR 47.9bn in 2011 to EUR 48.6bn in 2012. We believe our market position and size, serving approximately 25.4 million accesses as of December 31, 2012 (2011: 24.5 million), enable us to capitalize on the anticipated growth opportunities presented by one of Europe's largest telecommunications markets, in particular for wireless data services. Rising consumer spending in the German mobile telecommunication market is being driven partly by increased smartphone use and partly by digital trends. Germany holds significant market catch-up and growth potential for data, with a relatively low smartphone penetration of 45.7% (France: 50.5%, Sweden 57.5%, UK: 55.95%) and blended data ARPU of EUR 6.1 (France: EUR 10.9, Sweden: EUR 8.1, UK: EUR 10.2) in 2012 compared to other developed western European telecommunications markets.

(Source: Yankee Group Research Global ConnectedView Forecast December 2012)

Increasing smartphone penetration

Smartphones have been a phenomenal success and are likely to remain so in 2013. In 2012 we had a smartphone share of above 90% of total handset sales, resulting in rapid smartphone penetration growth. We expect wireless services growth to be our main growth driver over the next few years. We intend to maintain our strategic focus on the provision of wireless services to smartphone users who generally generate sustainable, above average ARPU. Our early focus on the wireless data area has already enabled us to successfully monetize data traffic growth. We believe there is significant growth potential in this area in Germany due to increasing smartphone penetration and a marked increase in the demand for newly developed digital media. We intend to leverage our large and growing smartphone customer base to monetize wireless data opportunities, as smartphone users are increasingly accessing the internet and a range of digital media through their devices.

Though generally concentrating on the postpaid market, we recently have seen market momentum especially in prepaid wireless data and believe there is a dynamic growth opportunity in this area. We intend to exploit this opportunity by further driving smartphone penetration and encouraging wireless data usage by continuing to provide attractive and competitive prepaid data offers, services and devices in line with the special needs of prepaid customers.

LTE impact

We believe that we have the right assets to participate in the future growth of the wireless data business. After having acquired additional spectrum, particularly in the 800 MHz band, we have started to build a next-generation network based on the new LTE technology. This investment will open the door to further opportunities in the data sector.

We see 2013 and 2014 as key years for our LTE rollout. We initially approached the German LTE market with a smart follower strategy, which allowed us to adjust investments to overall market development. As white spots have been covered, our aim is to focus the rollout of our LTE network in the most profitable areas. In 2013 we will also be able to employ much more targeted advertising/branding in terms of customers who are already educated about LTE and we will be able to focus on product marketing, distribution and selling.

In 2013 we will further accelerate the rollout of our LTE network and significantly increase the population coverage. We will continue to expand our LTE network in accordance with market demand, focusing on providing service in major cities, and have proven our ability to do so in the past. Our LTE strategy will also lead to CapEx savings in the mid-term as traffic can be offloaded from UMTS to LTE with increased LTE usage.

The highly improved user experience provided by LTE technology through maximum download speeds of up to 50 Mbit/s on the go, improved latency leading to short reaction times and fluent surfing as well as better indoor coverage through 800 MHz frequency gives us the opportunity to target quality oriented high value customers. With LTE becoming mass market in terms of demand and affordable devices in 2013 (expected 5.1 million registered LTE lines and 3.4 million LTE smartphones in use in Germany 2013) resulting in high commercial impact, we are positioning LTE within our premium O_2 tariffs at a higher than average price point to fully leverage the resulting benefits.

(Source: Yankee Group Research Global ConnectedView Forecast December 2012)

Network cooperation

In 2011 we signed an attractive backhaul sharing agreement with Deutsche Telekom GmbH. However, the agreement terms do not prevent us from reaching further network cooperation agreements. We are constantly exploring strategic cooperation scenarios, including in the field of network sharing. Even in case of a more comprehensive network sharing agreement in the access network, we will still be able to secure our competitive advantage by having exclusive access to the acquired LTE 800 MHz spectrum.

High-speed wireline offering – VDSL

Regulation enables competitors to access Deutsche Telekom GmbH's super-fast VDSL network. In recent years there has been a significant investment in VDSL network infrastructure, primarily by Deutsche Telekom GmbH, with its network coverage reaching 11 million households in 48 cities across Germany. In late 2012 we signed a long-term partnership with Deutsche Telekom GmbH, enabling us to utilize the VDSL contingent model and have a highly competitive high-speed wireline offering in addition to our successful wireless offer.

Demand for converged products

We anticipate customer demand for converged product offerings, and we therefore plan to continue to attract customers by maximizing the potential of bundled offerings. We believe that our convergence strategy will allow us to protect our growth in wireless services, increase the profitability of our wireline services and reduce churn.

Next generation sales and services

We intend to offer a truly simple, reliable and personalized customer experience across all touch points and channels. This will be realized by leveraging our customer insights more efficiently offering customers the products and services that suit their needs and allow them to seamlessly switch channels. Additionally, we will bring more service to our shops and sell more via our customer service channel, allowing us to use all existing touch points to generate additional revenue.

We are extending our online and eCare capacities in order to enable our customers to easily answer their questions and problems online on their own through various channels such as our web portal, mobile portal, help and support community, self-service and social media. To achieve this, we are strengthening our digital services within our retention, telesales and customer services teams and also increasing online facilities at our point of sales. Furthermore, we foster an internal mindset change towards a fundamental digital behavior. In order to support this we have developed a new multi-channel customer journey as a strategic guideline for interacting with our customers. This will not only lead to higher customer satisfaction but also minimize customer service costs.

Corporate segments and wholesale markets

We intend to raise customers' perception of our core O_2 brand as a business brand. Opportunities to gain market share among larger business customers include providing managed services, which we see as a key growth driver in the German telecommunications market. Such managed services include WAN and LAN and PBX management. We also intend to expand our product offerings to business customers to include selective cloud, security and IT consulting services. Through specialized and tailored service offerings to wholesale partners, we aim to increase revenues and improve margins. We offer an extensive portfolio of wireless and wireline services to our wholesale partners to enable them to service their end customers, which allows us to increase our reach and leverage scale.

Cloud-based business solution: Office Voice Cloud

In October 2012 Telefónica Germany GmbH & Co. OHG and nfon AG, a leading vendor of IP-Centrex telecommunication systems jointly launched the "Office Voice Cloud" for Telefónica Deutschland Group's business customers. This integrated and future-oriented solution enhances all business communications by perfectly combining wireline telephony with wireless communication. The offering consists of a cloud-based telephone system provided by nfon AG with integrated O_2 wireless service via a VPN-linkage. This enables users to access the cloud-based telephone system's features on the go via their mobile phone and employees are available on their office phone number during their international business travels. With this cooperative approach we aim to increase sales of our O_2 branded business wireless contracts and to position ourselves as a provider of converged cloud based business solutions in a dynamic growth market.

Digital innovation

In order to leverage our strong position in the German wireless services market and monetize additional growth opportunities, we either recently have launched or intend to launch several digital innovations in a variety of business areas such as communication (e.g. Joyn), financial services (e.g. mpass) and M2M (e.g. fleet management). These innovations have been or are primarily developed together with the Telefónica Digital division or by one of the many sponsored start-up companies at our Wayra academies. Telefónica Digital is a global business division of Telefónica Group. Its mission is to seize the opportunities within the digital world and deliver new growth for Telefónica Group.

Joyn

As a communications company, we want our customers to enjoy the latest communication products with no compromise on reliability, security and trust. Joyn – based on RCS (Rich Communication Services) technology – is a major play by the operator community to compete more effectively with the OTT players. It enables services such as enhanced messaging and voice, video calling and content sharing directly from the phone's contact book, regardless of the network or device used. Offering new features that will enrich and simplify our customers' lives, Joyn is the evolution of core Telco services. As a global initiative under the GSM Association, we will benefit from this newly created Telco ecosystem. The seamless integration within our core services and products gives us a competitive advantage compared to existing OTT services.

mpass

The German market will see an increased importance of mobile payment via smartphone (expected EUR 2bn transaction value through remote or proximity mobile payments in 2013). People will use their smartphones for mobile payment more and more as this gives them a safe and convenient way to make day-to-day payments.

With mpass, Telefónica Deutschland Group is the first German network provider to offer mobile payment in retail. Since October 2012 mpass-customers have been able to pay contactless via mobile phone in thousands of stores in Germany and abroad. A multi-level security system makes mpass safe and convenient. As more and more people own smartphones and shops install the infrastructure, mobile payment will become a huge trend in 2013. And mpass is just the first step: With "O_2 Wallet", which starts mid-February, we are offering a whole bundle of wireless financial services including person-to-person payments and a digital wallet.

(Source: Yankee Group Research Global ConnectedView Forecast December 2012)

M2M

The M2M market will see a positive trend (expected EUR 133m M2M revenue in Germany). Connectivity is becoming more and more a mere enabler and customer expectations are growing. To satisfy these expectations we have set up an end-to-end business model in close collaboration with Telefónica Digital, which has been very well received by our customers. Our M2M activities focus on a variety of different business segments such as vending machines/ point of sale, automation, mobility, energy and healthcare.

We have developed a customized time-tracking terminal geared to the needs of a leading personnel service provider, resulting in significant potential savings. At the moment we are preparing the international rollout. Furthermore, we are in the final development stage of a fleet management solution for one of the world's leading car rental service providers in close collaboration with M2M suppliers. To position ourselves in the very promising energy market, we established a competence center within our M2M unit that already develops and markets energy efficiency solutions for companies in collaboration with market-leading partners. The same holds true for the vertical markets automation and mobility.

(Source: Yankee Group Research Global ConnectedView Forecast December 2012)

With pay how you drive insurance telematics solutions Telefónica Deutschland Group is providing an end-to-end solution to car insurers, which enables them to offer a usage based insurance. Developed by Telefónica Digital, our telematics-based solutions to collect and analyze individual driving behavior open up a whole new range of possibilities for insurers to acquire new customers and improve customer engagement. With a volume of EUR 20.9bn in 2011, the car insurance market in Germany is currently undergoing a significant change triggered by technical developments such as telematics as well as by legal requirements such as the E-Call initiative. Telefónica Deutschland Group will enter this market in 2013 as part of its overarching M2M strategy for Germany.

(Source: ARS Marktreport 2012)

Wayra

Wayra is a Telefónica Digital initiative whose main aim is to identify talent and promote innovation in Latin America and Europe by supporting and accelerating digital business ideas from concept to reality. Its global project acceleration model helps to develop entrepreneurs, providing them with technological tools, qualified mentors, a cutting edge working space and the financing required to accelerate their growth.

With our direct investment in "early stage" companies in 2012, Telefónica Deutschland Group has once again proven its commitment to taking the first step in the area of venture capital. In a little over a year, Wayra has received more than 16,000 business proposals (nearly one per hour since Wayra launched operations) that feature the internet and technology as a driving force.

The Wayra portfolio of 178 sponsored companies covers fast-paced and high potential industries such as cloud computing, machine-to-machine, video or e-Learning, just to name a few. However, it also extends to emerging and disruptive sectors such as wearable technology, security and artificial intelligence.

In 2012, Telefónica Deutschland Group introduced its start-up-accelerator Wayra in Germany. During the six-week application period, 268 teams submitted their proposals. Seven start-ups were selected, who then moved into the new Munich Academy in fall. These innovative companies receive an investment of up to kEUR 50 in the form of a convertible note, have access to a large network of high-caliber mentors and experts both from within Telefónica Deutschland Group and the German entrepreneurial community and over 1000 square meters of creative co-working space in the heart of Munich's Kaufingerstrasse.

The launch of Wayra around the globe has generated a great deal of attention and interest, not only exposing Telefónica Deutschland Group to a great variety of new technologies, but also potentially opening up a world of 300 million customers to Wayra start-ups from Munich and around the world.

As reflected during the last Global demoDay held in the United States, nearly 90% of the start-ups have been launched or are in a beta phase, seven out of ten are already selling to customers and nearly one-third are already partnering with different Telefónica Group companies around the world.

Digital signage

In 2013, Telefónica Deutschland Group plans to introduce an out-of-the-box Digital Signage service addressing the yet untapped market segment of small retailers and small businesses. Overall we see a market potential of about 1 million businesses in this sector.

The innovative subscription-based offering will allow small businesses to create and display promotions and general information about their products and services in a professional fashion right at the point of sale. At the core of the service is a cloud-based easy-to-use content management system that does not require customers to have any previous or in-depth software experience. The offering will be complemented by a range of connected screens of various sizes, professional pre-configured content and optional content service packages.

Distribution of the service is planned through existing Telefónica Deutschland Group's sales channels and third-party aggregators.

6. Events after the reporting period

Rating

On January 16, 2013 the international rating agency FitchRatings, London assigned Telefónica Deutschland Holding AG an initial first long-term issuer default rating (IDR) of "BBB" with a stable outlook and a senior unsecured rating to Telefónica Germany GmbH & Co. OHG of "BBB".

7. Basics of compensation system

Compensation of management board members

Admission to trading on the Frankfurt Stock Exchange was granted to Telefónica Deutschland Holding AG on October 29, 2012 and the trading in the shares commenced on October 30, 2012. According to a shareholders' resolution adopted on October 5, 2012 and based on section 314 (2) s. 2 and section 286 (5) German Commercial Code (HGB), Telefónica Deutschland Holding AG does not disclose the additional information for listed stock corporations in accordance with section 314 (1) no. 6 lit. a) s. 5-8 German Commercial Code (HGB). In this chapter the basics of the compensation system of the management board is described except to this restriction.

The current service contracts of the members of the management board ("Vorstand") of Telefónica Deutschland Holding AG were concluded on September 18, 2012 and will each expire on September 17, 2015. Until September 26, 2012 they were – next to others – managing directors ("Geschäftsführer") of Telefónica Germany Verwaltungs GmbH (which was converted into Telefónica Deutschland Holding AG by resolution dated September 18, 2012 and registration ("Eintragung") with the Commercial Register on September 26, 2012). They were and are – next to others – also managing directors ("Geschäftsführer") of Telefónica Germany Management GmbH and received (until September 17, 2012) direct remuneration by Telefónica Germany Management GmbH, which is the managing shareholder ("geschäftsführender Gesellschafter") of Telefónica Germany GmbH & Co. OHG and became a legal subsidiary of Telefónica Deutschland Holding AG in September 2012. The aggregate compensation pursuant to section 314 (1) no. 6 lit. a) German Commercial Code (HGB), which was granted to the management of Telefónica Germany Verwaltungs GmbH, now Telefónica Deutschland Holding AG, by Telefónica Germany Management GmbH and Telefónica Deutschland Holding AG for the year ended December 31, 2012, amounted to kEUR 6,876 and to kEUR 8,725 for the year ended December 31, 2011, respectively.

Such aggregate compensation for the period ended December 31, 2012 includes the remuneration granted for nine other, former managing directors of Telefónica Germany Verwaltungs GmbH who ceased to be managing directors ("Geschäftsführer") before the conversion of Telefónica Germany Verwaltungs GmbH into Telefónica Deutschland Holding AG.

Included in the above total remuneration for the period ended December 31, 2012 is a total compensation of kEUR 822 granted to the members of the management board ("Vorstand") of Telefónica Deutschland Holding AG for the period after the conversion.

Total compensation to the management board consists of fixed salary, cash bonus, long-term incentives, company car, life and accident insurance, pension supplements and monetary benefit of i. a. disturbance and accommodation allowances, compensation of costs of UK national insurance, relocation, home leave flights, school fees and employer expenses, tax equilization and exchange rate loss. Such benefits are not granted to each member of the management board. For more information please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 12).

The compensation of the members of the management board consists of a fixed portion and a variable portion.

The fixed portion consists of the fixed annual salary, which is paid in twelve equal monthly installments, and monetary benefits mentioned above. The members of the management board receive either a pension allowance equal to 20% of the fixed component of his or her remuneration or a pension commitment.

Since November 1, 2012, the variable portion of the compensation consists of three variable, performance-based components.

1. The first variable component of the compensation is an annual cash bonus ("Bonus I"). Bonus I is calculated according to the formula target bonus x business performance x personal performance. The target bonus is determined as a percentage of the fixed annual salary.

For the company or business performance in general six parameters (operating revenue, OIBDA, Operating Cash Flow, market share, customer satisfaction and employee satisfaction) are determinative, for which the targets and weighting are set annually by the supervisory board. For the business performance factor the respective result of the telecommunications segment* of Telefónica Deutschland Group for the relevant parameter is weighted at 70%. The remaining 30% are divided equally between the respective results of Telefónica Europe and Telefónica Group. If less than 50% of the respective goals are reached the value for the factor business performance is 0% (knock-out). In the event of target attainment it amounts to 100% and if the target is exceeded there is a cap at 125%. Intermediate values of the target achievement are not interpolated linearly but rather on the basis of a pay-out curve set by the supervisory board.

* The telecommunications segment represents the continuing operations of Telefónica Deutschland Group.

To determine the personal performance for each member of the management board personal goals are set by the supervisory board annually at the beginning of the year. After the end of the year the target attainment is reviewed and the supervisory board ranks the members of the management board in one of five performer classes to which respectively ranges of target achievement percentages are allocated and it assigns a certain percentage value to each member of the management board. Here the knock-out threshold is also 50%. The personal performance is capped at 150%.

2. The second variable component of the compensation is the participation in the Performance and Investment Plan 2011, which was adopted by the general meeting of Teleónica S.A. in 2011 ("PIP").

Under the PIP a certain number of Performance Shares is offered as award to each member of the management board with the consent of the supervisory board. The number of Performance Shares is calculated by dividing an amount equivalent to a percentage of the fixed annual salary of the respective board member by the average share price of Telefónica S.A. ("Core Award"). After three years the Performance Shares give rise to the entitlement to acquire (free of charge) the corresponding number of shares of Telefónica S.A., if the individual remains employed by a Telefónica S.A. Group company at the end of such period and the change in share price of Telefónica S.A.'s shares over the vesting period aggregated with dividends paid on such shares during such period (the "Total Shareholder Return S.A.") is at least equal to the median total share return reflected in a benchmark index of global telecommunications companies. 30% of the awarded shares will vest if the Total Shareholder Return S.A. equals the median performance of such companies. The amount of vested shares equals 100% if the Total Shareholder Return S.A. is in the upper quartile of the benchmark index. If the Total Shareholder Return S.A. is between the upper quartile and median, the awarded shares are calculated on a linearly proportionate basis. If the Total Shareholder Return S.A. is below the median of the benchmark index, the awarded shares do not vest and will lapse.

In addition to this Core Award there is an Enhanced Award which requires members of the management board to acquire a certain number of shares of Telefónica S.A. at his or her own expense. The own investment is limited to 25% of the Performance Shares offered as Core Award. If the targets relating to the Total Shareholder Return S.A. are reached, the member of the management board receives shares of Telefónica S.A. corresponding to 30% rsp. 100% of the shares acquired with own funds. The number of such granted shares is 25% of the Core Award.

For more information please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 26).

3. The third variable component is a deferred cash bonus ("Bonus II"). In order to avoid an excessive incentive through the PIP and thus too strong incentives to pursue corporate group targets, the Bonus II exists. Here an amount equalizing to a percentage of the fixed annual salary is offered as an award to each member of the management board. The board member is entitled to this amount in full after a period of three years if the Total Shareholder Return ("TSR") of Telefónica Deutschland Holding AG is in the upper quartile of the TSR of the peer group composed of the DAX 30 companies and in the amount of 50% of the award if the TSR of Telefónica Deutschland Holding AG is at the median of the peer group. If the TSR of Telefónica Deutschland Holding AG is between the upper quartile and median, the Bonus II is calculated on a linear proportionate basis. If Telefónica Deutschland Holding AG is below the median, no entitlement to payment arises.

From September 18, 2012 until October 31, 2012 the variable portion was based on two variable, performance-based components.

1. The first variable component was a cash bonus. It was construed and calculated in the same manner as the Bonus I.

2. The second variable component was the participation in the PIP 2011 (tranche 2012), however, the amounts of the Core Award and the Enhanced Award were higher. In order to comply with section 87 (1) German Stock Corporation Act after the listing of Telefónica Deutschland Holding AG those Awards were reduced by approximately 50% and the Bonus II was added to the compensation system as second long term incentive.

Until September 17, 2012 the variable portion of the remuneration was composed of a cash bonus, construed and calculated in the same manner as the Bonus I and the participation in various share and investment plans.

1. Performance Share Plan 2006 of Telefónica S.A. (tranche 2009), pursuant to which shares in Telefónica S.A. were awarded to members of the management board in 2009 depending on the achievement of certain targets, and subject to a three year vesting period ended in 2012. Conditions for vesting include: the individual remains employed by a Telefónica S.A. Group company at the end of such period; and the change in share price of Telefónica S.A.'s shares over the vesting period aggregated with dividends paid on such shares during such period (the "Total Shareholder Return S.A.") is at least equal to the median total share return reflected in a benchmark index of global telecommunications companies. 30% of the awarded shares will vest if the Total Shareholder Return S.A. equals the median performance of such companies. The amount of vested shares increases on a sliding scale, up to 100% if the Total Shareholder Return S.A. is in the upper quartile of the benchmark index. If the Total Shareholder Return S.A. is between the upper quartile and median, the awarded shares are calculated on a linear proportionate basis. If the Total Shareholder Return S.A. is below the median of the benchmark index, the awarded shares do not vest and will lapse.

2. Performance Share Plan 2006 of Telefónica S.A. (tranche 2010), pursuant to which shares in Telefónica S.A. were awarded to members of the management board in 2010 depending on the achievement of certain targets and subject to a three year vesting period ending in 2013. The award and vesting criteria are the same as the Performance Share Plan 2006.

For more information regarding the Performance Share Plan 2006 please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 26).

3. Performance and Investment Plan 2011 (tranche 2011), pursuant to which shares in Telefónica S.A. were granted to members of the management board in 2011 depending on the achievement of certain targets and subject to a three year vesting period ending in 2014. The award and vesting criteria are the same as the Performance Share Plan 2006, subject to an optional co-investment right. This option allows a member of the management board to receive an additional award in the amount of 25% of the awarded shares, if such member holds a number of shares in his or her account at the end of the vesting period equal to 25% of the awarded shares.

4. Performance and Investment Plan 2011 (tranche 2012), pursuant to which shares in Telefónica S.A. were granted to members of the management board in 2012 depending on the achievement of certain targets, and subject to a three year vesting period ending in 2015. The award and vesting criteria are the same as the Performance Share Plan 2006, subject to an optional co-investment right. This option allows a member of the management board to receive an additional award in the amount of 25% of the awarded shares, if such member holds a number of shares in his or her account at the end of the vesting period equal to 25% of the awarded shares.

For more information regarding the Performance and Investment Plan 2011 please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 26).

5. A Global Employee Share plan of Telefónica S.A from 2010, pursuant to which the members of the management board, will, if they purchase shares in Telefónica S.A. with a minimum value of EUR 300 and a maximum value of EUR 1,200 in the first year, receive a matching number of shares as a benefit, if they hold these shares for one more year and if the individual remains employed by a Telefónica Group company at the end of the plan. Matching shares had been released in 2012.

6. A Global Employee Share plan of Telefónica S.A. from 2012, pursuant to which all employees, also the members of the management board, will, if they purchase shares in Telefónica S.A. with a minimum value of EUR 300 and a maximum value of EUR 1,200 in the first year, receive a matching number of shares as a benefit if they hold these shares for one more year and if the individual remains employed by a Telefónica Group company at the end of the plan. Matching shares will be released in 2014.

For more information regarding the Global Employee Share Plans please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 26).

The members of the management board receive either a pension allowance equal to 20% of the fixed component of his or her remuneration or a pension commitment.

Compensation of supervisory board members

Pursuant to the articles of association, the members of the supervisory board receive a fixed compensation payable after the end of the fiscal year in the amount of EUR 20,000 per annum. The chairperson of the supervisory board will receive EUR 80,000 and the deputy chairperson EUR 40,000. The chairperson of the audit committee will additionally receive EUR 50,000 unless the chairperson of the supervisory board or his deputy chair this committee. Members of the supervisory board who hold their office in the supervisory board or who hold the office as chairperson or chairperson of a committee only during a part of the fiscal year will receive a corresponding portion of the compensation to be determined pro rata temporis.

In addition to the compensation the company will reimburse the members of the supervisory board for their out-of-pocket expenses incurred in the performance of their duties as supervisory board members as well as the value-added tax on their compensation and out-of-pocket expenses, if applicable.

All current members of the supervisory board also working for Telefónica S.A. or Telefonica Europe plc. waived for their compensation of their current term of office to the extent that such claims exceed an amount of EUR 2,000 per year. The two former members of the supervisory board who held office as members of the supervisory board only for a short period of time received a remuneration pro rata temporis, together in the amount of EUR 1,935. The independent financial expert within the meaning of section 100 (5) of the German Stock Corporation Act (AktG) received an amount of EUR 17,000 for his pro-rata activity since October 5, 2012. No remuneration was paid for services provided personally beyond the aforementioned board and committee activities, in particular for advisory or agency services.

For more information please refer to the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 (Note 12).

8. Internal control and risk management system related to the process of group accounting

The risk management and internal control system related to Telefónica Deutschland Group accounting is an integral element of the overall risk management process and reports and tasks intermesh with it extensively.

Under the given corporate governance the accounting related internal control system ("ICS") of Telefónica Deutschland Group is designed in a way to meet both the provisions of statutory requirements such as section 107 (3) sentence 2 of the German Stock Corporation Act (AktG) and section 243 (1) of the German Commercial

Code (HGB) to ensure appropriate accounting. The accounting related ICS aims to ensure that the Consolidated Financial Statements of Telefónica Deutschland Group are prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union (EU), as well as the regulations under the commercial law as set forth in section 315a (1) of the HGB. Furthermore, the preparation of annual financial statements of Telefónica Deutschland Holding AG in accordance with German GAAP is another objective of our accounting related ICS. Acknowledging the obligations of its majority shareholder under the Sarbanes-Oxley Act (SOX), released in the U.S. in 2002 deriving from the listing with the "U.S. Securities and Exchange Commission" (SEC) also affecting subsidiaries, Telefónica Deutschland Group is ensuring compliance with SOX requirements.

The audit committee of Telefónica Deutschland Holding AG supervises the effectiveness of the Internal Control System as required by section 107 (3) sentence 2 of the AktG leaving the definition of precise scope and structure to the discretion of the management board.

The internal audit department is assigned the responsibility of performing independent reviews on the effectiveness and efficiency of the ICS within all subsidiaries. In order to fulfill its tasks, Internal Audit is granted unlimited audit, information and access rights. At least twice a year an opinion on the effectiveness of the SOX-relevant controls, covering currently among others some 95% of our total revenue and expenses, is reported to the CEO and CFO of Telefónica Deutschland.

The internal control system embraces both the complete set of processes relevant for the accounting process as well as those supporting the IT systems. With regard to the IT systems, especially IT security, change management and operations are controlled. The main pillars of the control systems are the employment of sufficient qualified and continuously trained professionals, strict observance of a four-eyes-principle wherever necessary and a clear segregation of duties to meet the objectives of the ICS such as ensuring the correctness and completeness of the individual and Consolidated Financial Statement.

The accounting process follows a set of accounting principles and is communicated to all relevant entities and departments, ensuring a group-wide homogeneous approach. All subsidiary accounting is further handled either by or in close cooperation with Telefónica Germany GmbH & Co. OHG. In order to ensure the identification of risks at an early stage, financial reporting occurs on a monthly basis. Under the SOX (section 302) activity additionally a quarterly reporting of financial indicators is compiled, making transparent and assessing the reasons for major changes in the most relevant accounts.

Identified failures, weaknesses or improvement possibilities are addressed to the respective owner with action plans that are the object for follow-up activities by Internal Audit in order to further enhance the effectiveness and efficiency of the ICS.

9. Other declarations

9.1. Report on relations with affiliated companies

Telefónica Deutschland Holding AG was a directly dependent company in the sense of section 312 of the German Stock Corporation Act of Telefónica Germany Holdings Limited, Slough, United Kingdom, during the period from September 26 to December 31, 2012. Furthermore, Telefónica Deutschland Holding AG was an indirectly dependent company in the sense of section 312 of the German Stock Corporation Act (AktG) of O2 (Europe) Limited, Slough, United Kingdom and of Telefónica S.A., Madrid, Spain. Neither a domination agreement nor a profit and loss pooling agreement is in place.

Therefore, the management board of Telefónica Deutschland Holding AG drew up a report on its relations to related parties in accordance with section 312 (1) of the AktG. This report contains the following final conclusion:

"Our company has, with respect to the legal transactions and measures reported in the report on related party transactions, according to the circumstances known to us at the time of entering into the legal transaction or undertaking or refraining from a measure, received adequate compensation in all legal transactions and has not been disadvantaged by undertaking or refraining from such measures."

9.2. Management Declaration in accordance with section 289a of the HGB

The company has published this declaration which also comprises the Declaration of Compliance under section 161 of the AktG on its website (www.telefonica.de) and in the category "Corporate Governance / Declaration of Compliance" in the annual report. This Management Declaration in accordance with section 289a of the HGB shall form part of this management report.

9.3. Takeover-related disclosures pursuant to section 315 (4) and section 289 (4) of the HGB

Composition of subscribed capital

The registered share capital of Telefónica Deutschland Holding AG totals EUR 1,116,945,400. It is divided into 1,116,945,400 registered shares with no-par value, each representing a notional amount of EUR 1.00 of the registered share capital ("shares"). The registered share capital is fully paid in. As of December 31, 2012 and when compiling this management report Telefónica Deutschland Holding AG did not hold any treasury shares. Pursuant to section 6 (2) of the articles of association, shareholders' claims to the issuance of individual share certificates are in principle excluded. Each share confers one vote at the general shareholders' meeting. The shares are freely transferable.

Restriction on voting rights or transfer of shares

There are no restrictions on voting rights. We are not aware of any contractual agreements with Telefónica Deutschland Holding AG or other agreements restricting voting rights or the transfer of shares. Apart from the statutory law on insider-related issues, there are no internal governance provisions implementing further lock-up periods for management board members or employees with regard to the purchase and sale of shares linked to the publication of quarterly and annual results.

Restrictions on voting rights pursuant, inter alia, to section 136 of the German Stock Corporation Act may exist.

Shareholdings in share capital exceeding 10% of voting rights

Telefónica Germany Holdings Limited, Slough, United Kingdom, holds more than 75% of the shares in Telefónica Deutschland Holding AG; thereby Telefónica Germany Holdings Limited holds more than 75% of the voting rights. Via Telefónica Germany Holdings Limited both O2 (Europe) Limited, Slough, United Kingdom, and Telefónica S.A., Madrid, Spain, hold indirectly more than 75% of shares in Telefónica Deutschland Holding AG. Beyond that we have not been notified of, and are not aware of, any shareholdings in the share capital of Telefónica Deutschland Holding AG exceeding 10% of the voting rights.

Shares with special rights

There are no shares bearing special rights. In particular there are no shares with rights conferring powers of control.

Voting right control if employees have a share in the capital

Like all other shareholders, employees who hold shares in Telefónica Deutschland Holding AG exercise their control rights directly in accordance with statutory provisions and the articles of association.

Management board members‘ appointment and dismissal

Pursuant to section 7 of the articles of association and section 84 of the AktG the supervisory board is responsible for determining the number of management board members, for their appointment and dismissal as well as for the appointment of the chief executive officer (CEO). Deputy members of the management board may be appointed. Currently the management board of Telefónica Deutschland Holding AG comprises the CEO as well as two further members. Management board members are appointed by the supervisory board for a maximum period of five years. Such appointment may be renewed and the terms of office may be extended, provided that no term exceeds five years. The supervisory board may revoke the appointment of an individual member of the management board or CEO for good cause, such as gross negligence of duties or a vote of no-confidence by shareholders at the general meeting.

Telefónica Deutschland Holding AG is subject to the regulations of the German Co-Determination Act (Mitbestimmungsgesetz – MitbestG). The election of employees’ representatives to the supervisory board has not yet taken place, which is why the supervisory board of Telefónica Deutschland Holding AG at present is made up of only six members elected at the general shareholders’ meeting. Pursuant to section 31 of the MitbestG, the appointment of management board members and also their dismissal require a majority of at least two-thirds of the supervisory board members. If such majority is not established in the first vote by the supervisory board, upon proposal of the mediation committee, which has to be established according to section 27 (3) of the MitbestG, the appointment or dismissal may be made in a vote with a simple majority of the votes cast by the supervisory board members. Should the required majority not be established in this case either, a third vote, again requiring a simple majority, must be held in which, however, the chair of the supervisory board has two votes.

Furthermore, the local court in Munich shall in accordance with section 85 (1) of the AktG in urgent cases make the necessary appointment upon application by any party involved, if the management board does not have the required number of members.

Amendments to the articles of association

Pursuant to section 179 (1) sentence 1 of the AktG the articles of association of Telefónica Deutschland Holding AG may in principal only be amended by a resolution passed at the general shareholders’ meeting. Pursuant to section 27 of the articles of association in conjunction with section 179 (2) sentence 2 of the AktG the general meeting of Telefónica Deutschland in principle resolves upon amendments to the articles of association with a simple majority of votes cast and with a simple majority of the nominal capital represented when passing the resolution. If mandatory legal provisions stipulate a larger majority of voting rights or capital, such provisions shall apply. When it comes to amendments solely relating to the wording, the supervisory board is, however, authorized to make these modifications in accordance with section 179 (1) sentence 2 of the AktG in conjunction with section 17 (3) of the articles of association.

Authorization of the management board to issue shares

The authorizations of the management board are regulated by section 76 et seq. of the AktG in conjunction with section 8 et seq. of the articles of association. In particular, the management board is responsible for managing the company and for representing the company judicially and extra-judicially.

The authorization of the management board to issue shares is regulated by section 4 of the articles of association and by statutory provisions:

Authorized Capital
Until September 17, 2017 and subject to the approval of the supervisory board, the management board is authorized to increase the registered share capital of the company on one or more occasions by a total amount of up to EUR 558,472,700, by issuing up to 558,472,700 new non-par value registered shares against contribution in cash and/or in kind (Authorized Capital 2012/I). The authorization provides that the subscription right of the shareholders, however, may be excluded in total or in part in certain situations (section 4 (3) of the articles of association).

Contingent Capital
By resolution at the general meeting of October 5, 2012 the management board has been authorized until October 4, 2017 and subject to the approval of the supervisory board to, on one or more occasions, issue convertible bonds, warrant bonds, profit participation rights and/or participating bonds (and/or combinations of such instruments) (together "bonds") in bearer and/or registered form with or without limited maturity in an aggregate nominal value of up to EUR 1,500,000,000 and to grant and/or impose on the holders or creditors of bonds conversion or option rights to shares in the company representing a total notional amount in the share capital of up to EUR 558,472,700 (in words: five hundred fifty-eight million four hundred and seventy-two thousand and seven hundred Euro), subject to the more detailed terms and conditions of issue of such bonds. Shareholders shall in principle be granted a right to subscribe for the bonds. The authorization provides that subject to the approval of the supervisory board, the subscription right of the shareholders can, however, be excluded
a) for fractional amounts; furthermore
b) provided that the issue price is not substantially lower than the market value of the bonds with conversion and/or option rights or option obligation and the shares issued or to be issued in order to satisfy the conversion and option rights or conversion obligation do not exceed in total 10% of the share capital;
c) to the extent profit participation rights or participating bonds are issued without conversion rights or obligations or an option right, provided the interest rate and the issue price of the profit participation rights or participating bonds correspond at the date of issue to current market values; and
d) to the extent the bonds are issued in written form contributions in kind for the purpose of directly or indirectly acquiring companies, parts of companies, participations in companies or other assets and the value of the contribution in kind is reasonably proportionate to the value of the bonds.

For the purpose of granting non-par value shares in registered form to holders or creditors of bonds the share capital of the company is increased conditionally by up to EUR 558,472,700 by issuing up to 558,472,700 new non-par value shares in registered form ("Contingent Capital 2012/I")

Authorization of the management board to repurchase shares

The authorizations of the management board to repurchase own shares are governed by section 57 (1) sentence 2 and section 71 et seq. of the AktG. An authorization of the management board by the shareholders at the general shareholder's meeting according to section 71 (1) no. 8 of the AktG to repurchase own shares does not exist.

Change of control/Compensation agreements

Material agreements entered into by Telefónica Deutschland Holding AG containing a change-of-control clause relate to financing. In the case of a change of control, these agreements, in accordance with common practice, entitle the parties to terminate the agreement followed by the settlement of outstanding obligations.

The employment contracts of the members of the management board grant the right to terminate with three-month notice their respective employment contracts with Telefónica Deutschland Holding AG in the event of a takeover offer by a third party, provided however that such termination is declared within six months after a change of control. In such case the respective board member is entitled to a one-time compensation of an annual salary plus the recently received bonus; however, no more than the compensation payable up to the end of the contract.

10. Outlook for Telefónica Deutschland Group

10.1. Economic outlook for Germany

Germany's economy is expected to continue to grow in 2013 (GDP growth of around 0.7% in 2013). According to Germany's GfK research company, income expectations, willingness to buy and consumer climate for 2013 remain at a constant high level. Stable labor market data, a positive overall trend in wages and salaries and modest inflation reinforce the indications. Furthermore, the interest rate in Germany is still well below the level of inflation, which means that consumers think it is prudent to spend their money on major purchases rather than saving.

(Source: Federal Statistical Office, FocusEconomics Consensus Forecast Euro Area, February 2013; GfK Consumer climate press release, January 2013)

10.2. Market expectations

Market development in Germany, one of Europe's largest telecommunications markets, will continue to be driven by wireless business, strongly benefitting from wireless data due to increased adoption of wireless data devices such as smartphones and tablets. This trend will be reinforced in 2013 with the deployment of LTE networks. Mobile voice, which still accounts for the majority of r evenues in the wireless market, will be affected by mobile termination rate cuts. Increasing demand for speed in both mobile and fixed networks with strong demand from German consumers for convergent solutions will also be an additional market driver.

(Source: Company data)

10.3. Expectations for Telefónica Deutschland Group

Our strategy will remain focused around gaining scale in the telecommunications market, driven by our innovative multi-brand approach based on data services. We expect the German telecommunication market to remain active and competitive in 2013 and 2014, with significant impacts from mobile termination rate cuts, changing customers' communication behaviors, and the variability of device launches and replacement cycles.

We see the introduction of the LTE technology in mobile networks as one of our drivers for future revenues and performance during 2013 and 2014, with timing of impacts depending on the uptake of new LTE-centric devices in the German market.

As a challenger in the market we are, of course, impacted by the variability of these diverging trends. Thus, our goal for long term success is to maintain a consistent focus on gaining service revenue market share in our core wireless business and achieve further efficiencies of scale.

For the financial years 2013 and 2014, we aim to continue outperforming the German wireless market and increase our wireless service revenue market share. Our wireline business is not expected to be a driver of growth for us within the next two years but will strengthen our wireless business through converged product offerings. Total wireline revenues are expected to decline. As a result, we would expect to see total revenue trends to be more or less stable. The development of revenues will depend on the variability of the above mentioned factors.

In the past periods, we have implemented a series of cost saving measures that, paired with strong revenue performance, has helped us to improve our margins. In the financial years 2013 and 2014, we aim for our OIBDA margin to sustain this trend on the back of scale effects and efficiency improvements, driven by our focus on market share expansion.

In terms of investments, we consider 2013 and 2014 as being key years for our LTE network roll-out. However, we do not expect capital expenditures to exceed the levels reached in 2010 (EUR 680m) when we were rolling out 3G capacity. Thereafter, we expect CapEx to decline to lower levels again. Future investments to be made by the group will be funded by operating cash flow generation of the business. We like to point out that actual results may differ significantly from our expectations due to uncertainties, or if the assumptions underlying the forward-looking information prove to be inappropriate.

We have a clearly stated financing policy to support a strongly funded and stable statement of financial position, aiming to maintain the leverage ratio (defined as Net Financial Debt divided by last twelve month OIBDA excluding non-recurring factors) below 1.0x for the financial years 2013 and 2014.

Munich, February 28, 2013

Telefónica Deutschland Holding AG
The management board

René Schuster   Rachel Empey   Markus Haas

Consolidated Financial Statements

for the year ended December 31, 2012

Consolidated Statement of Financial Position

Euros in thousands

Assets	Note	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
A) Non-current assets		**7,652,337**	**7,996,891**	**8,535,864**
Goodwill	7	705,576	705,576	705,576
Intangible assets	6	3,277,456	3,662,491	3,964,196
Property, plant and equipment	8	2,973,440	3,119,370	3,348,972
Investments in associates	9	–	1,972	1,771
Other non-current financial assets	16	114,675	95,449	102,839
Deferred tax assets	21	581,191	412,033	412,510
B) Current assets		**1,417,469**	**5,657,420**	**4,672,670**
Inventories		84,671	70,428	84,317
Trade and other receivables	13	1,009,031	1,349,290	1,394,462
Other current financial assets	16	101	2,887,051	2,885,897
Cash and cash equivalents	14	323,666	1,350,651	307,995
Total assets (A+B)		**9,069,807**	**13,654,311**	**13,208,534**

Equity and Liabilities	Note	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
A) Equity	**15**	**6,428,793**	**12,282,644**	**11,736,109**
Common stock		1,116,946	1,116,946	1,116,946
Additional paid-in capital		430	–	18,078,540
Retained earnings		5,309,936	11,164,353	(7,463,506)
Other components of equity		1,481	1,345	1,192
Equity attributable to owners of the company		**6,428,793**	**12,282,644**	**11,733,172**
Non-controlling interests		–	–	2,937
B) Non-current liabilities		**1,091,576**	**75,289**	**122,621**
Non-current interest-bearing debt	16	1,000,000	–	–
Other payables	17	9,193	6,342	5,846
Non-current provisions	18	82,382	68,947	116,775
C) Current liabilities		**1,549,438**	**1,296,378**	**1,349,804**
Current interest-bearing debt	16	250,878	–	–
Trade payables	17	918,458	891,321	822,831
Other payables	17	219,130	188,747	207,624
Other current financial liabilities	16	–	4,836	–
Current provisions	18	7,000	41,609	182,429
Deferred income	17	153,972	169,866	136,920
Total equity and liabilities (A+B+C)		**9,069,807**	**13,654,311**	**13,208,534**

Consolidated Income Statement

Euros in thousands

	Note	January - December 2012	January - December 2011	January - December Delta	January - December Delta %
Revenues	22	5,212,838	5,035,552	177,286	3.5%
Other income	22	60,806	60,991	(185)	(0.3%)
Supplies		(2,130,869)	(2,047,139)	(83,730)	4.1%
Personnel expenses	29	(464,533)	(437,756)	(26,778)	6.1%
Other expenses	22	(1,399,169)	(1,462,411)	63,242	(4.3%)
Operating income before depreciation and amortization (OIBDA)		**1,279,074**	**1,149,237**	**129,835**	**11.3%**
Depreciation and amortization	22	(1,133,183)	(1,082,189)	(50,994)	4.7%
Operating income		**145,891**	**67,048**	**78,841**	**>100%**
Finance income	20	15,678	14,271	1,407	9.9%
Exchange gains	20	715	707	8	1.2%
Finance costs	20	(21,385)	(8,389)	(12,996)	>100%
Exchange losses	20	(1,132)	(559)	(573)	>100%
Net financial income (expense)		**(6,123)**	**6,030**	**(12,153)**	**>100%**
Profit before tax from continuing operations		**139,768**	**73,078**	**66,688**	**91.3%**
Income tax	21	167,756	(1,732)	169,488	>100%
Profit for the year from continuing operations		**307,523**	**71,346**	**236,176**	**>100%**
Profit after taxes from discontinued operations	5	1,027,030	482,557	544,473	>100%
Total profit for the year		**1,334,553**	**553,904**	**780,649**	**>100%**
Profit for the year attributable to owners of the parent		**1,334,553**	**553,904**	**780,649**	**>100%**
Profit for the year		**1,334,553**	**553,904**	**780,649**	**>100%**
Earnings per share	**25**				
Basic earnings per share in EUR		**1.20**	**0.49**	**0.71**	**>100%**
- from continuing operations		0.28	0.06	0.22	>100%
- from discontinued operations		0.92	0.43	0.49	>100%
Diluted earnings per share in EUR		**1.20**	**0.49**	**0.71**	**>100%**
- from continuing operations		0.28	0.06	0.22	>100%
- from discontinued operations		0.92	0.43	0.49	>100%

Consolidated Statement of Comprehensive Income

Euros in thousands

	Note	January - December 2012	2011
Profit for the year		**1,334,553**	**553,904**
Other comprehensive income (loss)			
Gains on measurement of available-for-sale investments	16	199	225
Income tax impact		(63)	(72)
		136	153
Actuarial gains (losses) and impact of limit on assets for defined benefit pension plans	18	(3,882)	(4,352)
Income tax impact		1,490	1,327
		(2,392)	(3,025)
Total other comprehensive income (loss)		**(2,256)**	**(2,871)**
Total comprehensive income		**1,332,297**	**551,033**
Attributable to:			
Equity owners of the parent		**1,332,297**	**551,033**
Total comprehensive income		**1,332,297**	**551,033**

Consolidated Statement of Cash Flows

Euros in thousands

	January - December	
	2012	2011
Cash Flow from Operating Activities		
Profit for the year	**1,334,553**	**553,904**
Adjustments to profit		
Net financial result	5,707	(5,882)
Gains on disposal of assets	(492,121)	(272)
Net income tax expense	(167,756)	1,732
Depreciation and amortization	1,135,751	1,086,997
Change in Working Capital		
Trade and other receivables	(40,172)	45,172
Inventories	(14,272)	13,889
Other current assets	(5,594)	(7,855)
Trade and other payables	(105,573)	42,243
Other current liabilities and provisions	(25,126)	(103,038)
Other non-current assets and liabilities	4,681	(44,766)
Interest received	15,615	13,934
Interest paid	(13,871)	(1,351)
Total Cash Flow from Operating Activities	**1,631,823**	**1,594,707**
Cash Flow from Operating Activities from discontinued operations	**349,070**	**355,006**
Cash Flow from Operating Activities from continuing operations	**1,282,754**	**1,239,701**
Cash Flow from Investing Activities		
Proceeds on disposals of property, plant and equipment and intangible assets	1,978	3,185
Payments on investments in property, plant and equipment and intangible assets	(594,120)	(548,240)
Proceeds on disposals of companies, net of cash and cash equivalents disposed	557,446	–
Payments made on financial investments not included under cash equivalents	(14,930)	–
Total Cash Flow from Investing Activities	**(49,626)**	**(545,055)**
Cash Flow from Investing Activities from discontinued operations	**557,170**	**(952)**
Cash Flow from Investing Activities from continuing operations	**(606,797)**	**(544,104)**
Cash Flow from Financing Activities		
Acquisition of non-controlling interests	–	(3,006)
Repayment of capital reserves	(251)	(237)
Proceeds from borrowing/debt	2,398,060	–
Repayment of borrowing/debt	(706,991)	(3,752)
Dividends paid	(4,300,000)	–
Total Cash Flow from Financing Activities	**(2,609,182)**	**(6,995)**
Cash Flow from Financing Activities from discontinued operations	**445,060**	**(3,006)**
Cash Flow from Financing Activities from continuing operations	**(3,054,242)**	**(3,989)**
Net increase (decrease) in cash and cash equivalents	**(1,026,985)**	**1,042,656**
Cash and cash equivalents at beginning of period	**1,350,651**	**307,995**
Cash and cash equivalents at end of period	**323,666**	**1,350,651**

Consolidated Statements of Changes in Equity

Financial position as of January 1, 2011
Profit for the year
Other comprehensive income (loss)
Total comprehensive income
Acquisitions of non-controlling interests
Withdrawal from capital reserve
Other movements
Financial position as of December 31, 2011
Financial position as of January 1, 2012
Profit for the year
Other comprehensive income (loss)
Total comprehensive income
Dividends
Contribution in kind
Other movements
Financial position as of December 31, 2012

Euros in thousands

Common stock	Additional paid-in capital	Retained earnings	Other components of equity: Available-for-sale investments	Total equity attributable to owners of the company	Non-controlling interests	Total equity
1,116,946	**18,078,540**	**(7,463,506)**	**1,192**	**11,733,172**	**2,937**	**11,736,109**
–	–	553,904	–	553,904	–	553,904
–	–	(3,025)	153	(2,872)	–	(2,872)
–	**–**	**550,879**	**153**	**551,032**	**–**	**551,032**
–	–	(69)	–	(69)	(2,937)	(3,006)
–	(18,078,540)	18,078,540	–	–	–	–
–	–	(1,492)	–	(1,492)	–	(1,492)
1,116,946	**–**	**11,164,353**	**1,345**	**12,282,644**	**–**	**12,282,644**
1,116,946	**–**	**11,164,353**	**1,345**	**12,282,644**	**–**	**12,282,644**
–	–	1,334,553	–	1,334,553	–	1,334,553
–	–	(2,392)	136	(2,256)	–	(2,256)
–	**–**	**1,332,162**	**136**	**1,332,297**	**–**	**1,332,297**
–	–	(7,185,897)	–	(7,185,897)	–	(7,185,897)
–	430	(430)	–	–	–	–
–	–	(251)	–	(251)	–	(251)
1,116,946	**430**	**5,309,936**	**1,481**	**6,428,793**	**–**	**6,428,793**

Notes to the Consolidated Financial Statements

for the year ended December 31, 2012

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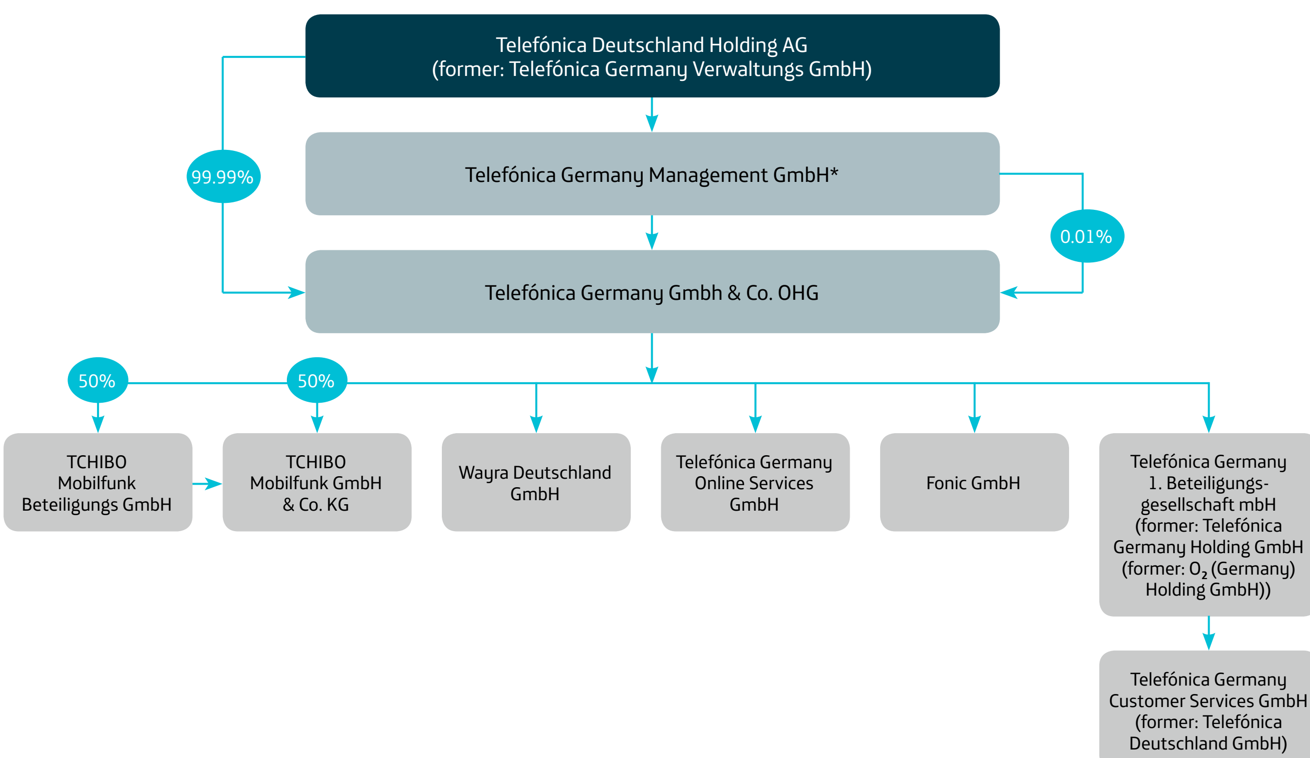
1. Reporting Entity

Telefónica Deutschland Holding AG (hereafter "Telefónica Deutschland"; formerly "Telefónica Germany Verwaltungs GmbH" prior to September 26, 2012) is located in Germany, Georg-Brauchle-Ring 23-25, 80992 München.

In 2012 Telefónica Deutschland applied for admission of its entire share capital, consisting of 1,116,945,400 shares, to trading on the regulated market of the Frankfurt Stock Exchange as well as on the sub-segment of the regulated market with additional post-admission obligations (Prime Standard). The admission to trading on the Frankfurt Stock Exchange was granted on October 29, 2012 and the trading in the shares commenced on October 30, 2012. Telefónica Germany Holdings Limited, an indirect wholly owned subsidiary of Telefónica S.A., Madrid, Spain ("Telefónica"; together with its direct and indirect subsidiaries as well as its investments in associates and jointly controlled entities excluding Telefónica Deutschland Group referred to as the "Telefónica Group"), is the major shareholder of Telefónica Deutschland, holding a total share of 76.83%. The remaining 23.17% of the shares are widely spread.

The Consolidated Financial Statements of Telefónica Deutschland as at and for the year ended December 31, 2012 comprise Telefónica Deutschland and its subsidiaries as well as interests in associates and jointly controlled entities (together referred to as the "Telefónica Deutschland Group" or "TDG" or "Group").

As of December 31, 2012 the legal entities included in the Consolidated Financial Statements of Telefónica Deutschland Group are organized as illustrated in organizational chart below.



* Telefónica Germany Management GmbH has been acquired during the year 2012 within a common control transaction. Please refer to section 3 b) for accounting policies applied.

In the first nine months of 2012 and during the whole financial year 2011 Telefónica Deutschland Group consisted of two reportable segments according to IFRS 8 (see Note 4 “Segment Information”):

- Telecommunications
- Global Services

The entities of the reportable segment “Global Services” (comprising Telefónica Global Services GmbH (“TGS”), Telefónica Global Roaming GmbH (“TGR”), Telefónica Compras Electronicas S.L., and the 40% interest in Adquira España S.A.) as well as Group 3G UMTS Holding GmbH (“G3G”) and Quam GmbH (“Quam”) have been sold as of October 1, 2012.

All shares of these companies were held by Telefónica Global Activities Holdings B.V. (former Telefónica Chile Holding B.V.). Prior to the IPO, Telefónica Deutschland Holding AG sold all shares in Telefónica Global Activities Holdings B.V. to Telfisa Global B.V., a Telefónica Group entity. After the sale, Telefónica Global Activities Holdings B.V. and all of the aforementioned entities ceased to be members of the group.

Telefónica Deutschland Group is one of only three integrated network operators in Germany having both a wireline and wireless network. It offers its consumer retail and business customers post-paid and prepaid wireless communications products, along with wireless data services using Global Packet Radio Service (“GPRS”), Universal Mobile Telecommunications System (“UMTS”) and Long Term Evolution (“LTE”) technology as well as Digital Subscriber Line (“DSL”) wireline telephony and high-speed internet services.

Telefónica Deutschland Group markets their products under a multi-brand strategy and offers the majority of its post-paid and pre-paid mobile and fixed-line products and services through their core premium O_2 brand. The group accesses additional customer groups through secondary and partner brands as well as wholesale channels. Secondary brands are fully controlled brands such as FONIC and netzclub or brands held through joint ventures and strategic partnerships such as Tchibo mobil and Türk Telekom Mobile. The group markets high-speed internet access and fixed-line telephony via DSL (under the standards ADSL2+ and VDSL) and targets the Small offices/Home offices (SoHo) and Small and Medium-sized Enterprise (SME) business customers through the O_2 brand, and large, national companies and multinational corporations through the Telefónica Multinational Solutions brand. In the wholesale service business, the group offers mobile and fixed-line services to customers such as 1&1, mobilcom/debitel, Drillisch and the two major German cable operators. The products are offered through a diversified distribution platform comprising direct (nationwide network of self-operated shops and O_2 partner shops, premium partners, online and telesales) and indirect (retail/e-retail partnerships and dealers/cooperations) sales channels.

Telefónica Deutschland Group is incorporated in the Consolidated Financial Statements of its ultimate parent, Telefónica S.A. Madrid, Spain, as of December 31, 2012.

2. Basis of Preparation

Statement of compliance
The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) with the exception of certain provisions under IFRS 1 with respect to the transition date of January 1, 2011. These are the Group’s first Consolidated Financial Statements prepared in accordance with IFRSs and as a consequence IFRS 1 First-time Adoption of International Financial Reporting Standards has been applied.

The Consolidated Financial Statements were authorized for issue by the management board of Telefónica Deutschland Holding AG on February 28, 2013.

Basis of measurement

The Group has applied IFRS 1.D16 (b), as the Group was acquired after Telefónica's date of transition to IFRS. However, the accounting principles used by Telefónica Deutschland Group for the preparation of its Consolidated Financial Statements do not differ from those used in the preparation of the financial information for the Telefónica Consolidated Financial Statements in accordance with IFRS as adopted by the EU with the exception of certain provisions under IFRS 1 with respect to the transition date of January 1, 2011. The Consolidated Financial Statements have been prepared by measuring assets and liabilities at the carrying amounts, based on the Telefónica Deutschland Group's date of transition to IFRS. No previous Consolidated local GAAP accounts were prepared, thus no transition is presented in accordance with IFRS 1. The Consolidated Financial Statements have been prepared on a historical cost basis, except for derivative financial instruments and available-for-sale financial assets that have been measured at fair value.

Estimates

The Consolidated Financial Statements present assets and liabilities as presented in the authorized Consolidated Financial Statements of Telefónica for the years ended December 31, 2012 and 2011 as well as comparative information as of January 1, 2011 prepared under IFRS as adopted by the EU. Estimates in accordance with IFRS used in preparation of Telefónica's Consolidated Financial Statements, remain unchanged for purposes of preparation of the Consolidated Financial Statements of Telefónica Deutschland Group. Circumstances which provide new information to past events but have arisen subsequent to the respective reporting dates are not adjusted for. If estimates contain an error, the error is corrected to appropriately reflect the situation at the respective date.

Functional and presentation currency

These Consolidated Financial Statements are presented in Euro, which is the Telefónica Deutschland Group's functional currency. The Euro ("EUR" or "€") is the functional currency of all Telefónica Deutschland Group companies.

Other

The Consolidated Statement of Financial Position is structured in current and non-current in accordance with IAS 1. The Consolidated Income Statement is presented in accordance with the nature of expense method. The figures in these Consolidated Financial Statements are expressed in thousands of Euros, unless otherwise indicated, and therefore rounded to three decimal places. Due to rounding differences figures might deviate by one thousand Euros.

3. Accounting Policies

The principal accounting policies used in preparing the accompanying Consolidated Financial Statements are as follows:

a) Foreign currency transactions

Monetary transactions denominated in foreign currencies are translated to Euros at the exchange rates prevailing on the transaction date. Monetary assets and liabilities in foreign currency are translated at the closing rate at the date of the Statement of Financial Position.

The following exchange rates have been used at the respective year ends:

	As of December 31,		As of January 1,
Euro/Foreign Currency	2012	2011	2011
USD	1.319	1.294	1.328
GBP	0.816	0.835	0.860
BRL	2.703	2.427	2.218
CHF	1.207	1.216	1.250

All realized and unrealized exchange gains or losses are included in the Consolidated Income Statement.

b) Goodwill

- For business combinations occurring from January 1, 2010, the effective date of Revised IFRS 3, Business Combinations, goodwill represents the excess of acquisition cost over the fair values of identifiable assets acquired and liabilities assumed at the acquisition date. Acquisition date is the date on which control is transferred to Telefónica Deutschland Group. Cost of acquisition is the sum of the fair value of consideration delivered and the value attributed to existing non-controlling interests. For each business combination, Telefónica Deutschland Group determines the value of non-controlling interests at either their fair value or their proportional part of the net identifiable assets acquired. After initial measurement, goodwill is carried at cost, less any accumulated impairment losses. Whenever an equity interest is held in the acquiree prior to the business combination (business combinations achieved in stages), the carrying value of such previously held equity interest is remeasured at its acquisition-date fair value and the resulting gain or loss, if any, is recognized in profit or loss. Transaction costs in connection with business combinations are expensed as incurred.

- For business combinations that occurred after January 1, 2004, the IFRS transition date, and prior to January 1, 2010, the effective date of Revised IFRS 3, Business Combinations, goodwill represents the excess of the acquisition cost over the acquirer's interest, at acquisition date, in the fair values of identifiable assets, liabilities and contingent liabilities of an acquired subsidiary or joint venture. After initial measurement, goodwill is carried at cost, less any accumulated impairment losses.

In all cases, goodwill is recognized as an asset denominated in the currency of the company acquired.

Goodwill is not amortized but tested for impairment annually or more frequently if there are certain events or changes indicating the possibility that the carrying amount may not be fully recoverable (see Note 7 "Goodwill").

Business combinations involving entities under common control are excluded from the scope of IFRS 3, as a result the group uses predecessor accounting by incorporating predecessor carrying values. Furthermore, the date of transaction under common control is accelerated to the start of the earliest period presented even if the transaction occurs part of the way during the year.

c) Intangible assets

Intangible assets are carried at acquisition or production cost, less any accumulated amortization or any accumulated impairment losses. Subsequent expenditure is capitalized only when it increases the future economic benefit embodied in the asset to which it relates. All other expenditure on internally generated goodwill and brands is recognized in profit or loss as incurred.

The useful lives of intangible assets either finite or indefinite are assessed individually. Telefónica Deutschland Group has not recognized intangible assets with indefinite useful lives. Intangible assets with finite lives are amortized systematically over the useful economic life and assessed for impairment whenever events or changes indicate that their carrying amount may not be recoverable. Intangible assets with indefinite useful lives are not amortized, but are tested for impairment annually, or more frequently in the event of indications that their carrying amount may not be recoverable (see Note 6 “Intangible Assets”). Intangible assets that have not been completed yet are subject to an impairment test in the event of indications that their carrying amount may not be recoverable.

Useful lives, amortization methods and residual values are revised annually at year end and, where appropriate, adjusted prospectively.

Service concession arrangements and licenses

Such arrangements relate to the acquisition cost of the licenses granted to Telefónica Deutschland Group by the public authorities to provide telecommunications services and to the value allocated to licenses held by certain companies at the time they were included in Telefónica Deutschland Group.

These concessions are amortized on a straight-line basis over the duration of related licenses from the moment commercial operation begins.

Other intangible assets

This item primarily represents the allocation of acquisition costs attributable to customers acquired in business combinations, as well as the acquisition value of this type of assets in a third-party transaction for good and valuable consideration. Amortization is on a straight-line basis over the estimated period of the customer relationship (10 years).

Software

Software, including self-generated software, is carried at cost and amortized on a straight-line basis over its useful life, generally estimated to be between two and five years.

d) Property, plant and equipment

Property, plant and equipment are carried at cost less any accumulated depreciation and any accumulated impairment in value. Land is not depreciated.

Cost includes external and internal costs comprising warehouse materials used, direct labor used in installation work and the allocable portion of the indirect costs required for the related investment. The latter two items are recorded as revenues under “Other income – Own work capitalized”. Cost includes, where appropriate, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which the entity incurs either when the item is acquired or as a consequence of having used it.

The costs of expansion, modernization or improvement leading to increased productivity, capacity, and efficiency or to a lengthening of the useful lives of assets are capitalized when recognition requirements are met.

Upkeep and maintenance costs are expensed as incurred.

If an asset consists of multiple components with different useful lives, each part of the asset having a significant acquisition value is depreciated separately over the term of the useful life of the individual component (component approach).

Telefónica Deutschland Group assesses the need to write down, if appropriate, the carrying amount of each item of property, plant and equipment to its recoverable amount, whenever there are indications that the asset's carrying amount exceeds the higher of its fair value less costs to sell or its value in use. The impairment charge is reversed if the factors giving rise to the impairment disappear (see Note 3 e) "Impairment of property, plant and equipment, goodwill and intangible assets").

Telefónica Deutschland Group depreciates its property, plant and equipment, net of its residual values, once they are in full working condition using the straight-line method based on the assets' estimated useful lives, calculated in accordance with technical studies which are revised periodically based on technological advances and the rate of dismantling, as follows:

	Years of estimated useful life
Buildings	5 - 20
Plant and machinery (incl. telephone installations, networks and subscriber equipment)	5 - 20
Furniture, tools and other items	2 - 10

Assets' estimated residual values and methods and depreciation periods are reviewed, and adjusted if appropriate, prospectively at each financial year end.

e) Impairment of property, plant and equipment, goodwill and intangible assets

Non-current assets, including property, plant and equipment, goodwill and intangible assets are evaluated at each reporting date for indications of impairment losses. Wherever such indications exist, or in the case of assets which are subject to an annual impairment test, the recoverable amount is estimated. An asset's recoverable amount is the higher of fair value less costs to sell and value in use.

In assessing fair value less costs to sell, the estimated future cash flows deriving from the asset or its cash generating unit, as applicable, are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

When the carrying amount of an asset exceeds its recoverable amount, the asset is considered to be impaired. In this case, the carrying amount is written down to the recoverable amount and the resulting loss is recognized in the Consolidated Income Statement. Future depreciation or amortization charges are adjusted for the asset's new carrying amount over its remaining useful life. Each asset is individually assessed, unless the asset does not generate cash inflows that are largely independent of those from other assets.

The impairment test is constituted at the lowest level, at which goodwill is monitored for internal management purposes. This is the segment level for the respective cash generating unit. Telefónica

Deutschland Group has two segments. The potential impairment loss regarding goodwill is determined by assessing the recoverable amount of the cash generating unit (or group of cash-generating units) to which the goodwill relates when originated. If this recoverable amount is less than the carrying amount, an irreversible impairment loss is recognized in profit and loss. If the impairment loss recognized for the cash generating unit exceeds the carrying amount of the allocated goodwill, the additional amount of the impairment loss is recognized through the pro-rata reduction of the carrying amounts of the assets allocated to the cash generating unit.

As of December 31, 2012 Telefónica Deutschland Group comprises one single cash generating unit, which represents the reportable segment Telecommunications. Until September 30, 2012, Telefónica Deutschland Group comprised two cash generating units, which represented the reportable segments Telecommunications and Global Services.

Telefónica Deutschland Group determines the recoverable amount of a cash generating unit on the basis of fair value less costs to sell. Value in use is not calculated unless the impairment charge is impending. Since there is no evidence of a binding sale agreement in an arm's length transaction or an observable market price in an actively traded market, the entity relies on a discounted cashflow approach to measure fair value less costs to sell. These calculations use cash flow projections based on the business plan covering a 3-year detail planning period followed by the terminal value. The business plan has been approved by the management as well as used for internal purposes and is based on wireless service revenue growth projections as well as improving OIBDA margins in line with Company's aim to outperform the German mobile market in the medium term. Free Cash flows beyond the detail planning horizon are extrapolated using a steady state growth rate of 0.5%. The growth rates are in line with market expectations, e.g. analyst reports of investment banks.

The applied pre-tax discount rate is obtained from weighted average cost of capital calculations (WACC) following a peer group approach.

The following pre-tax discount rates were taken as a basis:

Discount rates	2012	2011	2010
Pre-tax discount rates	7.59%	8.00%	7.63%

Telefónica Deutschland Group bases its WACC calculations on the average financing costs and debt/market capitalization ratios of the Group's major competitors.

The annual impairment testing took place in June 2012. The result of the impairment test was that no impairment charges need to be recorded as the carrying amount is lower than the fair value less costs to sell. Since no triggering events existed, an additional testing was not carried out on the reporting date.

Telefónica Deutschland Group conducted a scenario analysis concerning the key value drivers capital expenditure to revenue ratio and OIBDA margin to determine sensitivity. Within a reasonable range a change in key assumptions would not cause the carrying amount to exceed the recoverable amount. In addition, sensitivity analyses were performed on changes reasonably expected to occur in the primary valuation variables, and the recoverable amount remained above the net carrying amount.

When there are new events or changes in circumstances that indicate that a previously recognized impairment loss no longer exists or has been decreased, a new estimate of the asset's recoverable amount is made. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case, the carrying amount of the asset is increased to its recoverable amount.

The reversal is limited to the net carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in profit or loss and the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount. Impairment losses relating to goodwill shall not be reversed in future periods.

f) Lease contracts

The determination of whether an arrangement is, or contains a lease is based on the substance of the agreement and requires an assessment of whether the fulfillment of the arrangement is dependent on the use of a specific asset and the agreement conveys a right to Telefónica Deutschland Group to use the asset.

Leases where the lessor does not transfer substantially all the risks and rewards of ownership of the asset are classified as operating leases. Operating lease payments are recognized as an expense in the Consolidated Income Statement on a straight-line basis over the lease term.

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards incidental to ownership of the leased item to Telefónica Deutschland Group. These are classified at the inception of the lease, in accordance with its nature and the associated liability, at the lower of the present value of the minimum lease payments or the fair value of the leased property. Lease payments are apportioned between finance costs and reduction of the principal of lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance costs are reflected in the Consolidated Income Statement over the lease term.

In sale and leaseback transactions resulting in a finance lease, the asset sold is not derecognized and the capital received is considered financing for the asset during the lease term. However, when the sale and leaseback transaction results in an operating lease, and it is clear that both the transaction and subsequent lease income are established at fair value, the asset is derecognized and any gain or loss generated on the transaction is recognized.

g) Investments in joint ventures

Telefónica Deutschland Group's investments in companies over which it exercises joint control with third parties are accounted for using the proportionate consolidation. Therefore, the Consolidated Financial Statements include the share of the assets that Telefónica Deutschland Group jointly controls and the share of the liabilities which are incurred in the course of pursuing the joint operation. The Consolidated Statement of Comprehensive Income includes the expenses that Telefónica Deutschland Group incurs and its share of the income that it earns from the joint operation.

Telefónica Deutschland Group combines its share of each of the assets, liabilities, income and expenses of the jointly controlled entity with the similar items, line by line, in its Consolidated Financial Statements.

h) Investments in associates

The Telefónica Deutschland Group's investments in companies over which it exercises significant influence but does not control or jointly control with third parties are accounted for using the equity method. The Group evaluates whether it exercises significant influence not only on the basis of its percentage ownership but also on the existence of qualitative factors such as representation on the board of directors of the investee, its participation in decision-making processes, interchange of managerial personnel and access to technical information.

The carrying amount of investments in associates includes related goodwill and the Consolidated Income Statement reflects the share of profit or loss from operations of the associate. If the associate recognizes any gains or losses directly in equity, the Group also recognizes the corresponding portion of these gains or losses directly in its own equity. The Group assesses the existence of indicators of impairment of the investment in each associate at each reporting date in order to recognize any required valuation adjustments.

i) Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments in the form of financial assets and financial liabilities are generally presented separately. Financial instruments are recognized as soon as Telefónica Deutschland Group becomes a party to the contractual provisions of the financial instrument. All regular way purchases and sales of financial assets are recognized in the statement of financial position on the trade date, i.e. the date that Telefónica Deutschland Group commits to purchase or sell the financial asset. Upon initial recognition, financial instruments are measured at fair value. Transaction costs directly attributable to acquisition or issuance are considered in determining the carrying amount if the financial instruments are not measured at fair value through profit or loss.

For the purpose of subsequent measurement, financial instruments are allocated to the categories "Financial assets at fair value through profit or loss", "Loans and receivables", "Available-for-sale financial assets", "Financial liabilities measured at amortized cost" as well as "Financial liabilities at fair value through profit or loss". Telefónica Deutschland Group does not allocate financial instruments to the category "held to maturity".

Financial Assets

Financial assets primarily comprise receivables from Telefónica Group, trade receivables, receivables from banks and cash and cash equivalents.

Financial assets at fair value through profit or loss
Financial assets held for trading are included in the category financial assets at fair value through profit or loss and presented as current or non-current assets, depending on their maturity. Derivatives are classified as held for trading. Financial instruments included in this category are recorded at fair value and are remeasured at subsequent reporting dates at fair value, with any realized or unrealized gains or losses recognized in the Consolidated Income Statement.

Loans and receivables
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, such as financial receivables from Telefónica Group or trade receivables. After initial recognition, loans and receivables are subsequently carried at amortized cost using the effective interest method less any impairment losses. Gains and losses are recognized in the Consolidated Income Statement when the loans and receivables are derecognized or impaired. Interest effects on the application of the effective interest method are also recognized in profit or loss.

Cash and cash equivalents
Cash and cash equivalents consist primarily of receivables from cash pooling agreements with Telfisa Global B.V., Netherlands, and Telefónica Finanzas S.A., Spain, receivables from banks with an original term of up to three months and cash on hand. Cash and cash equivalents correspond with the classification in the Consolidated Statement of Cash Flows.

Available-for-sale financial assets
Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale or that are not classified in any of the preceding categories. This category comprises assets incurred by Telefónica Deutschland Group to meet its pension obligations but which do not qualify as plan assets under IAS 19.

After initial measurement, available-for-sale financial assets are measured at fair value, with unrealized gains or losses being recognized in other comprehensive income. If objective evidence of impairment exists, these changes are recognized in the Consolidated Income Statement. Upon disposal of financial assets, the accumulated gains and losses recognized in other comprehensive income/loss resulting from measurement at fair value are recognized in profit or loss.

Impairment of financial assets

At each reporting date, the carrying amounts of financial assets other than those to be measured at fair value through profit or loss are assessed to determine whether there is objective evidence of impairment. Objective evidence may exist for example if a debtor faces serious financial difficulties or is unwilling to pay.

For financial assets classified as available for sale, objective evidence for impairment exists if there is a significant (> 20%) or prolonged decline (over a 6 months-period) in the fair value of the instrument.

Loans and receivables
The amount of the impairment loss on loans and receivables is measured as the difference between the carrying amount of the asset and the present value of expected future cash flows (excluding expected future credit losses that have not been incurred), discounted at the original effective interest rate of the financial asset. The amount of the impairment loss is recognized in the Consolidated Income Statement. If, in a subsequent reporting period, the amount of the impairment loss decreases and the decrease can be attributed objectively to an event occurring after the impairment was recognized, the impairment loss recorded in prior periods is reversed and recognized in the Consolidated Income Statement. Impairment losses on loans and receivables (e.g. trade receivables) are recorded using allowance accounts. When receivables are assessed as uncollectible, the impaired asset is derecognized.

Available-for-sale financial assets
If an available-for-sale financial asset is impaired, the difference between its cost (less any principal payment and amortization) and its current fair value (less any impairment loss previously recognized in the Income Statement) is reclassified from the statement of comprehensive income to the Consolidated Income Statement. Reversals with respect to equity instruments classified as available-for-sale are recognized in the statement of comprehensive income. Reversals of impairment losses on debt instruments are recorded in the Consolidated Income Statement if the increase in fair value of the instrument can be objectively attributed to an event occurring after the impairment losses were recognized in the Consolidated Income Statement.

Financial liabilities

Financial liabilities primarily include trade payables, loans, other payables and derivative financial liabilities.

Financial liabilities at fair value through profit or loss.
Financial liabilities held for trading are included in the category financial assets at fair value through profit or loss and presented as current or non-current assets, depending on their maturity. Derivatives are classified as held for trading. Financial instruments included in this category are recorded at fair value and are remeasured at subsequent reporting dates at fair value, with any realized or unrealized gains or losses recognized in the Consolidated Income Statement.

Financial liabilities measured at amortized cost

After initial recognition, financial liabilities are subsequently measured at amortized cost using the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period to the net carrying amount on initial recognition. Interest expense is recognized on an effective interest basis.

Derivative financial instruments

Generally, Telefónica Deutschland Group uses derivative financial instruments only to manage foreign currency risks. For material identified foreign currency risks, derivatives are contracted with Telefónica Group treasury. Derivative financial instruments are measured at fair value upon initial recognition and at each subsequent reporting date. The fair value of listed derivatives is equal to their positive or negative market value. If a market value is not available, fair value is calculated using standard financial valuation models such as discounted cash flow or option pricing models. Derivatives are presented as assets if their fair value is positive and as liabilities if the fair value is negative. Changes in the fair value of derivative financial instruments are recognized periodically in the Consolidated Income Statement. Telefónica Deutschland Group does not apply hedge accounting as set out in IAS 39.

Derecognition of financial assets and liabilities

Financial assets are derecognized when the rights to receive cash flows from the assets expire or the financial assets are transferred and Telefónica Deutschland Group has transferred substantially all the risks and rewards of ownership of the financial assets. On derecognition of a financial asset, the difference between the asset´s carrying amount and the sum of the consideration received and receivable and the cumulative gain or loss that had been recognized in the statement of comprehensive income is recognized in the total comprehensive income. If Telefónica Deutschland Group retains substantially all the risks and rewards of ownership of a transferred asset, Telefónica Deutschland Group continues to recognize the financial asset and recognize a collateralized borrowing for proceeds received. If Telefónica Deutschland Group does not retain or transfer substantially all risks and rewards, and retains control, it continues to recognize the transferred asset to the extent of its continuing involvement. Financial liabilities are derecognized when the obligation specified in the relevant contract is discharged, cancelled or expired. The difference between the carrying amount of the financial liability derecognized and the consideration paid and payable is recognized in profit or loss.

j) Inventories

Inventories for consumption and replacement are stated at the lower of cost and net realizable value. Cost is determined on the basis of weighted average cost and comprises direct materials and where applicable, direct labor cost and overhead that has been incurred in bringing the inventory to its present location and condition. The estimates of net realizable value are based on the most reliable evidence available at the time estimates are made of the amount the inventories are expected to realize. These estimates take into consideration the fluctuations of price or costs and the purpose for which the inventory is held.

Obsolete, defective or slow-moving inventories have been written down to estimated net realizable value. When the circumstances that previously caused inventories to be written down no longer exist, the amount of the write-down is reversed, so that the new carrying amount is the lower of cost and revised net realizable value.

k) Provisions

Pensions and other employee benefit obligations

Provisions required to cover the accrued liability for defined benefit pension plans are determined using “the projected unit credit” actuarial valuation method. The calculation is based on demographic and financial assumptions for the country considering the macroeconomic environment. The discount rates are determined based on market yield curves. Plan assets are measured at fair value. Actuarial gains and losses on post-employment defined benefit plans are recognized immediately in other comprehensive income and all expenses related to defined benefit plans in personnel expenses. For defined contribution pension plans, the obligations are limited to the payment of the contributions, which are recognized to the Consolidated Income Statement as occurred.

The measurement of a net defined benefit asset is limited to the lower of the surplus in the defined benefit plan and the asset ceiling. Asset ceiling is defined as “the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan”.

In accordance with the terms and conditions of the defined benefit plan contracts relating to companies where asset ceiling had to be considered, it has been determined, that the present value of economic benefits (available in the form of refunds from the plan or reductions in future contributions to the plan) is lower than the total fair value of plan assets less the total present value of the liability. This calculation has been separately conducted for every plan. As a result, a limitation of the defined benefit asset has been necessary for those companies.

In cases where asset ceiling has not been relevant, it has been determined, that the present value of economic benefits (available in the form of refunds from the plan or reductions in future contributions to the plan) is higher than the total fair value of plan assets less the total present value of the liability. This calculation has been separately conducted for every plan.

Provisions for other post-employment benefits (e.g. early retirement or other) are calculated individually based on the terms agreed with the employees.

Other provisions

Provisions are recognized when Telefónica Deutschland Group has a present obligation (legal or constructive), as a result of a past event that can be estimated reliably and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. If the effect of the time value of money is material, provisions are discounted, and the corresponding increase in the provision due to the passage of time is recognized as interest expense. When Telefónica Deutschland Group expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset, but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the Consolidated Income Statement net of any reimbursement.

Provisions for restructuring are recognized if there is a detailed, formal plan that provides for the individual measures and has been adopted by the appropriate managing bodies. In addition, implementation is expected to begin as soon as possible and a valid expectation has been raised in those affected that the restructuring will be carried out.

Provisions for decommissioning, retirement and site reconditioning costs are recognized if Telefónica Deutschland Group has a legal or constructive obligation to dismantle the relevant items after their utilization. The estimated costs are recognized as an asset and a provision. Changes in the timing or estimation of the costs are reflected in the asset and in the provision, respectively.

l) Share-based payments

The Group has compensation systems linked to the market value of Telefónica's shares, providing employees share options. Certain compensation plans are cash-settled, while others are equity-settled.

For cash-settled share-based transactions, the total cost of the rights granted is recognized as an expense in the Consolidated Income Statement over the vesting period with recognition of a corresponding liability. The total cost of the options is measured initially at fair value at the grant date using statistical techniques, taking into account the terms and conditions established in each share option plan. At each subsequent reporting date, the Group reviews its estimate of fair value and the number of options expected to be settled, remeasuring the liability, with changes in fair value recognized in the Income Statement.

For equity-settled share option plans, fair value at the grant date is measured by applying statistical techniques or using benchmark securities. The cost is recognized, together with a corresponding increase in equity, over the vesting period. At each subsequent reporting date, the company reviews its estimate of the number of options it expects to vest, with a corresponding adjustment to equity.

m) Income tax

The income tax expense includes both current and deferred taxes. Current and deferred tax is recognized in the Consolidated Income Statement except to the extent that it relates to a business combination or items directly recognized in equity or in other comprehensive income.

Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are applicable by the reporting date.

Telefónica Deutschland Group determines deferred tax assets and liabilities by applying the tax rates that will be effective when the corresponding asset is received or the liability is settled, based on tax rates and tax laws that are enacted (or substantively enacted) at the reporting date.

Deferred tax assets and liabilities are not discounted to present value and are classified as non-current, irrespective of the date of their reversal.

The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilized. Unrecognized deferred tax assets are reassessed at each reporting date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax liabilities on investments in subsidiaries, branches, associates and joint ventures are not recognized if the parent company is in a position to control the timing of the reversal and if the reversal is unlikely to take place in the foreseeable future.

Deferred income tax relating to items directly recognized in equity is recognized in equity. Deferred tax assets and liabilities arising from the initial recognition of the purchase price allocation of business combinations impact the amount of goodwill. However, subsequent changes in tax assets acquired in a business combination are recognized as an adjustment to profit or loss.

Deferred tax assets and liabilities are offset if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

n) Revenues and expenses

Revenues and expenses are recognized on the Consolidated Income Statement based on an accruals basis (i.e. when the goods or services represented by them take place), regardless of when actual payment or collection is being made.

Telefónica Deutschland Group principally obtains revenue from providing the following telecommunications services: traffic, connection fees, regular (normally monthly) network usage fees, interconnection, network and equipment leasing, handset sales and other services such as pay TV, value-added services (e.g. text or data messaging) and maintenance. Products and services may be sold separately or in promotional packages (bundled).

Revenue from calls carried on Telefónica Deutschland Group's networks (traffic) entail an initial call establishment fee plus a variable call rate, based on call length, distance and type of service. Both wireline and wireless traffic is recognized as revenue as service is provided. For prepaid calls, the amount of unused traffic generates deferred revenue presented in "Trade and other payables" on the statement of financial position. Prepaid cards generally expire within 12 months and any deferred revenue from prepaid traffic is recognized directly to the Consolidated Income Statement when the card expires as Telefónica Deutschland Group has no obligation to provide service after this date.

Revenue from traffic sales and services at a fixed rate over a specified period of time (flat rate) is recognized on a straight-line basis over the term covered by the rate paid by the customer.

Connection fees arising when customers connect to the Group's network are deferred and recognized in the Consolidated Income Statement throughout the average estimated customer relationship period, which varies by type of service. All related costs, except those related to network enlargement expenses, administrative expenses and overhead, are recognized in the Consolidated Income Statement as incurred.

Installment fees are taken to the Consolidated Income Statement on a straight-line basis over the related period. Equipment leases and other services are taken to profit or loss as they are consumed.

Interconnection revenue from wireline-wireless and vice versa calls and other customer services is recognized in the period in which the calls are made.

Revenue from handset and equipment sales is recognized once the sale is considered complete, i.e., generally when delivered to the end customer. Revenue from installment sales is recognized in the amount of the discounted future receipts.

Wireless customers are offered to participate in loyalty campaigns whereby customers obtain points for the telephone traffic they generate. The amount assigned to points awarded is recognized as deferred income until the points are redeemed and recognized as sales or services according to the product or service chosen by the customer. Point redemption can be for discounts on the purchase of handsets, traffic or other types of services depending on the number of points earned and the type of contract involved. The accompanying Consolidated Statements of Financial Position include the related deferred revenue, based on an estimate of the value of the points accumulated at year-end, under "Trade and other payables."

Bundle packages, which include multiple elements, are sold in the wireline, wireless and internet businesses. They are assessed to determine whether it is necessary to separate the separately identifiable elements and apply the corresponding revenue recognition policy to each element. Total package revenue is allocated among the identified elements based on their respective fair values (i.e. the fair value of each element relative to the total fair value of the package).

As connection or initial activation fees, or upfront non-refundable fees, are not separately identifiable elements in these types of packages, any revenues received from the customer for these items are allocated to the remaining elements.

However, amounts contingent upon delivery of undelivered elements are not allocated to delivered elements.

All expenses related to bundled promotional packages are taken to the Consolidated Income Statement as incurred.

o) Use of estimates, assumptions and judgments

The key assumptions concerning the future and other relevant sources of uncertainty in estimates at the reporting date that could have a significant impact on the Consolidated Financial Statements within the next year are discussed below. The estimated and associated assumptions are based on historical experience and other factors that are considered to be relevant.

A significant change in the facts and circumstances on which these estimates and related judgments are based could have a material impact on Telefónica Deutschland Group's results and financial position.

Unforeseeable development outside management's control may cause actual amounts to differ from the original estimates. In this case the underlying assumptions, and if necessary the carrying amounts of the pertinent assets and liabilities, will be adjusted accordingly.

Changes are recognized in the period in which they occur, and also in following periods if changes affect both the reporting period and the subsequent ones.

Pensions – Defined benefit plans

In the fiscal year 2012 Telefónica Deutschland Group changed its estimate of the interest rate for defined benefit plans in the following manner. Based on the market developments in high quality corporate bonds, which serve as basis for determining the discount rate, the portfolio was extended in the course of the financial year: Included are now bonds that were rated with AA by at least one rating agency. The minimum volume for the consideration was reduced to EUR 50m. Furthermore, information on corporate bonds with a rating of A were taken into account, after deducting the spread between AA and A when extrapolating market rates along the yield curve to arrive at the prevaling maturity.

Since the derivation of the discount rate will no longer be continued using the earlier data base, the effects of this extension at the end of the financial year cannot be calculated. If the extended data base would already have been applied at the beginning of the year, the DBO, at this time, would be:
with a duration of 10 years, lower by 1%;
with a duration of 15 years higher by 3%;
with a duration of 20 years higher by 8%.

Property, plant and equipment, intangible assets and goodwill

The accounting treatment of investments in property, plant and equipment and intangible assets entails the use of estimates to determine the useful life for depreciation and amortization purposes and to assess fair value at their acquisition dates for assets acquired in business combinations.

Determining useful life requires making estimates in connection with future technological developments and alternative uses for assets. There is a significant element of judgment involved in making technological development assumptions, since the timing and scope of future technological advances are difficult to predict.

When an item of property, plant and equipment or an intangible asset is considered to be impaired, the impairment loss is recognized in the Consolidated Income Statement for the period. The decision to recognize an impairment loss involves estimates of the timing and amount of the impairment, as well as analysis of the reasons for the potential loss. Furthermore, additional factors, such as technological obsolescence, the suspension of certain services and other circumstantial changes are taken into account.

Telefónica Deutschland Group evaluates its cash-generating units' performance regularly to identify potential goodwill impairments. Determining the recoverable amount of the cash-generating units to which goodwill is allocated also entails the use of assumptions and estimates and requires a significant element of judgment.

Deferred income taxes

Telefónica Deutschland Group assesses the recoverability of deferred tax assets based on estimates of future earnings. The ability to recover these taxes depends ultimately on Telefónica Deutschland Group's ability to generate taxable earnings over the period for which the deferred tax assets remain deductible. This analysis is based on the estimated schedule for reversing deferred tax liabilities, as well as estimates of taxable earnings, which are sourced from internal projections and are continuously updated to reflect the latest trends.

The recognition of tax assets and liabilities depends on a series of factors, including estimates as to the timing and realization of deferred tax assets and the projected tax payment schedule. Actual income tax receipts and payments of Telefónica Deutschland Group could differ from the estimates made by Telefónica Deutschland Group as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

Tax loss carryforwards and deductible temporary differences have been determined under the probability criteria.

Provisions

Provisions are recognized when Telefónica Deutschland Group has a present obligation as a result of a past event, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. This obligation may be legal or constructive, deriving from inter alia regulations, contracts, normal practices or public commitments that lead third parties to reasonably expect that Telefónica Deutschland Group will assume certain responsibilities. The amount of the provision is determined based on the best estimate of the outflow of resources required to settle the obligation, bearing in mind all available information at the statement of financial position date, including the opinions of independent experts such as legal counsel or consultants.

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

Revenue recognition

Connection fees
Connection fees, generated when customers connect to the Group's network, are deferred and recognized as revenue over the average estimated customer relationship period.

The estimate of the average estimated customer relationship period is based on the recent history of customer churn. Potential changes in estimates could lead to changes in both the amount and timing of the future recognition of revenues.

Bundled offers
Bundled offers that combine different elements are assessed to determine whether it is necessary to separate the different identifiable components and apply the corresponding revenue recognition policy

to each element. Total package revenue is allocated among the identified elements based on their respective fair values.

Determining fair values for each identified element requires estimates that are complex due to the nature of the business.

A change in estimates of fair values could affect the apportionment of revenue among the elements and, as a result, the date of recognition of revenue.

p) Non-current assets held for sale

Non-current assets held for sale are classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. These assets are measured at the lower of the carrying amount and fair value less cost to sell and are classified as non-current assets held for sale. Such assets are no longer depreciated. If impairment of such assets is recognized, as a rule, if fair value less costs to sell subsequently increases, the impairment losses previously recognized must be reversed. The reversal of impairment losses is limited to the impairment losses previously recognized for the assets concerned.

q) Discontinued operations

Components of the company that meet the requirements of IFRS 5 are classified as discontinued operations and presented separately in the Consolidated Income Statement and the Consolidated Statement of Cash Flows, if they meet the definition of a major line of business under IFRS 5. All changes made in the current reporting period to amounts that are directly related to the sale of discontinued operations in one of the prior reporting periods are likewise presented within this separate category. If a component of the company is no longer classified as held for sale, the profit or loss of this component, which had previously been presented within discontinued operations, is reclassified as continuing operations in all presented reporting periods. If supplies of goods and services between continued and discontinued operations also continue after disposal, these supplies are recorded prior to consolidation in the Consolidated Income Statement.

r) Consolidation methods

The consolidation methods applied are as follows:

- Full consolidation method for companies which Telefónica Deutschland Group controls either by exercising effective control or by virtue of agreements with other shareholders.

- Proportionate consolidation method for Group companies which are jointly controlled with third parties (joint ventures). Similar items are grouped together such that the corresponding proportion of these companies' overall assets, liabilities, expenses and revenues and cash flows are integrated on a line by line basis into the Consolidated Financial Statements.

- Equity method for companies in which there is significant influence, but no control or joint control with third parties.

In certain circumstances, some of the investees of Telefónica Deutschland Group may require a qualified majority to adopt certain resolutions. This, together with other relevant factors, is taken into account when selecting the consolidation method.

All material accounts and transactions between the consolidated companies were eliminated on consolidation. The returns generated on transactions involving capitalizable goods or services by subsidiaries with other Telefónica Deutschland Group companies were eliminated on consolidation.

The financial statements of the consolidated companies have the same financial year-end as the parent company's individual financial statements and are prepared using the same accounting policies. In the case of Group companies whose accounting and valuation methods differed from those of the Telefónica Deutschland Group, adjustments were made on consolidation in order to present the Consolidated Financial Statements on a consistent basis.

The Consolidated Income Statement and Consolidated Statement of Cash Flows include the revenues and expenses and cash flows of companies that are no longer in the Telefónica Deutschland Group up to the date on which the related holding was sold or the company was liquidated, and those of the new companies included in the Group from the date on which the holding was acquired or the company was incorporated at year end.

The share of non-controlling interests in the equity and results of the fully consolidated subsidiaries is presented under "Non-controlling interests" on the Consolidated Statement of Financial Position and Consolidated Income Statement, respectively.

s) Acquisitions and disposals of non-controlling interests

Changes in investments in subsidiaries without loss of control:
Effective January 1, 2010, any increase or decrease in the percentage of ownership interest in subsidiaries that does not result in a loss of control is accounted for as a transaction with owners in their capacity as owners. This means that as of the aforementioned date, any difference between the carrying amount of the non-controlling interests and the fair value of the consideration received or paid, as applicable, is recognized in equity. On the partial disposal of a subsidiary that includes a foreign operation, the proportionate share of the cumulative translation differences recorded in equity is re-attributed to the non-controlling interests in that foreign operation.

t) New IFRS and IFRIC-interpretations issued but not yet effective as of December 31, 2012

At the date of preparation of the accompanying Consolidated Financial Statements, the following IFRS, amendments and IFRIC interpretations had been published, but their application was not mandatory:

Standards and amendments		Mandatory application: annual periods beginning on or after
IFRS 1	First-time Adoption of IFRS, Amendment Government Loans	January 1, 2013
IFRS 9	Financial instruments	January 1, 2015
IFRS 10	Consolidated Financial Statements	January 1, 2013
	Amendments Investment Entities	January 1, 2014
IFRS 11	Joint arrangements	January 1, 2014
IFRS 12	Disclosures of interests in other entities	January 1, 2014
	Amendments Investment Entities	January 1, 2014
IFRS 13	Fair value measurement	January 1, 2013
Revised IAS 19	Employee benefits	January 1, 2013
Revised IAS 27	Separate financial statements	January 1, 2013
	Amendments Investment Entities	January 1, 2014
Revised IAS 28	Investments in associates and joint ventures	January 1, 2013
Amendments to IFRS 7	Disclosures – Offsetting of financial assets and liabilities	January 1, 2013
	Disclosures – Transition to IFRS 9	January 1, 2015
Amendments to IAS 32	Offsetting of financial assets and liabilities	January 1, 2014
Annual improvements to IFRS (2011)	Amendments to IFRS 1, IAS 1, IAS 16, IAS 32 and IAS 34	January 1, 2013

Interpretations		Mandatory application: annual periods beginning on or after
IFRIC 20	Stripping costs in the production phase of a surface mine	January 1, 2013

Improvements to IFRS (2011), IFRS 9 and IFRS 9/IFRS 7 (amendment mandatory effective date and transition disclosure) have not been endorsed by the European Union. Telefónica Deutschland Group is currently assessing the impact of the application of the standards, amendments and interpretations.

Based on the analyses made to date, Telefónica Deutschland Group estimates that – with the exception of the changes of IAS 19 and IFRS 9 – their adoption will not have a significant impact on the Consolidated Financial Statements in the initial period of application.

In June 2011 the IASB issued amendments to IAS 19 “Employee Benefits”. Changes to IAS 19 become mandatory for the fiscal year 2013. Because Telefonicà Deutschland Group already covered the actuarial gains and losses in other comprehensive income, this has no impact on the Consolidated Financial Statements. One significant consequence of these amendments is that the expected return on plan assets has to be calculated using the same discount rate that is used to measure the defined benefit obligation. Therefore in 2013 there will be a decrease of approximately kEUR 12 of expenses due to an increase of the remeasurement of plan assets in the other comprehensive income (net of tax). Furthermore, revised version of IAS 19 will enhance disclosure requirements. The standard will be applied retrospectively.

The changes introduced by IFRS 9 will affect the accounting for financial instruments and transactions with financial assets carried out on or after January 1, 2015.

4. Segment Information

General information

Telefónica Deutschland Group consists of two reportable segments: (a) Telecommunications and (b) Global Services, of which Global Services has been disposed with effect of October 1, 2012.

The measurement principles used by Telefónica Deutschland Group in preparing this segment reporting are based on IFRS. These principles are also the basis for the segment performance assessment.

The management board of Telefónica Deutschland Holding AG acts as a chief operating decision maker on a group-wide basis by assessing the performance and allocating resources on group level. As performance indicator, the chief operating decision maker controls the performance by the group's adjusted OIBDA.

Segment Telecommunications

Telefónica Deutschland Group offers wireless and wireline telephony and internet services to its German customers as well as access to its infrastructure and service capabilities for its wholesale partners in Germany. Therefore, a geographical segmentation is not suitable for the group, as it operates only in one geographical area, the Federal Republic of Germany.

Telefónica Deutschland Group pursues a multi-brand strategy, but focusing on its premium brand O_2. TDG accesses additional customer groups through its secondary and partner brands as well as its wholesale channels. Secondary brands are fully-controlled brands, such as FONIC or brands held through joint ventures and strategic partnerships, such as Tchibo mobil and Türk Telekom Mobile. In its wholesale service business, Telefónica Deutschland Group offers mobile and fixed-line services to customers such as 1&1, Mobilcom/Debitel, Drillisch and the two major German cable operators Unitymedia/KabelBW and Kabel Deutschland. TDG offers their products through a diversified distribution platform comprising direct and indirect sales channels.

The objective of Telefónica Deutschland Group is to dismount access to telecommunication and information areas for its customers by offering technology, multimedia, information and entertainment as well as any service connected or related with these areas, including the distribution of hardware. Telefónica Deutschland Group expedites the distribution of hardware through its premium brand O_2 with the "O_2 My Handy" contracts (launched 2009). To provide the possibility to acquire a wide range of different hardware such as mobile phones, handsets and other additional technical equipment at an affordable price, customers are able to revert to attractive payment terms like 12 or 24 subsequent monthly installments. This generates price transparency with respect to the costs.

Disposal of segment Global Services during 2012

Legally effective as of October 1, 2012 following companies, which formed the segment Global Services, were sold: Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Telefónica Compras Electronicas S.L. and Adquira España S.A.

Telefónica Deutschland Group's Global Services segment has been reported for the first nine months in 2012. The business activities reported therein contain all global procurement activities. Telefónica Global Services GmbH acted as an agent for all companies on group-level by pooling the composite demand of each group entity. This bargaining power opposite to the suppliers generates for the group economies of scale. To ensure a group-wide smoothly running tender and proposal proceeding, Telefónica Global Services GmbH and its suppliers are able to use an electronic data processing system provided by Telefónica Compras Electronicas S.L.. Telefónica Global Services GmbH received commissions from the supplier depending on the order volume for the service offered. The handling of purchasing process, meaning delivery and payment, was settled between the supplier and the individual entity of Telefónica Deutschland Group.

Adquira España S.A. was founded in the year 2000 by four Spanish companies (Telefónica, BBVA, Iberia, Repsol) to bundle and optimize their buying process.

Over the last decade Adquira developed as a specialist in the segment of e-commerce. Adquira focuses on the support and optimization of the buying process by using its data platform and keeping it updated. The company is able to revert to a huge data base with over 4,500 suppliers in Spain, which gives each client of Adquira the possibility to select its products out of a variety of goods, thereby maximizing economies of scale.

Telefónica Global Roaming GmbH is in charge of Telefónica's international business, delivering integrated fixed, mobile and IT services. Telefónica Global Roaming GmbH manages the roaming business in the group with the objective of optimizing and providing the best possible roaming-services to its customers.

Operating income before depreciation and amortization ("OIBDA") before group fees ("adjusted OIBDA")

Operating income before depreciation and amortization (OIBDA), used by the group as a performance indicator, is calculated by excluding depreciation and amortization from operating income to eliminate the impact of investments in fixed assets that cannot be directly controlled by management in the short term. OIBDA is considered to be more important for investors as it provides a gauge of operating performance and profitability using the same measures utilized by management. This metric also allows comparison with other companies in the telecommunications sector without consideration of their asset structure.

Adjusted OIBDA is calculated in the same manner as OIBDA, but detaches the group fees of the calculation to facilitate operating performance comparisons from period to period.

Adjusted OIBDA is used by the chief operating decision maker to track the performance of the business and to establish operating and strategic targets. Adjusted OIBDA is a commonly reported measure and is widely used among analysts, investors and other interested parties in the telecommunications industry, although it is not a measure explicitly defined in IFRS and therefore may not be comparable to similar indicators used by other companies. Adjusted OIBDA should not be considered as an alternative to operating income as a measurement of our operating results or as an alternative to cash flows from operating activities as a measurement of our liquidity.

The following table presents the two reportable segments and the reconciliation for the Telefónica Deutschland Group for the years ended December 31, 2012 and 2011.

2012 Thousands of euros

	Telecom-munications	Global Services (discontinued)	Total	Reconciliations	Group
Revenues	5,212,838	412,629	5,625,467	(412,629)	5,212,838
Thereof: Revenues from external customers	5,212,838	394,958	5,607,796	(394,958)	5,212,838
Thereof: Revenues from transactions with other operating segments	–	17,671	17,671	(17,671)	–
Adjusted OIBDA	1,351,385	411,184	1,762,570	(411,192)	1,351,377
CapEx	608,838	275	609,114	(275)	608,838

2011 Thousands of euros

	Telecom-munications	Global Services (discontinued)	Total	Reconciliations	Group
Revenues	5,035,552	534,717	5,570,269	(534,717)	5,035,552
Thereof: Revenues from external customers	5,035,552	513,938	5,549,490	(513,938)	5,035,552
Thereof: Revenues from transactions with other operating segments	–	20,779	20,779	(20,779)	–
Adjusted OIBDA	1,219,469	486,078	1,705,547	(486,864)	1,218,683
CapEx	557,651	952	558,603	(952)	557,651

There is no customer of Telefónica Deutschland Group providing more than 10% of the total revenues.

Reconciliation

Revenue Reconciliation Thousands of euros

	2012	2011
Total revenue for reportable segments	5,625,467	5,570,269
- Elimination of inter-segment revenue	17,671	20,779
- Elimination of discontinued operations	394,958	513,938
= Consolidated revenue	5,212,838	5,035,552

Profit or loss reconciliation Thousands of euros

	2012	2011
Adjusted OIBDA reportable segments	1,762,570	1,705,547
+/- Adjusted OIBDA of other activities (G3G and Management GmbH)	8	(786)
- Adjusted OIBDA from discontinued operations	411,176	486,864
- Eliminations	–	–
= Adjusted OIBDA of Group (continuing operations)	**1,351,385**	**1,219,469**
- Group fees	(72,311)	(70,232)
= OIBDA of Group (continuing operations)	**1,279,074**	**1,149,237**
- Depreciation and amortization	(1,133,183)	(1,082,189)
= Operating income (continuing operations)	**145,891**	**67,048**
- Net financial income (expense)	(6,123)	6,030
= Profit before tax from continuing operations	**139,768**	**73,078**

Adjusted OIBDA of other activities

The figures reported therein represent business activities of Group 3G Holding UMTS GmbH and Quam GmbH, which do not qualify as operating segments.

Group fees

Group fees represent fees towards the Telefónica Group under a range of agreements, including management and consulting services, licenses, cost sharing and other services.

Capital expenditure reconciliation Thousands of euros

	2012	2011
Total CapEx for reportable segments	609,114	558,603
- CapEx for discontinued operations	275	952
- Eliminations	–	–
= CapEx total	**608,838**	**557,651**
+ Non-recurring investments	–	–
=Net additions fixed assets / intangibles / associates and joint ventures	**608,838**	**557,651**

Information about geographical areas

External revenues 2012

Thousands of euros

	Wireless	Wireline	Other	Total
Germany	3,845,053	1,363,203	4,582	5,212,838

External revenues 2011

Thousands of euros

	Wireless	Wireline	Other	Total
Germany	3,605,747	1,425,740	4,065	5,035,552

For more information regarding the content and development of revenues please refer to Note 22 “Revenues and Expenses”.

Non-current assets as of December 31, 2012

Thousands of euros

	Total
Germany	6,956,472
Other	–

Non-current assets as of December 31, 2011

Thousands of euros

	Total
Germany	7,482,582
Other	4,855

Non-current assets as of January 1, 2011

Thousands of euros

	Total
Germany	8,010,033
Other	8,711

5. Discontinued Operations

As of October 1, 2012 Telefónica Deutschland Group sold within a single sales transaction

- its entire Segment "Global Services" (see Note 4 "Segment Information") and
- the following entities: Group 3G UMTS Holding GmbH and Quam GmbH.

The entities contained in this transaction were not classified as a discontinued operation or held-for-sale at December 31, 2011 and the comparative Consolidated Income Statement has been prepared to show the discontinued operation separately from continuing operations. Management committed to the plan to sell these areas on July 1, 2012 following the strategic plan to focus on the Group's key competencies, being its telecommunication services operations in Germany.

The following table shows the analysis of the result of the discontinued operation:

Thousands of euros	2012	2011
Revenues	412,629	534,717
Other income	8,401	1,444
Finance income	24,826	13,413
Supplies	(409)	(538)
Personnel expenses	(17,092)	(22,363)
Other expenses	(11,696)	(7,188)
Depreciation and amortization	(2,574)	(4,808)
Financial charges	(22,928)	(9,556)
Results from discontinued operations before tax	**391,157**	**505,121**
Income tax	143,962	(22,564)
Results from discontinued operations after tax	**535,119**	**482,557**
Gain or loss recognized on the measurement to fair value less costs to sell	–	–
Gain or loss recognized on the disposal of the assets or disposal group(s) constituting the discontinued operation	491,911	–
Related income tax expenses	–	–
Result from discontinued operations after tax	**1,027,030**	**482,557**

The effect of the disposal on the financial position of the Group is as follows:

Thousands of euros	2012
Intangible assets	2,308
Property, plant and equipment	254
Non-current financial assets	2,794
Inventory	28
Trade and other receivables	379,628
Cash and cash equivalents	145,554
Deferred tax assets	155,000
Trade and other payables	444,217
Provisions	29,457
Deferred income	803
Net assets and liabilities	**211,089**
Cash consideration received, satisfied in cash	703,000
Cash and cash equivalents disposed of	145,554
Net cash inflow	**557,446**

6. Intangible Assets

The composition of and movements in net intangible assets in the years ended December 31, 2012 and 2011 are as follows:

Thousands of euros	As of January 1, 2012	Additions	Amortization	Disposals	Transfers and other	Decon-solidation as of October 1, 2012	As of December 31, 2012
Service concession arrangements and licenses	2,917,434	–	(271,581)	–	–	–	2,645,853
Software	444,633	155,350	(217,617)	–	302	1,921	380,747
Other intangible assets	279,668	261	(42,516)	–	–	–	237,413
Prepayments on intangible assets	20,756	100	–	–	(7,026)	387	13,443
Net intangible assets	**3,662,491**	**155,711**	**(531,714)**	**–**	**(6,724)**	**2,308**	**3,277,456**

Thousands of euros	As of January 1, 2011	Additions	Amortization	Disposals	Transfers and other	As of December 31, 2011
Service concession arrangements and licenses	1,843,927	–	(226,746)	–	1,300,253	2,917,434
Software	497,607	155,586	(205,950)	(39)	(2,571)	444,633
Other intangible assets	309,979	–	(43,399)	–	13,088	279,668
Prepayments on intangible assets	1,312,683	27,664	–	–	(1,319,591)	20,756
Net intangible assets	**3,964,196**	**183,250**	**(476,095)**	**(39)**	**(8,821)**	**3,662,491**

The gross costs, accumulated amortization and impairment losses – if any – of intangible assets as of December 31, 2012 and 2011 are as follows:

			As of December 31, 2012
Thousands of euros	Gross cost	Accumulated amortization	Net intangible assets
Service concession arrangements and licenses	9,830,811	(7,184,958)	2,645,853
Software	1,334,818	(954,071)	380,747
Other intangible assets	373,423	(136,010)	237,413
Prepayments on intangible assets	13,443	–	13,443
Net intangible assets	**11,552,495**	**(8,275,039)**	**3,277,456**

			As of December 31, 2011
Thousands of euros	Gross cost	Accumulated amortization	Net intangible assets
Service concession arrangements and licenses	9,830,836	(6,913,402)	2,917,434
Software	1,283,325	(838,692)	444,633
Other intangible assets	383,709	(104,041)	279,668
Prepayments on intangible assets	20,756	–	20,756
Net intangible assets	**11,518,626**	**(7,856,135)**	**3,662,491**

Service concession arrangements and licenses:

Telefónica Germany GmbH & Co. OHG obtained a Global System for Mobile Communications ("GSM") license (2G) in May 1997. As of December 31, 2012 the license has a carrying amount of kEUR 1,660 (2011 kEUR 1,994). The GSM licenses expire on December 31, 2016.

In August 2000 and in May 2010, Telefónica Germany GmbH & Co. OHG obtained UMTS licenses (3G) expiring on December 31, 2020. The carrying amount as of December 31, 2012 was kEUR 1,478,447 (2011 kEUR 1,660,022).

In May 2010, Telefónica Germany GmbH & Co. OHG acquired LTE licenses (4G) expiring in 2025. The acquisition was recognized as "Additions" of prepayments on intangible assets and reclassified as concessions and licenses in 2011. The carrying amount as of December 31, 2012 was kEUR 1,165,722 (in 2011 kEUR 1,255,392). There were no further significant additions of licenses in the years 2012 and 2011.

Software:

Software mainly includes licenses for Office and IT application software. The software is amortized on a straight-line basis over its useful life, generally estimated to be between two and five years. Within the additions in software in the financial years 2012 and 2011 were no significant single additions. All additions were made within the course of normal commercial activity.

Other intangible assets:

"Other intangible assets" includes mainly the amounts allocated to rights for brands and customer base.

Intangible assets are also subject to impairment tests whenever there are indicators of a potential loss in value and, in any event, at the end of each year for intangible assets with indefinite useful lives. There was no impairment recognized in the Consolidated Financial Statements for 2012 and 2011 as a result of these impairment tests. Regarding parameters used in the impairment test, please see Note 3 "Accounting Policies".

The depreciation of the intangible assets for the financial year 2012 amounting to kEUR 531,714 contains kEUR 2,311 based on discontinued operations. So the depreciation presented above is not comparable to the depreciation presented in the profit and loss.

7. Goodwill

In the years 2012 and 2011 there were no movements of goodwill. The carrying amount represents the gross costs amounting kEUR 705,576:

Thousands of euros	2012	2011
Carrying amount of goodwill at the beginning of the year	**705,576**	**705,576**
Acquisitions	–	–
Carrying amount of goodwill at the end of the year	**705,576**	**705,576**

The acquired and recognized goodwill is entirely assigned to the segment Telecommunications.

The carrying amount of goodwill results in the amount of kEUR 423,081 from the acquisition of MediaWays GmbH by HighwayOne Germany GmbH, a subsidiary of Telefónica as of September 30, 2002. On October 2, 2002 HighwayOne Germany GmbH and MediaWays GmbH merged into Telefónica Deutschland GmbH. On March 23, 2011 Telefónica Deutschland GmbH was changed to Telefónica Germany Customer Services GmbH.

The rest of the carrying amount of goodwill (kEUR 282,495) results from the acquisition of HanseNet Telekommunikation GmbH as of February 16, 2010.

The impairment tests carried out in 2011 and 2012 on the level of the segment Telecommunications did not identify the need to recognize any write-downs to goodwill at the 2012 and 2011 year ends as the recoverable amount, in all cases based on value in use, was higher than the carrying amount. Regarding parameters used in the impairment test, see Note 3 e) “Impairment of property, plant and equipment, goodwill and intangible assets”.

In addition, sensitivity analyses were performed on changes reasonably expected to occur in the primary valuation variables, and the recoverable amount remained above the net carrying amount.

8. Property, Plant and Equipment

The composition of and movements in the items comprising net “Property, plant and equipment” in December 31, 2012 and 2011 were the following:

Thousands of euros	As of January 1, 2012	Additions	Depreciation	Disposals	Transfers and other	Decon-solidation as of October 1, 2012	As of December 31, 2012
Land and buildings	40,476	11,682	(76,571)	–	324,831	–	300,418
Plant and machinery	2,917,077	430,856	(482,061)	(849)	(333,594)	–	2,531,429
Furniture, tools and other items	101,834	33,131	(45,405)	(919)	(9,860)	250	78,531
Total PP&E in service	**3,059,387**	**475,669**	**(604,037)**	**(1,768)**	**(18,623)**	**250**	**2,910,378**
PP&E in progress	59,983	(22,264)	–	–	25,347	4	63,062
Net PP&E	**3,119,370**	**453,405**	**(604,037)**	**(1,768)**	**6,724**	**254**	**2,973,440**

Thousands of euros	As of January 1, 2011	Additions	Depreciation	Disposals	Transfers and other	As of December 31, 2011
Land and buildings	59,054	6,501	(24,786)	(54)	(239)	40,476
Plant and machinery	3,089,461	375,783	(533,543)	(1,001)	(13,623)	2,917,077
Furniture, tools and other items	123,829	35,048	(52,573)	(1,815)	(2,655)	101,834
Total PP&E in service	**3,272,344**	**417,332**	**(610,902)**	**(2,870)**	**(16,517)**	**3,059,387**
PP&E in progress	76,628	(41,979)	–	(4)	25,338	59,983
Net PP&E	**3,348,972**	**375,353**	**(610,902)**	**(2,874)**	**8,821**	**3,119,370**

The gross costs, accumulated depreciation and impairment losses – if any – of property, plant and equipment as of December 31, 2012 and 2011 are as follows:

	As of December 31, 2012		
Thousands of euros	Gross cost	Accumulated depreciation	Net PP&E
Land and buildings	673,951	(373,533)	300,418
Plant and machinery	5,393,282	(2,861,853)	2,531,429
Furniture, tools and other items	302,272	(223,741)	78,531
Total PP&E in service	**6,369,505**	**(3,459,127)**	**2,910,378**
PP&E in progress	63,062	–	63,062
Net PP&E	**6,432,567**	**(3,459,127)**	**2,973,440**

	As of December 31, 2011		
Thousands of euros	Gross cost	Accumulated depreciation	Net PP&E
Land and buildings	123,310	(82,834)	40,476
Plant and machinery	5,690,850	(2,773,773)	2,917,077
Furniture, tools and other items	353,013	(251,179)	101,834
Total PP&E in service	**6,167,173**	**(3,107,786)**	**3,059,387**
PP&E in progress	59,983	–	59,983
Net PP&E	**6,227,156**	**(3,107,786)**	**3,119,370**

"Additions" for 2012 und 2011 totaling kEUR 453,405 and kEUR 375,353 mainly reflect Telefónica Deutschland Group's investments (i.e. cell masts) made during the year to improve the capacity and coverage of the wireless networks.

Property, plant and equipment deriving from finance leases amounted to kEUR 8,948 as of December 31, 2012 and kEUR 11,786 as of December 31, 2011. The most significant finance leases are disclosed in Note 24 "Finance Leases".

The depreciation of the property, plant and equipment for the fiscal year 2012 amounting to kEUR 604,037 contains kEUR 257 based on discontinued operations. So the depreciation presented above is not comparable to the depreciation presented in the profit and loss.

9. Investments in Associates

The investments in associates concern the 40% interest in Adquira España S.A. which has been sold with effect of October 1, 2012.

10. Joint Ventures

Telefónica Germany GmbH & Co. OHG jointly controls the TCHIBO Mobilfunk Beteiligungs GmbH and the TCHIBO Mobilfunk GmbH & Co. KG. Both companies are recognized proportionally with 50% in the Consolidated Financial Statements.

The contributions in assets, liabilities, income and expense before consolidation to Telefónica Deutschland Group's Consolidated Statement of Financial Position as of December 31, 2012 and 2011 as well as the contributions to the Consolidated Income Statements for the years 2012 and 2011 are as follows:

TCHIBO Mobilfunk Beteiligungs GmbH — Thousands of euros

	As of December 31,		As of January 1,
	2012	2011	2011
Financial Position:			
Current assets	72	54	66
Non-current assets	–	–	–
Current liabilities	(54)	(36)	(49)
Non-current liabilities	–	–	–
Income Statement:			
Income	–	–	
Expenses	–	–	

TCHIBO Mobilfunk GmbH & Co. KG — Thousands of euros

	As of December 31,		As of January 1,
	2012	2011	2011
Financial Position:			
Current assets	44,814	14,617	28,483
Non-current assets	261	–	–
Current liabilities	(41,227)	(11,269)	(25,187)
Non-current liabilities	–	–	–
Income Statement:			
Income	26,091	25,047	
Expenses	(25,598)	(25,034)	

11. Related Parties

Related party transactions include transactions between Telefónica Deutschland Group and Telefónica Group (Telefónica and its direct and indirect subsidiaries excluding Telefónica Deutschland Group), Telefónica Group's associated companies and joint ventures as well as Telefónica Deutschland Group's joint ventures. Furthermore, the related party transactions include transactions between Telefónica Deutschland Group and the members of Telefónica Deutschland's management board and supervisory board as well as other related individuals (other key management).

Telefónica Germany Holdings Limited, a subsidiary of O2 (Europe) Limited, a subsidiary of Telefónica S.A., is the parent company of Telefónica Deutschland Holding AG. Therefore Telefónica Group (see above) is a related party as Telefónica S.A. (the ultimate parent) controls Telefónica Deutschland Group.

Transactions with Telefónica Group

Telefónica Deutschland Group has entered into a number of contractual relationships considered to be related party transactions.

Due to a service agreement with O_2 Limited (now O2 (Europe) Limited), dated August 12, 2002 Telefónica Deutschland Group receives management consultancy and support services from Telefónica Group entities in the UK and Spain.

According to a license agreement dated January 1, 2011 Telefónica Deutschland Group is allowed to use brand rights from the Telefónica Group for which it pays a royalty fee.

Additionally, Telefónica Deutschland Group uses the O_2 brand from O2 (Europe) Limited pursuant to a license agreement and participates in a group cost share agreement with O2 (Europe) Limited and other Telefónica Group entities, both dated October 15, 2007. O2 (Europe) Limited owns and is responsible for, and bears the costs of central management and development and protection of the O_2 brand rights.

Telefónica Group has several departments called "areas of innovation" that are working on the development of new business opportunities and technologies in the following areas: cloud computing, video and digital home, content delivery network, machine to machine, applications, financial services, mobile security and e-health. Telefónica Deutschland Group participates in a cost share arrangement pursuant to which the related development and coordination costs are shared among the Telefónica entities that stand to benefit from such developments.

Furthermore Telefónica Deutschland Group has entered into a service agreement with Telefónica Global Roaming GmbH ("TGR") effective as of December 5, 2009. TGR manages the wholesale roaming business with third parties as well as the mutual roaming discounts with Telefónica Group entities. With respect to roaming arrangements with Telefónica Group entities, Telefónica Deutschland Group has GSMA-standard based international roaming agreements with all such entities.

Telefónica Deutschland Group benefits from multinational sales activities coordinated by the Telefónica global unit Telefónica Multinational Solutions ("TMS"). TMS has its own central budget and employees at the Telefónica level and each of the participating Telefónica Group entities dedicates a number of employees and resources to TMS activities. Telefónica Deutschland Group and Telefónica Group are collaborating with the business unit Telefónica Global Solutions for the development of a managed wide area network (mWAN). Due to the collaboration, Telefónica Global Solutions will develop and offer a global mWAN service for all Telefónica Group entities, including a service for the corporate clients in the German market.

Telefónica Deutschland Group has entered into an agreement dated December 13, 2010 with Telefónica Global Technology S.A.U. ("TGT") regarding the provision of its SAP system. TGT provides the company the license for various functions of the SAP software. There is a further agreement with TGT dated

May 3, 2011 regarding the provision and operation of the company's desktop workplace and e-mail system. In accordance with the agreement, TGT provides the company the software as well as the tools, network connectivity, and IP communications services.

Telefónica Deutschland Group has also entered into an agreement with Telefónica Global Applications S.L. ("TGA") dated August 1, 2011, pursuant to which TGA has the responsibility for working with developers on the company's behalf regarding the development, marketing and distribution of wireless applications and into two agreements with Telefónica Czech Republic ("Telefónica Czech").

Thus, Telefónica Czech provides monitoring services for the company's wireline networks and otherwise Telefónica Deutschland Group provides monitoring services for Telefónica Czech's wireless network, each dated August 29, 2011. The interconnection agreement with Telefónica Group entity Jajah, Inc. ("Jajah") provides Jajah with connections to the company's network and Jajah provides Telefónica Deutschland Group connections to Jajah's network for the purpose of termination of telecommunications traffic in the respective networks, as well as for the conducting of telecommunications traffic via the network of one party into the telecommunications network of a third party that is connected to such party's network.

With the Ireland-based Telefónica European People Services Centre effective October 10, 2010, the Telefónica Deutschland Group has entered into a services agreement for the provision of operational human resources, payroll and employment related services to Telefónica Deutschland Group.

Furthermore, Telefónica Deutschland Group has entered into a framework agreement with Telefónica Global Services GmbH ("TGS") dated January 1, 2010 and a framework agreement with TGR dated October 20, 2010. Therefore, Telefónica Deutschland Group concludes individual service agreements with TGR and TGS, that provide central services as well as operational support functions to TGR and TGS. TGS and TGR have such agreements with further companies within the Telefónica Group.

Due to a service agreement with TGS dated October 6, 2010, Telefónica Deutschland Group has outsourced its procurement process to TGS. TGS conducts the purchase of all kinds of goods and services and performs all related procurement processes including tenders, evaluations and negotiations on behalf of the Company.

Based on a sales purchase agreement dated September 27, 2012, effective October 1, 2012, 0.00 a.m., Telefónica Germany GmbH & Co. OHG sold to Telfisa Global B.V., Netherlands, a subsidiary of Telefónica Group, all its shares in Telefónica Global Activities Holdings B.V., Netherlands (former Telefónica Chile Holding B.V.), for a total purchase price of EUR 703m. As a result of this, G3G, Quam and TGS, together with its subsidiaries TGR, Telefónica Compras Electronicas S.L. and the indirectly held 40% interest in Adquira España S.A., ceased to be members of Telefónica Deutschland Group.

Prior to the sale of all its shares in Telefónica Global Activities Holdings B.V., Telefónica Germany GmbH & Co. OHG had (i) contributed to TGR, through TGS, all of its rights and obligations under a loan agreement with G3G, and (ii) contributed to Telefónica Global Activities Holdings B.V. all of its shares in its directly and indirectly held subsidiaries G3G, Quam and TGS, together with its subsidiaries TGR, Telefónica Compras Electronicas S.L. and Telefónica Deutschland Group's indirectly held 40% interest in Adquira España S.A.

As of September 30, 2012, 12.00 p.m., all existing profit and loss transfer agreements between Telefónica Germany GmbH & Co. OHG and each of G3G, Quam, TGS and TGR were terminated. Creditors of G3G, Quam, TGS and TGR are entitled to request OHG to provide security for claims against one of these entities, which were established prior to registering the termination of the respective profit and loss transfer agreements in the commercial register. Prior to such termination, prepayments on expected profits were made under these agreements in the total amount of EUR 854.5m in 2012 (net of a prepayment on an expected loss balance obligation arising from the profit and loss transfer agreements).

On December 3, 2009, Telefónica Deutschland Group entered into a purchase agreement with Telecom Italia S.p.A. (and several of its affiliates) on the acquisition of all shares in Hamburg-based Hanse-Net and certain existing shareholder loans.

Telefónica Deutschland Group receives policies for all material damages and business interruption (including cyber risk and crime) insurance and general liability, pure financial losses, and media contents liability insurance, from Telefónica Insurances S.A., which is an insurance company in the Telefónica Group registered in Luxembourg. The insurance program is managed and implemented by the broker Pleyade S.A., in Madrid, Spain, which is also part of the Telefónica Group.

Telefónica Deutschland Group participates in the cash management system used by the Telefónica Group under cash pooling and deposit agreements. Cash throughout the Telefónica Group is centralized through these arrangements, allowing them to benefit from the economies of scale from the overall Telefónica Group as well as from the in-house liquidation of payables and receivables between Telefónica Deutschland Group and the participating members of the Telefónica Group. Under the cash pooling arrangements, the entire cash surplus available on those of their bank accounts which are included in the cash pool is automatically transferred on a daily basis to master bank accounts held by Telefónica Finanzas S.A. and Telfisa Global B.V.; both are Telefónica Group subsidiaries.

Telefónica Germany GmbH & Co. OHG entered into a loan agreement dated September 12, 2012 with the Telefónica Group entity Telfisa Global B.V. as lender, pursuant to which Telfisa Global B.V. agreed to provide a loan facility (the "Facility") of EUR 1.25bn bearing interest at the rate of 3-month Euribor plus a margin of 120 basis points, increasing by 40 basis points per year, accruing on a daily basis after drawdown of funds on the basis of a 360 day year. The Facility has a repayment schedule of 20% per year until 2017. Telefónica Germany GmbH & Co. OHG has the right to prepay the Facility, in whole or in part in a minimum amount of €100,000, on any interest payment date or subject to payment of a market-based breakage fee.

The Facility is also subject to a mandatory prepayment in the event that OHG obtains financing that matures after September 13, 2017, in the amount of 25% of the proceeds received from such financing which will be applied as a prepayment of the Facility. Default interest of an additional 2 percentage points on top of the applicable interest rate will apply in case OHG fails to comply with any of its payment obligations under the loan agreement for any reason. The loan agreement contains certain restrictive covenants, including with respect to disposals of assets, creation of liens, and mergers and consolidations.

Telefónica Germany GmbH & Co. OHG entered into a short-term loan agreement dated as of September 12, 2012 with Telfisa Global B.V. as lender. Pursuant to such loan agreement, Telefónica Germany GmbH & Co. OHG borrowed an amount of EUR 703m from Telfisa Global B.V., which amount was entirely repaid as of October 1, 2012. In preparation for the public listing, Telefónica Deutschland Group entered into an indemnity and cost sharing agreement with Telefónica. Under this agreement, Telefónica agreed to indemnify Telefónica Deutschland Group from certain liability risks and to assume the transaction costs, in each case arising out of or in connection with public listing.

Sales of goods and services and other income as well as purchases of goods and services and other expenses from transactions with Telefónica Group in years 2012 and 2011 are presented in the following table:

	Sales of goods and services, other income and other transactions		Purchases of goods and services, other expenses and other transactions	
	From January 1 to December 31,		From January 1 to December 31,	
Thousands of euros	2012	2011	2012	2011
Telefónica Group	193,868	231,939	(139,561)	(111,278)

The other income includes interest income from cash pooling with an amount of EUR 6.5m (2011: EUR 6.3m).

The other expenses include group fees totaling EUR 54.7m in 2012 and EUR 49.5m in 2011.

Telefónica Deutschland Group's receivables from and payables to Telefónica Group are as follows:

	As of December 31,		As of January, 1
Thousands of euros	2012	2011	2011
Receivables from Telefónica Group	**335,028**	**4,265,882**	**3,191,754**
therein:			
from cash pooling	308,154	1,333,425	248,875
from financial assets	101	2,887,051	2,885,897
from other items	26,773	45,406	56,982
Liabilities to Telefónica Group	**1,492,776**	**149,389**	**136,228**
therein:			
from trade payables	210,802	144,553	136,228
from other items	31,096	4,836	–
from borrowing debt	1,250,878	–	–

Cash Pooling:

The amounts from cash pooling are related to the cash pooling agreement with Telfisa Global B.V. and Telefónica Finanzas S.A. (until September 30, 2012).

Financial Assets:

The other non-current financial assets as of December 31, 2011 and January 1, 2011 amounting to kEUR 2,885,897 comprise mainly receivables against O2 (Europe) Limited regarding Telefónica Deutschland's capital promise. In 2012, the receivable was offset against dividend distribution (see Note 15 "Equity").

Liabilities from borrowing debt:

These liabilities are relating to the Loan Facility, described above.

Contributions in Equity and Dividends:

Described in detail in Note 15 “Equity”.

Other Items:

The receivables and liabilities from other items mainly result from transaction of goods and services between Telefónica Deutschland Group and Telefónica Group. It includes receivables against Telefónica S.A. amounting to kEUR 262 and kEUR 990 as well as liabilities amounting to kEUR 5,836 and kEUR 5,721 at the reporting dates December 31, 2012 and 2011, respectively.

The position liabilities to Telefónica Group comprise primarily liabilities sold by the suppliers of Telefónica Germany GmbH & Co. OHG to a factoring company in which Telefónica has participation.

Transactions with Joint Ventures

The most significant balances and transactions with joint ventures and their contributions to the Consolidated Statement of Financial Position and Consolidated Income Statement are detailed below.

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Receivables from TCHIBO Mobilfunk GmbH & Co. KG	**4,876**	**2,907**	**12,260**
therein:			
from other items	4,876	2,907	12,260
Liabilities to TCHIBO Mobilfunk GmbH & Co. KG	**1,004**	**698**	**1,089**
therein:			
from other items	1,004	698	1,089

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Receivables from TCHIBO Mobilfunk Beteiligungs GmbH	**2**	**9**	**20**
therein:			
from other items	2	9	20
Liabilities to TCHIBO Mobilfunk Beteiligungs GmbH	**–**	**–**	**–**

Thousands of euros	Sales of goods and services, other income and other transactions From January 1 to December 31, 2012	 2011	Purchases of goods and services, other expenses and other transactions From January 1 to December 31, 2012	 2011
TCHIBO Mobilfunk GmbH & Co. KG	8,209	12,710	23,067	20,530

Thousands of euros	Sales of goods and services, other income and other transactions From January 1 to December 31, 2012	 2011	Purchases of goods and services, other expenses and other transactions From January 1 to December 31, 2012	 2011
TCHIBO Mobilfunk Beteili-gungs GmbH	6	96	–	–

Transactions with pension entities

For information regarding the funding of the principal pension benefits please see Note 18 “Provisions”.

Transactions with other related individuals

Key management of Telefónica Deutschland Group is defined as those people having authority and responsibility for planning, directing and controlling the activities of Telefónica Deutschland Group within their function and within the interest of Telefónica. For the period until incorporation of Telefónica Deutschland Holding AG (September 26, 2012), the key management comprised managing directors of the Telefónica Germany GmbH & Co. OHG, Telefónica Management GmbH, Telefónica S.A. and O2 (Europe) Limited and consisted of:

Telefónica Germany GmbH & Co. OHG and Telefónica Germany Management GmbH

Name	Position	Since date
Jens Prautzsch	Managing Director Strategy & Innovation	until March 2011
Robert Simmeth	Managing Director Service Technology (CIO)	until July 2011
Gregor Bieler	Managing Director Consumer Sales	until August 2011
André Krause	Managing Director Finance (CFO)	until October 2011
Johannes Pruchnow	Managing Director Business & Wholesale Service	until July 2012
Andrea Fabiana Folgueiras	Managing Director Network Technology	until January 2013
René Schuster	Chief Executive Officer (CEO)	
Markus Haas	Chief Strategy Officer (CSO)	
Joachim Kugoth	Managing Director Human Resources	
Peter Alec Rampling	Managing Director Marketing	
Michiel van Eldik	Managing Director Wholesale & Partner Management	
Rachel Clare Empey	Chief Financial Officer (CFO)	since October 2011
John Gerald McGuigan	Managing Director Consumer Sales	since October 2011
Dr. Eckart Pech	Managing Director Service Technology	since October 2011
Marc Irmisch	Vice President Small & Medium Enterprises & SoHo, Acting Lead of Business Unit	since June 2012

Telefónica S.A.

Name	Position	For the years
César Alierta Izuel	Board Member Telefónica S.A., Chairperson	
Isidro Fainé Casas	Board Member Telefónica S.A., Vice Chairperson	
Vitalino Manuel Nafría Aznar	Board Member Telefónica S.A., Vice Chairperson	until December 2011
Julio Linares López	Board Member Telefónica S.A., Vice Chairperson	
José María Abril Pérez	Board Member Telefónica S.A., Vice Chairperson	
José Fernando de Almansa Moreno-Barreda	Board Member Telefónica S.A.	
José María Álvarez-Pallete López	Board Member Telefónica S.A. (COO)	
David Arculus	Board Member Telefónica S.A.	until September 2012
Eva Castillo Sanz	Board Member Telefónica S.A.	
Carlos Colomer Casellas	Board Member Telefónica S.A.	
Peter Erskine	Board Member Telefónica S.A.	
Alfonso Ferrari Herrero	Board Member Telefónica S.A.	
Luiz Fernando Furlán	Board Member Telefónica S.A.	
Gonzalo Hinojosa Fernández de Angulo	Board Member Telefónica S.A.	
Pablo Isla Álvarez de Tejera	Board Member Telefónica S.A.	
Antonio Massanell Lavilla	Board Member Telefónica S.A.	
Ignacio Moreno Martínez	Board Member Telefónica S.A.	since December 2011
Francisco Javier de Paz Mancho	Board Member Telefónica S.A.	
Chang Xiaobing	Board Member Telefónica S.A.	since May 2011
Santiago Fernández Valbuena	Board Member Telefónica S.A.	since September 2012

O2 (Europe) Limited

Name	Position	Since date
Robert John Harwood	Director	
María Pilar López Álvarez	Director	since November 2011
Enrique Medina Malo	Director	since November 2011
Francisco Jesus, Perez de Uriquen Muinelo	Director	since August 2012
David Melcon Sanchez-Friera	Director	

Telefónica Germany Holdings Limited

Name	Position	Change during reporting period
Robert John Harwood	Director	since September 2012
María Pilar López Álvarez	Director	since September 2012
Enrique Medina Malo	Director	since September 2012
Francisco Jesus, Perez de Uriquen Muinelo	Director	since September 2012

With effect of the incorporation of Telefónica Deutschland Holding AG (September 26, 2012), key management personnel solely comprises the management board of the company as following:

- René Schuster (CEO),
- Rachel Clare Empey (CFO),
- Markus Haas (CSO).

Please refer to Note 12 “Transaction with management and supervisory board” for further details.

During the years to which these accompanying Consolidated Financial Statements refer, key management personnel did not perform any transactions with Telefónica Deutschland Group other than those in Telefónica Deutschland Group’s normal trading activity and business.

Compensation and other benefits paid to members of key management personnel are detailed as follows:

	From January 1 to December 31,	
Thousands of euros	2012	2011
Compensation	**5,503**	**8,447**
thereof:		
Short-term employee benefits	1,221	2,200
Termination benefits	–	717
Share-based payments	3	834
Defined benefit obligation	**19,737**	**14,921**

The movements in share options for the key management are as follows:

In units	2012	2011
Share options at beginning of the year	**260,117**	**273,164**
Exercise of share options	(93,350)	(107,034)
Addition of share options	104,409	93,987
Share options at end of the year	**271,176**	**260,117**

12. Transactions with Management and Supervisory Board

1. Management board

Admission to trading on the Frankfurt Stock Exchange was granted to Telefónica Deutschland Holding AG on October 29, 2012 and the trading in the shares commenced on October 30, 2012. According to a shareholders' resolution adopted on October 5, 2012, Telefónica Deutschland does not disclose the additional disclosures for listed stock corporations in accordance with section 314 (1) no. 6 a) p. 5-8 German Commercial Code (HGB).

Members of the management board

Name	Members of the management board of the listed Telefónica Deutschland Holding AG (Vorstand)	Management board before listing
René Schuster	since September 26, 2012	since June 2009
Rachel Empey	since September 26, 2012	since October 2011
Markus Haas	since September 26, 2012	since June 2009
Jens Prautzsch		since February 2010 until March 2011
Robert Simmeth		since February 2010 until July 2011
Gregor Bieler		since May 2011 until August 2011
André Krause		since December 2006 until October 2011
Johannes Pruchnow		since June 2009 until July 2012
Andrea Fabiana Folgueiras		since October 2007
Joachim Kugoth		since February 2010
Peter Alec Rampling		since May 2010
Michiel van Eldik		since September 2010
John Gerald McGuigan		since October 2011
Dr. Eckart Pech		since October 2011
Carsten Wreth		since November 2007 until September 2012

The current service contracts of the members of the management board ("Vorstand") of Telefónica Deutschland Holding AG were concluded on September 18, 2012 and will each expire on September 17, 2015. Until September 26, 2012 they were – next to others – managing directors ("Geschäftsführer") of Telefónica Germany Verwaltungs GmbH (which was converted into Telefónica Deutschland Holding AG by resolution dated September 18, 2012 and registration ("Eintragung") with the Commercial Register on September 26, 2012). They were and are – next to others – also managing directors ("Geschäftsführer") of Telefónica Germany Management GmbH and received (until September 17, 2012) direct remuneration by Telefónica Germany Management GmbH, which is the managing shareholder ("geschäftsführender Gesellschafter") of Telefónica Germany GmbH & Co. OHG and became a legal subsidiary of Telefónica Deutschland Holding AG in September 2012. The aggregate compensation pursuant to section 314 (1) no. 6 lit. a) German Commercial Code (HGB), which was granted to the management of Telefónica Germany Verwaltungs GmbH, now Telefónica Deutschland Holding AG, by Telefónica Germany Management GmbH and Telefónica Deutschland Holding AG for the year ended December 31, 2012, amounted to kEUR 6,876 and to kEUR 8,725 for the year ended December 31, 2011, respectively. Included in the amount are 105,806 (2011: 101,287) granted share options amounting to the total fair value of kEUR 1,021 (2011 kEUR 1,808). Such aggregate compensation for the period ended December 31, 2012 includes the remuneration granted for nine other, former managing directors of Telefónica Germany Verwaltungs GmbH who ceased to be managing directors ("Geschäftsführer") before the conversion of Telefónica Germany Verwaltungs GmbH into Telefónica Deutschland Holding AG.

At present, the Telefónica Deutschland Group has not granted securities or loans to members of the management board, nor has it assumed any guarantees for them.

In the fiscal years 2012 and 2011, total personnel compensation for former members of the management board and their surviving dependents amounted to kEUR 0 and kEUR 465, respectively.

As of December 31, 2012 and 2011, respectively, the pension liabilities for former members of the management board and their surviving dependents amounted to kEUR 20,391 and kEUR 14,964, respectively.

2. Supervisory board

Members of the supervisory board

Name	Member of the supervisory board of the listed AG
Eva Castillo Sanz	since October 5, 2012
María Pilar López Álvarez	since September 18, 2012
Angel Vilá Boix	since September 18, 2012
Patricia Cobian González	since September 18, 2012
Michael Hoffmann	since October 5, 2012
Enrique Medina Malo	since September 18, 2012
José María Álvarez-Pallete López	since September 18, 2012 until October 5, 2012
Christoph Herbert Steck	since September 18, 2012 until October 5, 2012

The total amount of benefits to the members of the supervisory board for 2012 and 2011 amounted to kEUR 19 and kEUR 0.

At present, the Telefónica Deutschland Group has not granted sureties or loans to members of the supervisory board, nor has it assumed any guarantees for them.

13. Trade and other Receivables

The breakdown of this item in the Consolidated Statements of Financial Position is as follows:

	As of December 31,		As of January 1,
Thousands of euros	2012	2011	2011
Receivables from sales and services	966,441	1,199,200	1,222,856
Receivables from related parties (note 11)	26,773	45,406	56,982
Other receivables	4,583	19,961	14,469
Prepayments	141,628	202,038	257,320
Provisions for bad debts	(130,394)	(117,315)	(157,165)
Total trade and other receivables	**1,009,031**	**1,349,290**	**1,394,462**

The breakdown of trade receivables is as follows:

	As of December 31,		As of January 1,
Thousands of euros	2012	2011	2011
Trade receivables billed	760,355	813,520	895,241
Trade receivables unbilled	206,086	385,680	327,615
Total	**966,441**	**1,199,200**	**1,222,856**

The ageing of the trade receivables and other receivables, which are not impaired, is as follows:

	As of December 31,		As of January 1,
Thousands of euros	2012	2011	2011
not past due	130,312	178,421	127,292
overdue since 1-30 days	2,736	6,515	–
overdue since 31-60 days	1,085	4,034	8,209
overdue since 61-90 days	(768)	6,285	555
overdue since 91-180 days	301	1,044	5,479
overdue since 181-360 days	–	13,713	1,970
overdue more than 360 days	–	–	919
Total	**133,666**	**210,012**	**144,424**

With regard to these receivables there were no indications of circumstances that may negatively affect their value at the respective reporting dates.

In November 2011 and during 2012 Telefónica Germany GmbH & Co. OHG entered into asset purchase agreements for "O_2 My Handy" receivables in order to optimize working capital and to access an alternative source of funding. The buyer bears the majority of the credit risks of these receivables. A small portion (in 2012 less 5%, in 2011 less 5%) of the sold assets has not been derecognized due to the continuing involvement. In the same amount a liability was recognized. Both will be dissolved over the term of the receivables sold. The continuing involvement recognized is the maximum risk that Telefónica Deutschland Group retains. It represents the maximum repurchase rate of defaulted receivables, the loss percentage and the late payment risk. In addition, Telefónica Deutschland Group recognizes a liability in the amount of the fair value of the guarantees given. The total loss recognized at the dates of transfers of the assets amounted to EUR 1.24m (2011: EUR 0.7m). The total carrying amount of the transferred receivables amounted to EUR 370.4m (2011: EUR 254.6m). The carrying amount of assets that Telefónica Deutschland Group continues to recognize amounted to EUR 16.0m as of December 31, 2012 and EUR 10.1m as of December 31, 2011. The carrying amount of the associated liabilities amounted to EUR 16.9m and EUR 10.7m, respectively. The impact on profit and loss from continuing involvement after the dates of sale comprises loss in the amount of EUR 1.1m in 2012 and in EUR 0.6m in 2011. As well as the cumulative loss impact from continuing involvement up to December 31, 2012 amounted to EUR minus 1.7m (2011 EUR -0.6m, respectively).

The following table shows the reconciliation of changes in the allowances account for the years ended December 31, 2012 and 2011:

	Thousands of euros
Allowances as of December 31, 2012	**(130,394)**
Additions	(74,059)
Reductions	56,315
Withdrawals from discontinued operations	4,665
Allowances as of December 31, 2011	**(117,315)**
Additions	(47,223)
Reductions	87,073
Allowances as of January 1, 2011	**(157,165)**

14. Cash and Cash Equivalents

	As of December 31,		As of January 1,
Thousands of euros	2012	2011	2011
Cash at bank and in hand	15,512	17,226	59,120
Cash pooling	308,154	1,333,425	248,875
Total	**323,666**	**1,350,651**	**307,995**

Cash and cash equivalents mainly consist of deposits related to cash pooling agreements with Telfisa Global B.V. and Telefónica Finanzas S.A. (until September 30, 2012).

15. Equity

Capital promise
On March 28, 2003 and April 30, 2004 O2 (Europe) Limited issued a declaration of obligation to Telefónica Deutschland (former "Telefónica Germany Verwaltungs GmbH"; former "O_2 Germany Verwaltungs GmbH") under which O2 (Europe) Limited obliged itself to provide Telefónica Deutschland by way of voluntary shareholder's contribution with an amount of kEUR 4,650,000 and kEUR 500,000 respectively. These amounts were to be remitted on first demand of Telefónica Deutschland and obligations have been unlimited in time. As of December 31, 2011 O2 (Europe) Limited contributed kEUR 2,264,104 of cash under the declarations of obligation. Therefore a receivable of Telefónica Deutschland against O2 (Europe) Limited remained in the amount of EUR 2,866m.

Pre-IPO dividend
Based on shareholder resolution dating August 24, 2012 the capital reserve has been unwinded according to section 270 par. 1 HGB to get it disposable for dividend distribution to shareholders. On September 14, 2012 Telefónica Deutschland declared a pre-IPO dividend to O2 (Europe) Limited amounting to EUR 7,186m. Thereof, EUR 4,300m have been considered as cash payments and EUR 2,886m were offset against the above mentioned capital promise.

Capital increase resolution
With resolution on September 18, 2012 and with entry in the Commercial Register on September 26, 2012, O2 (Europe) Limited has increased the share capital of Telefónica Deutschland from EUR 1,116,945,300 by EUR 100 to EUR 1,116,945,400 in return for a contribution in kind. The increase of the share capital was made through the issue of new shares with a total nominal value of EUR 100, which was subscribed by O2 (Europe) Limited. The capital increase in kind was made in full through the contribution of all shares of Telefónica Germany Management GmbH into Telefónica Deutschland within a common control transaction.

Authorized share capital
Until September 17, 2017 and subject to the approval of the supervisory board, the management board is authorized to increase the registered share capital of the company on one or more occasions by a total amount of up to EUR 558,472,700, by issuing up to 558,472,700 new non-par value registered shares against contribution in cash and/or in kind.

Legal reserve
Retained earnings include a legal reserve according to section 150 par. 2 Stock Corporation Act (AktG) amounting to kEUR 14, which has been remunerated from current year result.

Acquisition of non-controlling interests
The Group acquired the remaining 27.16% of Telefónica Compras Electronica S.L. shares at the beginning of 2011. As a result, the Groups' total interest increased to 100%. In return, a consideration of kEUR 3,006 has been paid in cash. By the time, the carrying amount attributable to the non-controlling interests amounted to kEUR 2,937. The difference between purchase price paid and carrying amount attributable to the acquired non-controlling interests in the amount of kEUR 69 has been offset in equity with retained earnings.

16. Financial Assets and Liabilities

The following tables list the carrying values and fair values of all financial assets and financial liabilities held by Telefónica Deutschland Group in accordance with the valuation categories of IAS 39. For simplification purposes the carrying amount of current financial assets and current financial liabilities is assumed to be the respective fair value.

In addition the tables show the categorization of financial assets and liabilities according to the importance of the input factors used for their respective valuation. For this purpose three levels are defined:

- Level 1: Quoted prices of the respective financial asset or financial liability in active markets
- Level 2: Other directly observable input parameters which contribute to establishing the fair value based on a valuation model
- Level 3: Input parameters not based on observable market data

	As of December 31, 2012								
			Measurement hierarchy						
Thousands of euros	Available-for-sale	Held for trading	Level 1 (Quoted prices)	Level 2 (Other directly observable market inputs)	Level 3 (Inputs not based on observable market data)	Loans and receivables	Total carrying amount	Total fair value	Not in scope of IFRS 7
Other non-current financial assets	5,759	–	–	5,759	–	108,916	114,675	114,675	–
Trade and other receivables	–	–	–	–	–	862,821	862,821	862,821	146,210
Other current financial assets	–	–	–	–	–	101	101	101	–
Cash and cash equivalents	–	–	–	–	–	323,666	323,666	323,666	–
Total	**5,759**	**–**	**–**	**5,759**	**–**	**1,295,504**	**1,301,263**	**1,301,263**	**146,210**

As of December 31, 2011

Thousands of euros	Available-for-sale	Held for trading	Measurement hierarchy: Level 1 (Quoted prices)	Measurement hierarchy: Level 2 (Other directly observable market inputs)	Measurement hierarchy: Level 3 (Inputs not based on observable market data)	Loans and receivables	Total carrying amount	Total fair value	Not in scope of IFRS 7
Other non-current financial assets	5,560	–	–	5,560	–	89,889	95,449	95,449	–
Trade and other receivables	–	–	–	–	–	1,144,891	1,144,891	1,144,891	204,399
Other current financial assets	–	1,154	–	1,154	–	2,885,897	2,887,051	2,887,051	–
Cash and cash equivalents	–	–	–	–	–	1,350,651	1,350,651	1,350,651	–
Total	**5,560**	**1,154**	**–**	**6,714**	**–**	**5,471,328**	**5,478,042**	**5,478,042**	**204,399**

As of January 1, 2011

Thousands of euros	Available-for-sale	Held for trading	Measurement hierarchy: Level 1 (Quoted prices)	Measurement hierarchy: Level 2 (Other directly observable market inputs)	Measurement hierarchy: Level 3 (Inputs not based on observable market data)	Loans and receivables	Total carrying amount	Total fair value	Not in scope of IFRS 7
Other non-current financial assets	5,335	–	–	5,335	–	97,504	102,839	102,839	–
Trade and other receivables	–	–	–	–	–	1,136,073	1,136,073	1,136,073	258,389
Other current financial assets	–	–	–	–	–	2,885,897	2,885,897	2,885,897	–
Cash and cash equivalents	–	–	–	–	–	307,995	307,995	307,995	–
Total	**5,335**	**–**	**–**	**5,335**	**–**	**4,427,469**	**4,432,804**	**4,432,804**	**258,389**

Other non-current financial assets include non-current other investments classified as loans and receivables. The major position under other non-current financial assets are "O_2 My Handy" receivables. The other investments comprise an amount of EUR 14.9m (2011: EUR 0m) of a deposit pledged as collateral to cover the maximum risk from silent factoring to be borne by Telefónica Deutschland Group. The deposit is pledged over the term of the receivables sold (see Note 13 "Trade and other Receivables"). Telefónica Deutschland Group is paid a fixed interest for the deposit.

Furthermore, other non-current financial assets comprise available-for-sale financial assets incurred by Telefónica Deutschland Group to meet its pension obligations but do not qualify as plan assets under IAS 19. Telefónica Deutschland Group realized net gains from available-for-sale financial assets amounting to kEUR 199 and kEUR 225 in the years 2012 and 2011, respectively, which were recognized directly in other comprehensive income.

Other current financial assets as of December 31, 2011 and as of January 1, 2011 comprise in the amount of kEUR 2,885,897 a capital promise between the Telefónica Deutschland Group and O2 (Europe) Limited (see Note 15 "Equity").

Other current financial assets classified as held for trading comprise foreign currency forwards (see Note 19 "Financial Instruments and Risk Management").

	As of December 31, 2012								
				Measurement hierarchy					
Thousands of euros	Liabilities at amortized cost	Finance Leases	Held for trading	Level 1 (Quoted prices)	Level 2 (Other directly observable market inputs)	Level 3 (Inputs not based on observable market data)	Total carrying amount	Total fair value	Not in scope of IFRS 7
Non-current liabilities	**1,004,209**	**4,984**	**–**	**–**	**–**	**–**	**1,009,193**	**1,009,193**	**–**
Loans	1,000,000	–	–	–	–	–	1,000,000	1,000,000	–
Other payables	4,209	4,984	–	–	–	–	9,193	9,193	–
Current liabilities	**1,215,555**	**3,964**	**–**	**–**	**–**	**–**	**1,219,519**	**1,219,519**	**168,947**
Trade payables	918,458	–	–	–	–	–	918,458	918,458	–
Loans	250,878	–	–	–	–	–	250,878	250,878	–
Other payables	46,219	3,964	–	–	–	–	50,183	50,183	168,947
Total	**2,219,764**	**8,948**	**–**	**–**	**–**	**–**	**2,228,712**	**2,228,712**	**168,947**

	As of December 31, 2011								
				Measurement hierarchy					
Thousands of euros	Liabilities at amortized cost	Finance Leases	Held for trading	Level 1 (Quoted prices)	Level 2 (Other directly observable market inputs)	Level 3 (Inputs not based on observable market data)	Total carrying amount	Total fair value	Not in scope of IFRS 7
Non-current liabilities	**–**	**6,342**	**–**	**–**	**–**	**–**	**6,342**	**6,342**	**–**
Other payables	–	6,342	–	–	–	–	6,342	6,342	–
Current liabilities	**992,431**	**5,444**	**4,836**	**–**	**4,836**	**–**	**1,002,711**	**1,002,711**	**82,193**
Trade payables	891,321	–	–	–	–	–	891,321	891,321	–
Other current financial liabilities	–	–	4,836	–	4,836	–	4,836	4,836	–
Other payables	101,110	5,444	–	–	–	–	106,554	106,554	82,193
Total	**992,431**	**11,786**	**4,836**	**–**	**4,836**	**–**	**1,009,053**	**1,009,053**	**82,193**

Thousands of euros	Liabilities at amortized cost	Finance Leases	Held for trading	Measurement hierarchy: Level 1 (Quoted prices)	Level 2 (Other directly observable market inputs)	Level 3 (Inputs not based on observable market data)	Total carrying amount	Total fair value	Not in scope of IFRS 7
									As of January 1, 2011
Non-current liabilities	**–**	**5,846**	**–**	**–**	**–**	**–**	**5,846**	**5,846**	**–**
Other payables	–	5,846	–	–	–	–	5,846	5,846	–
Current liabilities	**930,909**	**3,789**	**–**	**–**	**–**	**–**	**934,698**	**934,698**	**95,775**
Trade payables	822,831	–	–	–	–	–	822,831	822,831	–
Other payables	108,078	3,789	–	–	–	–	111,867	111,867	95,775
Total	**930,909**	**9,635**	**–**	**–**	**–**	**–**	**940,544**	**940,544**	**95,775**

Financial liabilities measured at amortized cost

Telefónica Germany GmbH & Co. OHG entered into loan agreements dated as of September 12, 2012 with Telfisa Global B.V. as borrower in the amount of EUR 703m and EUR 1,250m. The loan in the amount of EUR 703m was repaid in 2012. The loan in the amount of EUR 1,250m generally has a five-year term. The agreed yearly repayment is 20%. For this reason, EUR 1,000m of the amount is classified as non-current other payables to related parties. But Telefónica Germany GmbH & Co. OHG has the right to prepay the loan earlier voluntarily. In case Telefónica Germany GmbH & Co. OHG obtains other financing facilities, it will be required to prepay the loan in the amount of 25% of the proceeds of these facilities.

Other current payables comprise payables from investment in fixed assets.

Financial liabilities held for trading

Other current financial liabilities classified as held for trading comprise foreign currency derivatives (forwards).

17. Trade and other Payables and Deferred Income

The composition of “Trade and other payables” is as follows:

	As of December 31,				As of January 1,	
	2012		2011		2011	
Thousands of euros	Non-current	Current	Non-current	Current	Non-current	Current
Trade payables	–	379,402	–	335,621	–	295,641
Accruals	–	328,254	–	411,147	–	390,962
Payables to related parties (Note 11)	–	210,802	–	144,553	–	136,228
Trade payables	**–**	**918,458**	**–**	**891,321**	**–**	**822,831**
Other payables [1]	**9,193**	**219,130**	**6,342**	**188,747**	**5,846**	**207,624**
Defferred income	–	153,972	–	169,866	–	136,920
Total	**9,193**	**1,291,560**	**6,342**	**1,249,934**	**5,846**	**1,167,375**

[1] Thereof current payables to related parties: As of December 31, 2012 31,096 kEUR; As of December 31, 2011 4,836 kEUR; As of January 1, 2011 0 kEUR.

“Accruals” mainly includes liabilities for provisions, liabilities for personnel and liabilities for outstanding invoices.

“Deferred income” principally includes the amount of advance payments received on prepaid contracts and the accruals for future interests from installment purchases.

The detail of current "Other payables" is as follows:

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Current other payables			
Other creditors non trade	63,665	54,726	58,599
Capital creditors	78,870	101,110	108,078
Other taxes and social security	41,535	22,631	37,158
Current other payables to related parties	31,096	4,836	–
Finance leasing	3,964	5,444	3,789
Total current	**219,130**	**188,747**	**207,624**
Non-current other payables			
Other creditors non trade	4,208	–	–
Finance leasing	4,985	6,342	5,846
Total non-current	**9,193**	**6,342**	**5,846**
Total other payables	**228,323**	**195,089**	**213,470**

"Other creditors non trade" mainly includes liabilities from factoring and liabilities for deferred rent-free units.

"Capital creditors" mainly includes liabilities for outstanding invoices for non-current assets.

18. Provisions

The amounts of provisions are as follows:

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Non-current-provisions			
Pensions	7,459	–	9,044
Other provisions	74,923	68,947	107,731
Total	**82,382**	**68,947**	**116,775**
Current provisions			
Other provisions	7,000	41,609	182,429
Total	**7,000**	**41,609**	**182,429**
Total provisions	**89,382**	**110,556**	**299,204**

Employee benefits

Telefónica Deutschland Group has defined benefit plans for its employees. The following tables present the main data of these plans:

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Obligation	(80,708)	(55,739)	(57,122)
Assets	73,389	73,465	57,456
Net provision before asset ceiling	**(7,319)**	**17,726**	**334**
Asset ceiling	(140)	(17,050)	(9,378)
Net provision	(7,459)	–	(9,044)
Net assets	–	676	–

At December 31, 2012 the amount of the defined benefit obligation arising from plans that are wholly unfunded amounts to kEUR 3,251 and 2011 to kEUR 2,899, respectively and from plans that are wholly or partly funded amounts to kEUR 77,457 and kEUR 52,840, respectively.

The development in the present value of defined benefit obligations in 2012 and 2011 is as follows:

Thousands of euros	2012	2011
Present value of defined benefit obligation at the beginning of the year	**(55,739)**	**(57,122)**
Current service cost	(2,347)	(2,918)
Interest cost	(2,944)	(2,725)
Actuarial gains and losses	(21,380)	6,620
Benefits paid	1,126	347
Changes in the consolidated subsidiaries	851	–
Transfer to other companies	(275)	59
Present value of defined benefit obligation at the end of the year	**(80,708)**	**(55,739)**

Developments in the fair value of plan assets in 2012 and 2011 are as follows:

Thousands of euros	2012	2011
Fair value of plan assets at the beginning of the year	**73,465**	**57,456**
Expected return on plan assets	3,638	2,857
Actuarial gains and losses	(2,386)	(3,283)
Employer contributions	311	16,545
Benefits paid	(906)	(174)
Changes in the consolidated subsidiaries	(858)	–
Transfer to other companies	–	(75)
Others	125	139
Fair value of plan assets at the end of the year	**73,389**	**73,465**

Plan assets comprise solely qualifying insurance policies.

Expenses recognized in profit or loss are shown as follows:

	As of December 31,	
Thousands of euros	2012	2011
Current service costs	2,347	2,918
Interest cost	2,944	2,725
Expected return on plan assets	(3,638)	(2,857)
Recognition of past service cost	275	–
Total amount of expense	**1,928**	**2,786**

The actual return on plan assets for the year ended December 31, 2012 and 2011 amounts to kEUR 1,252 and kEUR minus 426.

The amounts of actuarial gains and losses of these plans recognized directly in equity in accordance with their asset ceiling before the related tax effect are as follows:

	As of December 31,	
Thousands of euros	2012	2011
Actuarial gains and losses	23,766	(3,337)
Effect of the limit in IAS 19.58b	(19,884)	7,689
Total amount of expense	**3,882**	**4,352**

The accumulated amount recognized in the other comprehensive income at December 31, 2012 and 2011 amounts to kEUR 33,189 and kEUR 29,307.

The various companies consolidated within Telefónica Deutschland Group have defined benefit plans, covered by plan assets.

The following experience adjustments arised as of December 31, 2012 and 2011:

Thousands of euros	As of December 31, 2012	2011
Present value of defined benefit obligation	(80,708)	(55,739)
Fair value of plan assets	73,389	73,465
Deficit/Surplus in the plan	(7,319)	17,726
Experience adjustments arising from defined benefit obligation	**3,709**	**(337)**
Experience adjustments arising from plan assets	**(5,663)**	**2,974**

The number of beneficiaries of these plans at December 31, 2012 and 2011 is as follows:

Employees	As of December 31, 2012	2011
Consolidated Group	6,409	6,189

The main actuarial assumptions used in valuing these plans are as follows:

Assumption	As of December 31, 2012	2011
Nominal rate of salary increase	2.60%	3.50%
Nominal rate of pension payment increase	2%	2%
Discount rate	4.20%	5.30%
Expected return on plan assets	4.20%	4.25%-4.0%
- Support fund	4.20%	4.25%
- Direct commitments	4.20%	4.00%
Mortality tables	Prof. Klaus Heubeck (RT 2005 G)	Prof. Klaus Heubeck (RT 2005 G)

The discount rate used is based on the duration of the DBO, which is greater than 20 years. The best estimate of contributions expected to be paid to the plans during the year ending December 31, 2013 will amount to approximately kEUR 7,615. The expected return on assets is based on the expected return of the underlying insurance contracts.

Other provisions

"Other provisions" include provisions for dismantling and restructuring. The movement is as follows:

	Non Current			Current		Non Current & Current
Thousands of euros	Dismantling	Restructuring	Total	Restructuring	Total	Total
Other provisions at December 31, 2012	**55,694**	**19,229**	**74,923**	**7,000**	**7,000**	**81,923**
Additions	157	–	157	6,952	6,952	7,109
Utilisation	(6,739)	(407)	(7,146)	(22,348)	(22,348)	(29,494)
Transfers	–	9,291	9,291	(19,213)	(19,213)	(9,922)
Unwinding of discount	3,674	–	3,674	–	–	3,674
Other provisions at December 31, 2011	**58,602**	**10,345**	**68,947**	**41,609**	**41,609**	**110,556**
Additions	3,382	–	3,382	2,095	2,095	5,477
Utilisation	(11,623)	(26,106)	(37,729)	(149,561)	(149,561)	(187,290)
Transfers	–	(6,646)	(6,646)	6,646	6,646	–
Unwinding of discount	2,209	–	2,209	–	–	2,209
Other provisions at January 1, 2011	**64,634**	**43,097**	**107,731**	**182,429**	**182,429**	**290,160**

Provisions for dismantling obligations include the estimated costs for dismantling and removing an asset (e.g. mobile masts and other fixed assets), and restoring the site on which it is located. The expected timing of use depends on the respective agreements of site usage. Respective agreements have a duration of up to 20 years.

"Restructuring" mainly includes provisions for staff reduction plans and provisions for vacancies in rented properties. The expected timing of use covers periods from short to medium term depending on the respective restructuring events. The provisions for restructuring include contingent liabilities from acquisition of HanseNet Telekommunikation GmbH in 2010 in regard to outstanding settlement agreements with sales agents. As of December 31, 2012 the provision amounts to EUR 0.7m and EUR 6.3m as of December 31, 2011 as EUR 5.2m have been reversed and EUR 0.4m used up. The expected timing of use depends on the progress of settlement agreements with sales agents.

19. Financial Instruments and Risk Management

General

Telefónica Deutschland Group is exposed to various financial market risks as a result of its business. However, due to Telefónica Deutschland Group's regional focused operations, foreign exchange risk does not affect Telefónica Deutschland Group materially. Telefónica Deutschland Group is subject to credit risk from the operating business (trade receivables) as well as from receivables towards Telefónica Group.

Furthermore, Telefónica Deutschland Group is exposed to liquidity risks relating to its credit risks and market risks or a weakening of its operating business or financial market disturbances.

If these financial risks materialize, they could adversely affect Telefónica Deutschland Group's financial position, cash flows and profitability.

Telefónica Deutschland Group has guidelines in place for risk management procedures and for the use of financial instruments, including a clear segregation of duties with regard to financial activities, settlement, accounting and the related controlling. Derivative financial instruments are only contracted to hedge underlying risks from its commercial and treasury financing activities. However, these instruments are always contracted with Telefónica Group treasury and Telefónica Deutschland Group has established guidelines derived from best practice standards for risk assessment procedures and supervision concerning the use of financial derivatives.

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates and interest rates will affect the value of financial instruments or income of Telefónica Deutschland Group.

Foreign exchange risk

Telefónica Deutschland Group has determined the Euro as its financial reporting currency. All financial statements of Telefónica Deutschland Group's subsidiaries are prepared in Euro and therefore Telefónica Deutschland Group is not exposed to foreign exchange translation risks. Besides translation risks, foreign exchange transaction risk exists, mainly arising from Telefónica Deutschland Group's business relations with suppliers or business partners in countries that use currencies other than the Euro. Given its funding solely by self-generated cash and equity no exchange risk from debt denominated in currencies other than the Euro occurs. The net exposure on foreign currency risk at the balance sheet consists of primary and derivative financial instruments in foreign currencies as well as planned positions in foreign currencies of the following year.

For material identified foreign currency risks, derivatives are contracted with Telefónica Group treasury. At the reporting date December 31, 2012 no foreign currency derivatives existed. In 2011 foreign exchange derivatives were contracted to hedge exposure from its activities in currencies other than Euro. The effects before tax on the Consolidated Income Statement and equity of a simultaneous parallel appreciation of the Euro against all foreign currencies of 10% at the reporting dates December 31, 2012 and December 31, 2011 are as follows:

	2012		2011	
	Exposure	+ 10%	Exposure	+ 10%
USD	(36.8)	3.3	224.2	(20.4)
GBP	(21.5)	2.0	54.0	(4.9)
BRL	0.0	0.0	36.2	(3.3)
Others	0.0	0.0	61.0	(5.5)

As Telefónica Deutschland Group does not apply cash Flow hedge Accounting the effect of the sensitivity analysis would only affect the Consolidated Income Statement. The significant decrease of the net exposure and the sensitivities results from the purchasing activities of TGS until October 1, 2012, which is exposed to foreign currency risks from its operating business.

Interest rate risk

Interest rate risks arise primarily from Telefónica Deutschland's cash pooling accounts and deposits and in 2012 additionally from a loan agreement as a borrower.

Telefónica Deutschland Group deposits cash surpluses in cash pooling accounts and deposit accounts with Telfisa Global B.V. These accounts as well as the bank accounts bear variable interests.

Beyond Telefónica Deutschland Group has a loan liability in the amount of EUR 1,250m, which is bearing variable interest. The loan generally has to be repaid in five equal annual installments from September 2013 until September 2017. But Telefónica Deutschland Group may repay the loan early at any time. In case of obtaining other financing facilities, Telefónica Deutschland Group has to prepay the loan mandatory in the amount of 25% of the proceeds of these facilities.

The net exposure on variable interest for Telefónica Deutschland Group at the reporting dates December 31, 2012 and 2011, amounted to kEUR minus 926,334 and kEUR 1,148,125, respectively, mainly resulting from the loan and the cash and cash equivalents deposited with Telfisa Global B.V.. Telefónica Deutschland Group did not enter into interest rate derivatives during the years ended December 31, 2012 and 2011.

The effects before tax on the Consolidated Income Statement of a change in interest rates for variable-rate financial instruments of +/-100 basis points on the reporting dates December 31, 2012 and 2011 are shown in the table below. There is no impact recognized directly in equity. The minimum interest rate applied to take changes in interest rates into account was 0%. This analysis assumes that all other variables remain constant.

Impact on Consolidated Income Statement

Thousands of euros	2012	2011
+100bp	(9,263)	11,481
-100bp	12,133	(11,171)

Credit risk

Credit risk is the risk of financial loss arising from counterparty's inability to repay or service debt in accordance with the contractual terms. Credit risk includes both the direct risk of default and the risk of a deterioration of creditworthiness as well as concentration risks. Telefónica Deutschland Group's maximum exposure to credit risk is initially represented by the carrying amounts of the financial assets (without consideration of guarantees or collateral, if available).

Telefónica Deutschland Group considers managing commercial credit risk as crucial to meet its sustainable business and customer base growth targets in a manner that is consistent with its risk management policy. Appropriate credit policies, procedures and authorization guidelines are established to manage and monitor credit risk.

This approach to manage credit risk is based on continuous monitoring of the risk assumed and the resources necessary. In particular, attention is given to those clients that could cause a material impact on Telefónica Deutschland Group's Consolidated Financial Statements for which depending on the segment and type of relation appropriate credit management instruments like credit insurance or collateral may be used to mitigate exposure to credit risk. The assets acquired as a result of these credit insurances or collaterals during the years ended December, 31 2012 and 2011 were not material. In order to control credit risk, Telefónica Deutschland Group regularly performs an ageing analysis of trade accounts receivables and books allowances for doubtful accounts receivables with similar exposure to credit risk only.

In case Telefónica Deutschland Group has entered into foreign currency derivatives, all trades have been conducted with Telefónica Group treasury according to group policy only.

With regard to its cash surpluses Telefónica Deutschland Group has entered into cash pooling agreements and deposit agreements with Telfisa Global B.V. according to Telefónica Group policy and places most of its cash surpluses with these institutions.

Thus, most of Telefónica Deutschland Group's cash surpluses will be concentrated in these companies belonging to Telefónica Group which is rated by international rating agencies with an investment grade rating. The remaining cash surplus is spread out over several German banks, which are rated by international rating agencies with an investment grade rating.

At year-end 2012 and 2011 financial assets with Telefónica Group as counterparty amounted to EUR 335m and EUR 4,266m, respectively.

Liquidity risk

Liquidity risk comprises the risk that a company is unable to meet its financial obligations that are settled by delivering cash or another financial asset. Telefónica Deutschland Group's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its obligations when due, under both normal and stressed conditions. Telefónica Deutschland Group manages its liquidity closely coordinated with Telefónica and has entered into cash pooling agreements and deposit agreements with Telfisa Global B.V. according to Telefónica Group policy and places most of its cash surpluses with these institutions. The cash inflows generated by Telefónica Deutschland Group's operating business as well as the possibility of factoring receivables and maintaining credit facilities are used to reduce Telefónica Deutschland Group's liquidity risk.

In August and September 2012, Telefónica Germany GmbH & Co. OHG, as borrower, entered into revolving credit facility agreements with several banks. As a result, Telefónica Germany GmbH & Co. OHG has undrawn committed credit lines with maturity beyond one year in a total amount of EUR 710m. Every agreement's calculation of interest is the percentage rate which is the aggregate of margin and EURIBOR.

Furthermore, Telefónica Deutschland Holding AG has authorized capital allowing the management board, upon approval by the supervisory board, to increase the registered share capital, against and/or non-cash contributions until September 2017 on one or more occasions by a total amount of up to EUR 558,472,700 by issuing new non-par value registered shares. At year-end 2012 and 2011, cash and cash equivalents totalled EUR 323.7m and EUR 1,350.7m, respectively.

The following table shows the maturity profile of Telefónica Deutschland Group's financial liabilities based on contractual undiscounted payments:

			As of December 31, 2012		
			remaining term		
Thousands of euros	Total carrying amount	Gross cash outflow	< 1 years	1 - 5 years	> 5 years
Non-current liabilities	**1,009,193**	**1,072,552**	**–**	**1,072,552**	**–**
Loans	1,000,000	1,063,217	–	1,063,217	–
Other payables	9,193	9,335	–	9,335	–
Current liabilities	**1,219,519**	**1,239,581**	**1,239,581**	**–**	**–**
Trade payables	918,458	918,458	918,458	–	–
Loans	250,878	270,940	270,940	–	–
Other payables	50,183	50,183	50,183	–	–
Total financial liabilities	**2,228,712**	**2,312,133**	**1,239,581**	**1,072,552**	**–**

			As of December 31, 2011		
			remaining term		
Thousands of euros	Total carrying amount	Gross cash outflow	< 1 years	1 - 5 years	> 5 years
Non-current liabilities	**6,342**	**6,473**	**–**	**6,473**	**–**
Loans	–	–	–	–	–
Other payables	6,342	6,473	–	6,473	–
Current liabilities	**1,002,711**	**1,003,067**	**1,003,067**	**–**	**–**
Trade payables	891,321	891,321	891,321	–	–
Other current financial liabilities	4,836	4,969	4,969	–	–
Other payables	106,554	106,777	106,777	–	–
Total financial liabilities	**1,009,053**	**1,009,540**	**1,003,067**	**6,473**	**–**

Capital management

Telefónica Deutschland Group aims to ensure sustainability of the business and maximize the value to shareholders. Telefónica Deutschland Group monitors its cost of capital with a goal of optimizing its capital structure. Telefónica Deutschland Group monitors the equity ratio and the OIBDA. As of December 31, 2012 and 2011, the equity ratio was 70.9% and 90%, while the OIBDA from continuing operations was EUR 1,279.1m and EUR 1,149.2m.

20. Financial Results

The breakdown of the “Financial Result” is as follows:

	As of December 31,	
Thousands of euros	2012	2011
Interest income from financial assets not accounted at fair value through profit and loss	12,068	11,426
Other interest income	3,610	2,845
Interest expenses from financial liabilities not accounted at fair value through profit and loss	(18,622)	(6,180)
Accretion of provisions and other liabilities	(2,763)	(2,209)
Other exchange gains/losses	(416)	148
Net financal result	**(6,123)**	**6,030**

The increase in interest expenses from financial assets not accounted at fair value through profit and loss mainly results from an increase in borrowings.

Other exchange gains/losses result from assets and liabilities not accounted at fair value through profit and loss. Gains and losses from foreign-exchange derivates only relate to discontinued operations.

21. Income Tax Matters

Consolidated tax group

Telefónica Deutschland has filed consolidated tax returns for certain companies of Telefónica Deutschland Group. The consolidated tax group comprises 6 companies as of December 31, 2012 (10 in 2011).

Deferred taxes

Total tax expense consists solely of deferred tax expense as follows:

	As of December 31,	
Thousands of euros	2012	2011
Deferred tax (expense)	167,756	(1,732)
Income tax (expense)	**167,756**	**(1,732)**

The movements in deferred taxes are as follows:

Thousands of euros	2012	2011
Balance at January 1	**412,033**	**412,510**
Deferred tax expense	167,756	(1,732)
Movement in deferred taxes recognized directly in equity as shown in the consolidated statement of comprehensive income	1,427	1,255
Other	(25)	–
Balance at December 31	**581,191**	**412,033**

Tax loss carry forwards and temporary differences

Tax loss carried forward for which no deferred tax assets have been recognized at December 31, 2012 amounted to kEUR 11,222,741 for corporate income tax and kEUR 11,239,147 for trade tax respectively (kEUR 21,441,697 and kEUR 21,125,664 in 2011 and kEUR 20,847,724 and kEUR 20,588,258 as of January 1, 2011). The reduction results from the sale of Group 3G UMTS Holding and Quam GmbH. No deferred tax assets have been recognised for temporary differences in the amount of kEUR 565,122 in 2012, kEUR 2,234,462 in 2011 and kEUR 2,472,469 as of January 1, 2011.

Tax loss carried forward of Telefónica Deutschland Group contain taxable income and losses surrendered by Telefónica Global Services GmbH, Telefónica Global Roaming GmbH, Group 3G UMTS Holding and Quam GmbH, which are disposed as discontinued operations.

Temporary differences are generated as a result of the difference between tax bases of the assets and liabilities and their respective carrying amounts. Deductible temporary differences and tax loss carried forward give rise to deferred tax assets on the consolidated statement of financial position, whereas taxable temporary differences in tax bases give rise to deferred tax liabilities on the consolidated statement of financial position. The sources of deferred tax assets and liabilities from temporary differences and losses carried forward recognized at December 31, 2012, 2011 and January 1, 2011 are as follows:

Thousands of euros	As of December 31 2012 Deferred tax assets	As of December 31 2012 Deferred tax liabilities	As of December 31 2011 Deferred tax assets	As of December 31 2011 Deferred tax liabilities	As of January 1 2011 Deferred tax assets	As of January 1 2011 Deferred tax liabilities
Goodwill and intangible assets	891,684	(80,486)	796,735	(84,125)	1,204,232	(75,761)
Tangible assets	–	(327,255)	–	(286,945)	43,975	(291,945)
Investments in subsidiaries, associates and joint ventures	–	–	–	(1)	–	–
Trade and other receivables	116,446	(441)	304,877	–	957,182	(274,718)
Other current financial assets	11,413	(49,564)	3,584	(6)	12,366	(1,834)
Debt, trade and other payables	1,138	(114,675)	97,112	(435,294)	128,318	(1,286,225)
Provisions including pension provisions	34,410	(5,173)	32,285	–	34,490	(9,380)
Other current financial assets	4,210	(2,319)	5,166	(21,356)	14,817	(43,007)
Tax loss carryforwards	101,802	–	–	–	–	–
Tax assets (liabilities)	**1,161,103**	**(579,913)**	**1,239,759**	**(827,726)**	**2,395,380**	**(1,982,870)**
Set off of tax	(579,913)	579,913	(827,726)	827,726	(1,982,870)	1,982,870
Net tax assets (liabilities)	**581,191**	**–**	**412,033**	**–**	**412,510**	**–**

Reconciliation of profit before taxes to taxable income

The reconciliation between profit and the income tax expense for 2012 and 2011 is as follows:

	As of December 31,	
Thousands of euros	2012	2011
Profit before tax from continuing operations	**139,768**	**73,078**
Tax expense at prevailing statutory rate (32%)	(44,628)	(23,334)
Non-deductible expenses	(9,429)	(9,111)
Tax free income	85,095	–
Change in unrecognised temporary differences and tax loss carryforwards	135,571	30,288
Other	1,147	425
Income tax (expense)	**167,756**	**(1,732)**
Deferred tax (expense)	167,756	(1,732)
Total income tax (expense)	**167,756**	**(1,732)**

22. Revenues and Expenses

Revenues

The breakdown of “Revenues” is as follows:

	As of December 31,	
Thousands of euros	2012	2011
Rendering of services	4,515,041	4,372,205
Net Sales	697,797	663,347
Total	**5,212,838**	**5,035,552**

Revenues breakdown by Wireless Business and Wireline Business is as follows:

	As of December 31,	
Thousands of euros	2012	2011
Revenues		
Wireless Business	3,845,053	3,605,747
Wireless Service Revenues	3,151,838	2,946,465
Handset Revenues	693,215	659,282
Wireline Business	1,363,203	1,425,740
Other	4,582	4,065
Total Revenues	**5,212,838**	**5,035,552**

Revenues mainly comprise Wireline revenues, Wireless Service revenues and Handset revenues. Service revenues comprise Wireless Service revenues as well as Wireline revenues.

Wireline Revenues

Wireline revenues are primarily comprised of retail DSL service revenue, retail DSL activation fees, revenue for DSL-related hardware and non-recurring charges (e.g. charges for address change, number portation, etc.); service and hardware revenue from Pay TV; revenues from wholesale ULL, also called wholesale DSL, revenue derived from the sale of our DSL network and services as well as hardware to other providers who then repackage and resell it to the end consumer; carrier traffic revenue related to the sale and trading of minutes between carriers to connect their customers' calls through other operators networks as well as revenue derived from hosting client content on our data center infrastructure and providing accompanying management services, such as the use of our data center infrastructure to host applications designed and operated by third parties. DSL revenue also comprises fixed line telephony revenues.

Wireless Service Revenues

The vast majority of Wireless Service Revenues consists of customer base and tariff fees charged for voice (including incoming and outgoing calls), text (including SMS and MMS) and wireless data services and revenue from service contracts. Access and interconnection fees paid by other operators for calls and SMS terminated on our network are also included in Wireless Service revenues, as well as visitor roaming revenue.

Handset Revenues

Handset revenues comprise of the sale of wireless devices under the "O_2 My Handy" model as well as cash sales. The revenue under the "O_2 My Handy" model is discounted as Telefónica Deutschland Group receives payments from customers in monthly installments, which are paid out over a 12 or 24-month period. Furthermore, one-time revenue payments, such as activation fees for the wireless business (primarily for post-paid), hardware for bundled pre-paid SIM and handset packages or post-paid contracts as well as accessories are included.

Other Revenues

Other Revenues comprise revenue derived from the vertical business.

Other income

The breakdown of "Other income" in 2012 and 2011 is as follows:

Thousands of euros	As of December 31, 2012	As of December 31, 2011
Ancillary income	191	249
Own work capitalized	60,405	60,471
Gain on disposal of assets	210	271
Total	**60,806**	**60,991**

Other expenses

Other expenses mainly consist of sales and marketing, infrastructure, management fee and other external services.

Operating Leases

The estimated payment schedule regarding operating leases, purchase and contractual obligations is as follows:

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Operating lease obligations			
Less than 1 year	300,347	297,589	311,308
1 to 5 years	821,735	873,664	907,599
Over 5 years	829,204	861,077	740,976
Total	**1,951,286**	**2,032,330**	**1,959,883**
Purchase and other contractual obligations			
Less than 1 year	125,932	197,053	184,526
1 to 5 years	49	30,774	16,076
Over 5 years	–	–	–
Total	**125,981**	**227,827**	**200,602**

The following amounts have been recognized in the Consolidated Income Statement:

Thousands of euros	As of December 31, 2012	As of December 31, 2011
Operate lease expense	312,295	313,812

The operate lease expenses mainly include expenses for real estate (i.e. office buildings and shops), cars and network equipment (i.e. leased lines and cell sites).

Telefónica Deutschland Group provides operating guarantees granted by external financial counterparts which are offered in the course of normal commercial activity especially with regard to antenna sites rental contracts.

These guarantees amounted to EUR 37.6m and EUR 35.8m as of December 31, 2012 and 2011 respectively.

Subleases

Telefónica Deutschland Group entered into various subleasing agreements for office buildings, cell sites and shops. The estimated payment schedule for subleases is as follows:

Thousands of euros	As of December 31, 2012	As of December 31, 2011	As of January 1, 2011
Sublease payments			
Less than 1 year	21,248	20,484	12,357
1 to 5 years	78,962	86,065	74,287
Over 5 years	56,141	36,406	21,496
Total	**156,351**	**142,955**	**108,140**

The following amounts have been recognized in the Consolidated Income Statement:

Thousands of euros	As of December 31, 2012	As of December 31, 2011
Sublease income	24,314	27,658

The main finance lease transactions are described in Note 24 "Finance Leases".

Depreciation and amortization

The breakdown of “Depreciation and amortization” is as follows:

Thousands of euros	2012	2011
Depreciation of property, plant and equipment	604,037	610,902
Amortization of intangible assets	531,714	476,095
Total	**1,135,751**	**1,086,997**

23. Other Information

Contingent liabilities and assets

As part of its ordinary business Telefónica Deutschland Group is involved in various proceedings both in and out of court. These proceedings are in total not material to the results of operations and financial position.

24. Finance Leases

The finance leases of Telefónica Deutschland Group are presented in the Consolidated Financial Statements of the year ended December 31, 2012 in the position “Property, Plant and Equipment” (Note 8 “Property, Plant and Equipment”) and are as follows:

Net carrying amount of lease assets Thousands of euros

	As of December 31,		As of January 1,
	2012	2011	2011
Plant and machinery	8,948	11,786	9,635
Total	**8,948**	**11,786**	**9,635**

These commitments mainly arise from lease agreements for IT and office equipment for internal usage.

The breakdown of the minimum lease payments is as follows:

Present value of minimum lease payments

Thousands of euros

	Minimum future lease payments obligation	Unamortized interest expense	Present value of minimum future lease payments obligation
			As of December 31, 2012
due within 1 year	4,162	198	3,964
due between 1 and 5 years	5,127	142	4,985
due in more than 5 years	–	–	–
Total	**9,289**	**340**	**8,949**
			As of December 31, 2011
due within 1 year	5,667	223	5,444
due between 1 and 5 years	6,473	131	6,342
due in more than 5 years	–	–	–
Total	**12,140**	**354**	**11,786**
			As of January 1, 2011
due within 1 year	4,096	307	3,789
due between 1 and 5 years	6,064	218	5,846
due in more than 5 years	–	–	–
Total	**10,160**	**525**	**9,635**

25. Earnings per Share

Until September 26, 2012, the respective parent company had the legal form of a GmbH (German limited liability company). As part of the transformation of the parent company into an Aktiengesellschaft (German stock corporation) 1,116,945,400 non-par value shares were issued with an imputed interest of EUR 1 per share in the subscribed capital of the group parent company. Therefore, the calculation of the weighted average of the shares outstanding was based on the existing subscribed capital in the twelve month period ended December 31, 2012.

Basic earnings per share amounts are calculated by dividing net profit for the year attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the year.

Diluted earnings per share amounts are calculated by dividing net profit for the year attributable to ordinary equity holders of the parent (adjusted for any dilutive effects inherent in converting potential ordinary shares issued) by the weighted average number of ordinary shares outstanding during the year plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. During the financial period presented, there were no dilutive instruments outstanding.

Telefónica Deutschland Holding AG has authorized capital allowing the company to increase the registered share capital until September 17, 2017 by a total amount of up to EUR 558,472,700 by issuing new non-par value registered shares. Shares included in authorized capital of a stock corporation are not subject of the Earnings per share (EPS) calculation since they are contingently issuable shares.

Both basic and diluted earnings per share attributable to equity holders of the parent are calculated based on the following data and in accordance with IAS 33.

	As of December 31,	
Thousands of euros	2012	2011
Profit attributable to ordinary equity holders of the parent from continuing operations	307,523	71,348
Profit attributable to ordinary equity holders of the parent from discontinued operations	1,027,030	482,557
Total profit attributable to equity holders of the parent for basic earnings	1,334,553	553,904
Adjustment for dilutive effects of the conversion of potential ordinary shares	–	–
Total profit attributable to equity holders of the parent for diluted earnings	1,334,553	553,904

The denominators used in the calculation of both basic and diluted earnings per share have been adjusted to reflect any transactions that changed the number of shares outstanding without a corresponding change in equity as if they had taken place at the start of the first period under consideration. There have been no transactions involving existing or potential ordinary shares between the end of the year and the date of preparation of the Consolidated Financial Statements.

	As of December 31,	
Number of shares in thousands	2012	2011
Weighted average number of ordinary shares (excluding treasury shares) for basic earnings per share	1,117,001	1,117,023
Telefónica Deutschland Group share option plan	–	–
Weighted average number of ordinary shares (excluding treasury shares) outstanding for diluted earnings per share	1,117,001	1,117,023

Basic and diluted earnings per share attributable to equity holders of the parent broken down by continuing and discontinued operations are as follows:

	Continuing operations		Discontinued operations		Total	
	As of December 31,		As of December 31,		As of December 31,	
In euros	2012	2011	2012	2011	2012	2011
Basic earnings per share	0.28	0.06	0.92	0.43	1.19	0.50
Diluted earnings per share	0.28	0.06	0.92	0.43	1.19	0.50

26. Share-Based Payments

At December 31, 2012 Telefónica Deutschland Group has the following share-based payment arrangements:

Description of the share-based payment plans

"Performance Share Plan" (equity-settled)

The Performance Share Plan is a long-term incentive plan for managers and executives of Telefónica and other Telefónica Group companies, Telefónica Deutschland Group included.

Under this plan, selected participants who met the qualifying requirements were given a certain number of Telefónica shares as a form of variable compensation. As the shares are delivered by Telefónica, the ultimate parent company is the settling entity in accordance with IFRS 2.

It is divided into five phases, each three years long, the first beginning on July 1, 2006 and ending on June 30, 2009, the fifth beginning on July 1, 2010. At the start of each phase the number of shares to be awarded to plan beneficiaries is determined based on their success in meeting targets set. The shares are delivered at the end date of each phase, subject to a number of conditions:

- The beneficiary must continue to work for the company throughout the three-year duration of each phase.
- The actual number of shares awarded at the end is calculated by multiplying the maximum number of shares assigned to each executive at the start of a phase by a percentage reflecting the performance of the Telefónica share. The performance is measured by comparing the Total Shareholder Return ("TSR"), which includes both share price and dividends, with the TSRs offered by a basket of listed telecom companies that comprise the comparison group. This will be 100% if the TSR of Telefónica is equal to or better than that of the third quartile of the comparison group and 30% if Telefónica's TSR is in line with the average. The percentage rises linearly for all points between these two benchmarks. If the TSR is below average no shares are awarded.

At June 30, 2011, the third phase of this plan ended, which entailed the following number of shares issued:

Phase	No. of shares delivered	Grant-date fair value per unit	End date
3rd phase July 1, 2008	137,507	8.39	June 30, 2011

At June 30, 2012, the fourth phase of this plan ended, which entailed the following number of shares issued:

Phase	No. of shares delivered	Grant-date fair value per unit	End date
4th phase July 1, 2009	287,828	8.41	June 30, 2012

The number of the shares granted in the outstanding phase at December 31, 2012 is as follows:

Phase	Maximum no. of shares to be issued	Grant-date fair value per unit	End date
5th phase July 1, 2010	141,316	9.08	June 30, 2013

The fair values of the equity instruments granted to employees were measured using the share price of Telefónica shares at grant date under consideration of market conditions.

The plan has been valued using a Monte Carlo method, thereby incorporating the performance target as a market condition. This method involves generating share prices and TSRs for each company, based on its dividend yield and volatility, taking into account the cross correlations between stocks. The model is used to define the probability for the shares to vest and establish share price growth associated with different ranking positions.

The other than market vesting condition, which requires that the employee has to stay working for the company until the end of the vesting period, is not incorporated in the grant date fair value, but the number of equity instruments included in the measurement is adjusted regularly.

Concerning expected dividends of the shares, which the employees do not receive until physical delivery of the shares, there is no compensation payment. This fact was incorporated in the measurement of the grand date fair value.

As this plan is an equity-settled plan, settled by Telefónica employee expenses were recognized with a corresponding entry in equity as a contribution by parent.

There is a recharge agreement in place between Telefónica and Telefónica Deutschland concerning the shares delivered to employees in Germany. The recharge was accounted for by a debit to equity and a credit to liabilities against Telefónica by analogy to the requirements for cash-settled share-based payments. This means that the valuation is adjusted at each reporting date and the amounts are recognized on a pro rata basis over the vesting period.

"Performance and Investment Plan" (equity-settled)

This plan will take effect following completion of the "Performance Share Plan" and addresses Telefónica Group directors and executive officers.

It is divided into three phases, each three years long, the first beginning on July 1, 2011 and ending on June 30 2014, the third beginning on July 1, 2013. At the start of each phase the number of shares to be awarded to plan beneficiaries is determined based on their success in meeting targets set. The shares will be delivered at the end date of each phase.

As the shares are delivered by Telefónica, the ultimate parent company is the settling entity in accordance with IFRS 2.

The calculation method used to determine the actual number of shares delivered is similar to the "Performance Share Plan". The condition, that each participant must still be a Telefónica Group employee at the delivery date for each phase, also applies.

In addition to this, the possibility of co-investing has been included for all the participants. Under the co-investment condition the participant must directly own 25% of the number of shares assigned to him or her under the "Performance and Investment Plan". The shares must be owned at the first anniversary (or within fifteen months exclusively for the first cycle) of the starting date of each cycle, and the participant must hold those until the vesting date, in order to be entitled to receive an additional award of 25% of the original number of shares. Consequently, the participant receives one free share for each co-invested share, subject to the Company's performance.

The first allocation of shares under this plan was made on July 1, 2011. Therefore, the maximum number of shares assigned (including the amount of co-investment) under the plan at December 31, 2012 is as follows:

Phase	Maximum no. of shares to be issued	Grant-date fair value per unit	End date
1st phase July 1, 2011	138,061	8.28	June 30, 2014

Phase	No. of shares co-invested	End date
1st phase July 1, 2011	20,153	June 30,2014

The second allocation of shares under this plan was made on July 1, 2012. Therefore, the maximum number of shares assigned (including the amount of co-invested) under the plan at December 31, 2012 is as follows:

Phase	Maximum no. of shares to be issued	Grant-date fair value per unit	End date
2nd phase July 1, 2012	262,007	8.28	June 30, 2015

Phase	No. of shares co-invested	End date
2nd phase July 1, 2012	33,707	June 30, 2015

The fair values of the equity instruments granted to employees were measured using the share price of Telefónica shares at grant date under consideration of market conditions.

The market condition, which implies that a performance target of the Telefónica share must be achieved, was incorporated in the measurement of the fair value by means of the Monte Carlo method as explained above.

The service condition, which requires that the employee has to stay working for the company until the end of the vesting period, is not incorporated in the grant date fair value, but the number of equity instruments included in the measurement is adjusted regularly.

The co-investment condition, being a non-vesting condition, is taken into account when estimating the fair value of the awards at the measurement date. Additionally, the condition to hold the shares until the vesting date, which is another non-vesting condition, was incorporated in the fair value.

Concerning expected dividends of the matching shares, which the employees do not receive until physical delivery of the shares, there is no compensation payment. This fact was incorporated in the measurement of the fair value.

As this plan is an equity-settled plan, settled by Telefónica, employee expenses were recognized with a corresponding entry in equity as a contribution by parent.

There is a recharge agreement in place between Telefónica, and Telefónica Deutschland concerning the shares delivered to employees in Germany. The recharge was accounted for by a debit to equity and a credit to liabilities against Telefónica by analogy to the requirements for cash-settled share-based payments.

"Performance Cash Plan" (cash-settled)

This plan is operating under the same conditions like the "Performance Share Plan". It entails delivery to executives of a specific number of theoretical options in Telefónica which, in the event, would be cash-settled at the end of each phase. The payment is equivalent to the market value of the shares on settlement date up to a maximum of three times the notional value of the shares at the delivery date.

As the payment is made by Telefónica Deutschland, it is the settling entity.

The value of theoretical options is established as the average share price in the 30 days immediately prior to the start of each phase, except for the first phase, where the average share price during the 30 days immediately prior to May 11, 2006 (12.83 Euros) was taken as the reference.

The estimated duration of this plan is 7 years, with 6 phases, each of 3 years, commencing on July 1 of each year, starting in 2006.

Like the "Performance Share Plan", the performance rate for setting payments is measured based on the TSR on Telefónica shares with respect to the comparison group's TSRs, in line with the same criteria.

The fair value at December 31, 2012 of the options delivered in each phase in force at that time was 10.19 (December 31, 2011: 13.39) Euros per option. This value is calculated by taking the Telefónica share price and including the estimated TSR and is updated at each year end.

The market condition, which implies that a performance target of the Telefónica share must be achieved, was incorporated in the measurement of the fair value, by means of the Monte Carlo method as explained above.

The service condition, which requires that the employee has to stay working for the company until the end of the vesting period, is not incorporated in the grant date fair value, but the number of equity instruments included in the measurement is adjusted regularly.

As this plan is a cash-settled plan, it was accounted for by recording employee expenses and a corresponding liability.

"Global Employee Share Plan" (equity-settled)

This plan is a share incentive plan for all employees of the Telefónica group worldwide, with certain exceptions. Under this plan, participants that meet the qualifying requirements are offered the possibility of acquiring Telefónica shares and receiving the same number of shares free of charge at the end of the period.

As the shares are delivered by Telefónica, the ultimate parent company is the settling entity in accordance with IFRS 2.

The initial duration of the plan is intended to be two years. Employees subscribed to the plan can acquire Telefónica shares through monthly installments of up to 100 Euros up to a maximum of 1,200 Euros over a twelve-month period of time (acquisition period). The shares are purchased at fair value at acquisition date. The employees participating in the plan are entitled to dividends on the shares they acquired. The first delivery of shares has taken place as at September 1, 2012 considering the following conditions:

- The beneficiary must have continued to work for the company throughout the two-year duration of the plan (consolidation period), except for employees leaving for a good reason.
- The beneficiary must have retained the shares acquired for an additional twelve-month period after the end of the acquisition period.

The acquisition period opened in August 2010, and at December 31, 2011, 2,844 employees had adhered to the plan.

At August 31, 2012, the vesting period of this plan ended and 141,135 shares have been delivered to participants:

As of December 31,	No. of shares delivered	Weighted average of grant date fair value per unit
2012	94,090	16.72
2011	47,045	18.07
Total	**141,135**	**–**

In December 2012, a further phase started with an acquisition period until November 2013. At December 31, 2012 the following number of shares have been assigned to participants:

As of December 31,	Maximum no. of rights for shares to be issued	Weighted average of grant date fair value per unit
2012	14,438	10.06

The fair values of the equity instruments granted to employees were measured using the share price of Telefónica shares at grant date.

The other than market vesting condition, which requires that the employee has to stay working for the company until the end of the vesting period, is not incorporated in the grant date fair value, but the number of equity instruments included in the measurement is adjusted regularly.

The holding condition concerning the shares, which is a non-vesting condition, was incorporated in the fair value.

Concerning expected dividends of the shares, which the employees do not receive until physical delivery of the shares, there is no compensation payment. This fact was incorporated in the measurement of the fair value.

The GESP is an equity-settled plan and is therefore accounted for by a debit to employee expenses and a credit to equity.

There is a recharge agreement in place between O2 (Europe) Limited and Telefónica Deutschland concerning the shares delivered to employees in Germany. The recharge agreement is recognized by deduction from equity and a corresponding liability to O2 (Europe) Limited.

Employee expenses

Thousands of euros	As of December 31, 2012	2011
Employee expenses arising from share-based payment transactions	2,576	3,520
Thereof from cash-settled plans	(615)	602
Thereof from equity-settled plans [1]	3,191	2,918
Liabilities arising from share-based payment transactions (without liabilities from recharge agreements)	–	602

[1] Part of other movements within the statement of changes in equity.

27. Events after the Reporting Period

Rating
On January 16, 2013 the international rating agency Fitch Ratings, London has assigned Telefónica Deutschland Holding AG an initial first long-term issuer default rating (IDR) of “BBB” with a stable outlook and a senior unsecured rating to Telefónica Germany GmbH & Co. OHG of “BBB”.

28. Group Auditor’s Fees and Remuneration

For the services performed by the Group auditor Ernst & Young (E&Y) in the years ended December 31, 2012 and 2011, the fees and expenses depicted in the following table were recognized in the Consolidated Income Statement. As Telefónica Deutschland Group conducts all of its business in Germany, the full amount was incurred in Germany.

Thousands of euros	As of December 31, 2012	2011
Type of fees:		
Audit fees	1,333	1,038
Other audit-related services	2,301	–
Total	**3,634**	**1,038**

The audit fees include mainly fees for the year-end audit of the Consolidated Financial Statements, and the statutory auditing of Telefónica Deutschland Group and the subsidiaries included in the Consolidated Financial Statements. The audit-related fees essentially comprise the auditors’ review of the interim Consolidated Financial Statements and the fees related to the Initial Public Offering.

29. Personnel Information

The following personnel costs are contained in the positions of the Consolidated Income Statement:

	As of December 31,	
Thousands of euros	2012	2011
Short-term employee benefits	456,664	428,616
Long-term employee benefits	7,869	9,140
Expenses relating to pension plans	5,293	5,620
Expenses arising from share-based payment transactions	2,576	3,520
Total	**464,533**	**437,756**

The table below presents the breakdown of Telefónica Deutschland Group's average headcounts in 2012 and 2011 grouped with respect to their status in labor law:

Average Headcount

	2012	2011
Office staff	5,599	5,705
thereof from Joint Ventures:	8	8
Temporary staff	613	620
Total	**6,212**	**6,325**

Expenses relating to defined contribution plan amount to EUR 28.4m in 2012 (EUR 28.3m in 2011).

30. Declarations of Conformity German Corporate Governance Code

On February 28, 2013, the executive board and the supervisory board of Telefónica Deutschland Holding AG issued a latest declaration of conformity in accordance with Art. 161 of the Stock Corporation Act (AktG) and is now publicly available to the shareholders on the company's website (www.telefonica.de/declaration-of-compliance).

Munich, February 28, 2013

Telefónica Deutschland Holding AG

The management board

René Schuster   Rachel Empey   Markus Haas

Companies comprising Telefónica Deutschland Group

The table below lists the companies comprising Telefónica Deutschland Group as at December 31, 2012 and 2011.

Included for each company are the company name, the registered office, country, Telefónica Deutschland Group's effective shareholding and the company or companies through which the Telefónica Deutschland Group holds a stake.

		As of December 31,	
Company name, registered office	**Country**	**2012**	**2011**
Parent company			
Telefónica Deutschland Holding AG, Munich (former: Telefónica Germany Verwaltungs GmbH)	Germany	n/a	n/a
Subsidiaries			
Telefónica Germany Management GmbH, Munich	Germany	100%	0%
Telefónica Germany GmbH & Co. OHG, Munich [1]	Germany	100%	99.99%
Telefónica Germany 1. Beteiligungsgesellschaft mbH, Munich (former: Telefónica Germany Holding GmbH (former: O_2 (Germany) Holding GmbH))	Germany	100%	100%
Telefónica Germany Customer Services GmbH, Munich (former: Telefónica Deutschland GmbH)	Germany	100%	100%
Telefónica Germany Online Services GmbH, Munich	Germany	100%	100%
Wayra Deutschland GmbH, Munich	Germany	100%	n/a
Fonic GmbH, Munich	Germany	100%	100%
Telefónica Germany Partner Services GmbH, Munich	Germany	n/a	100%
Telefónica Global Services GmbH, Munich	Germany	n/a	100%
Telefónica Global Roaming GmbH, Munich	Germany	n/a	100%
Telefónica Compras Electronicas S.L., Madrid	Spain	n/a	100%
Group3G UMTS Holding GmbH, Munich	Germany	n/a	100%
Quam GmbH, Munich	Germany	n/a	100%
Joint Ventures			
Tchibo Mobilfunk Beteiligungs GmbH, Hamburg	Germany	50%	50%
Tchibo Mobilfunk GmbH & Co. KG, Hamburg	Germany	50%	50%
Associates			
Adquira España S.A., Madrid	Spain	n/a	40%

[1] Exemption according to section 264 b German Commercial Code (HGB)

Telefónica Deutschland Holding AG

Responsibility statement of the management board

To the best of our knowledge, and in accordance with the applicable reporting principles, the consolidated financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the group, and the group management report includes a fair review of the development and performance of the business and the position of the group, together with a description of the material opportunities and risks associated with the expected development of the group.

Munich, February 28, 2013

Telefónica Deutschland Holding AG

The management board

René Schuster | Rachel Empey | Markus Haas

Audit opinion

We have audited the consolidated financial statements prepared by Telefónica Deutschland Holding AG (formerly: Telefónica Germany Verwaltungs GmbH), Munich, comprising the consolidated statement of financial position, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of cash flows, the consolidated statement of changes in equity, and the notes to the consolidated financial statements, together with the group management report for the fiscal year from 1 January to 31 December 2012. The preparation of the consolidated financial statements and the group management report in accordance with IFRSs as adopted by the EU and the additional requirements of German commercial law pursuant to Sec. 315a (1) HGB ["Handelsgesetzbuch": German Commercial Code] is the responsibility of the parent company's management. Our responsibility is to express an opinion on the consolidated financial statements and the group management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with Sec. 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the group management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the group management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of the entities to be included in consolidation, the determination of the entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements and the group management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the consolidated financial statements comply with IFRSs as adopted by the EU as well as the additional requirements of German commercial law pursuant to Sec. 315a (1) HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The group management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Munich, February 28, 2013

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft

Bostedt Wirtschaftsprüfer [German public auditor]	Weiß Wirtschaftsprüferin [German public auditor]

Glossary*

3G	Third generation mobile communications standard supporting higher transmission rates (see UMTS)
4G	Fourth generation mobile communications standard (see LTE)
ADSL	Asymmetrical Digital Subscriber Line (see DSL)
ARPU	Average Revenue per User
Broadband	Refers to telecommunication in which a wide band of frequencies is available to transmit information
CapEx	Capital Expenditure: Additions in fixed and intangible assets (without goodwill)
Carrier	Telecommunication network operator authorized by the federal network agency
CF	Cash flow
Cloud Service	Cloud services are dynamic infrastructure, software or platform services provided online
Cross-selling	Marketing term denoting the sale of related or complementary products or services
DLD	Digital-Life-Design
DSL	Digital Subscriber Line, technology to transmit data in the local loop to private end-customers
EasT	Experts as Trainers program for training and continuing education
EC	European Commission
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FCF	Free Cash Flow
FNA	Federal Network Agency: Bundesnetzagentur
FTR	Fixed network Termination Rates
GDP	Gross Domestic Product
GfK	Consumer research association (Gesellschaft für Konsumforschung)
GPS	Global Positioning System
GSM	Global System for Mobile Communications: This is the global standard for digital mobile communications.
HSPA	High-Speed Package Access
Hosting	Providing storage capacity via the Internet
IDR	Issuer Default Rating
Internet	Worldwide network of computers on the basis of an IP (Internet Protocol) without any central network management
IPO	Initial public offering

* The glossary also contains abbreviations as used in the Group Management Report.

IT	Information Technology
Joint-venture	Two or more companies founding a new enterprise for cooperation
LAN	Local Area Network: A group of computers and associated devices that share a common communications line or wireless link
LIBOR	London Interbank Offered Rate
LTE	Long Term Evolution: Further development of the UMTS/HSPA mobile communications standard
M2M	Machine-to-Machine communication, automatic exchange of information between machines
MMS	Multimedia Messaging Service
mpass	Mobile payment service
MTR	Mobile termination rates
MVNO	Mobile Virtual Network Operator
NFC	Near Field Communication: a short-range wireless connectivity standard
NGO	Non Governmental Organization
n.m.	not measured
NRA	National Regulatory Authority
OIBDA	Operating Income before Depreciation and Amortization
OTT	Over The Top
PBX	Private Branch Exchange: A telephone system within an enterprise that switches calls between enterprise users on local lines while allowing all users to share a certain number of external phone lines
PIP	Performance and Investment Plan
POS	Point of Sale
Prepaid	In contrast to postpaid contracts, prepaid communication services are services for which credit has been purchased in advance with no fixed-term contractual obligations
Retail	Sale of goods and services to end users; as opposed to resale or wholesale business
Roaming	Using a communication device or subscriber identity in a different network other than one's home network
SIM	Subscriber Identity Module, a chip card to insert into a mobile phone and identifies the user within the network
SIP	Session Initiation Protocol: an Internet Engineering Task Force (IETF) standard protocol for initiating an interactive user session that involves multimedia elements such as video, voice, chat, gaming, and virtual reality

Smartphone	Wireless handset that can be used as a mobile phone, a web browser, and an e-mail reader simultaneously
SME	Small and Medium-sized Enterprises
SMS	Short Message Service
SoHo	Small and Home offices
Tablet	A wireless, portable personal computer with a touch screen interface
Telefónica	Telefónica S.A., Madrid, Spain
Telefónica Deutschland	Telefónica Deutschland Holding AG (former: Telefónica Germany Verwaltungs GmbH), Munich
Telefónica Deutschland Group	The companies included in the Consolidated Financial Statements of Telefónica Deutschland
Telefónica Group	The companies included in the Consolidated Financial Statements of Telefónica
ULL	Unbundled Local Loop, bridges the distance between the local exchange and the termination point on the customer's premises or in their home, so it is also known as the "last mile"
UMTS	Universal Mobile Telecommunications Service: International mobile communications standard of the third generation which unites mobile multimedia and telematics service under the frequency spectrum of 2 GHz.
VAT	Value Added Tax
VDSL	Very High Data Rate Digital Subscriber Line
VPN	Virtual Private Network
WAN	Wide Area Network: a geographically dispersed telecommunications network
Wholesale	Selling services to third parties who sell them to their own end customers either directly or after further processing

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