O2 Telefónica Deutschland Finanzierungs GmbH Munich

Financial statement and management report

31 December 2017

Translation from the German Language[1]

[1] This report was published in German and English.
In case of doubt please refer to the German version which is mandatory.

Appendix 1

O2 Telefónica Deutschland Finanzierungs GmbH

Munich

Statement of Financial Position as of 31 December 2017

Assets	31.12.2017 EUR	31.12.2016 EUR	*Equity and liabilities*	31.12.2017 EUR	31.12.2016 EUR
A. Fixed assets			**A. Equity**		
Financial assets			Nominal capital	25,000.00	25,000.00
Loans to affiliated companies	1,100,000,000.00	1,100,000,000.00		**25,000.00**	**25,000.00**
	1,100,000,000.00	**1,100,000,000.00**	**B. Provisions**		
B. Current assets			Other provisions	57,119.00	69,042.00
Receivables and other assets				**57,119.00**	**69,042.00**
			C. Liabilities		
Receivables from affiliated companies --thereof due from shareholders EUR 11,865,314.06 (previous year EUR 11,879,825.22)--	11,900,123.85	11,901,655.32	1. Bonds --thereof with a remaining term of less than one year EUR 600,000,000.00 (previous year EUR 0)-- --thereof with a remaining term of more than one and less than five years EUR 500,000,000.00 (previous year EUR 1,100,000,000.00)--	1,100,000,000.00	1,100,000,000.00
	11,900,123.85	**11,901,655.32**			
C. Prepaid Expenses	**2,696,800.00**	**4,497,400.00**	2. Trade payables --thereof with a remaining term of less than one year EUR 10,192.00 (previous year EUR 0)--	10,192.00	0.00
			3. Other liabilities --thereof with a remining term of less than one year EUR 11,807,812.85 (previous year EUR 11,807,613.32)--	11,807,812.85	11,807,613.32
				1,111,818,004.85	**1,111,807,613.32**
			D. Deferred income	**2,696,800.00**	**4,497,400.00**
Total assets	**1,114,596,923.85**	**1,116,399,055.32**	**Total equity and liabilities**	**1,114,596,923.85**	**1,116,399,055.32**

O2 Telefónica Deutschland Finanzierungs GmbH

Munich

Income Statement
for the Reporting Period from 1 January 2017 to 31 December 2017

		01.01.2017 - 31.12.2017	01.01.2016 - 31.12.2016
		EUR	EUR
1.	Other operating income	241,319.85	276,212.69
2.	Other operating expenses	-241,319.86	-276,212.69
3.	Other interest and similiar income --thereof from affiliated companies EUR 25,100,119.44 (previous year 25,088,369.05)--	25,100,119.44	25,088,369.05
4.	Interest and similiar expenses	-25,100,119.44	-25,088,371.85
5.	**Result before profit-and-loss transfer**	**-0.01**	**-2.80**
6.	Income from profit-and-loss transfer	0.01	2.80
7.	**Result**	**0.00**	**0.00**

O2 Telefónica Deutschland Finanzierungs GmbH

Munich

Statement of Cash Flows
for the Financial Year from 1 January 2017 to 31 December 2017

		01.01.2017-31.12.2017 EUR	01.01.2016-31.12.2016 EUR
1.	**Cash flow from operating activities**		
	Result before profit-and-loss transfer	-0.01	-2.80
	Increase (+)/decrease (-) in inventories, trade accounts receivable and other assets	1,814,911.66	1,769,429.95
	Increase (+)/decrease (-) in trade accounts payable and other liabilities	-1,806,891.46	-1,781,793.96
	Cash flow from operating activities	8,020.19	12,366.81
2.	**Cash flow from investing activities**		
	Interest received (+)	23,125,000.00	23,125,000.00
	Cash flow from investing activities	23,125,000.00	23,125,000.00
3.	**Cash flow from financing activities**		
	Interest paid (-)	-23,125,000.00	-23,125,000.00
	Cash flow from financing activities	-23,125,000.00	-23,125,000.00
4.	**Cash and cash equivalents at the end of the period**		
	Cash-effective change in cash and cash equivalents	8,020.19	-12,366.81
	Cash and cash equivalents at the beginning of the period	21,508.40	33,875.21
	Cash and cash equivalents at the end of the period	29,528.59	21,508.40

5.	**Composition of cash and cash equivalents**		
	Cash equivalents	29,528.59	21,508.40
	Cash and cash equivalents at the end of the period	29,528.59	21,508.40

O2 Telefónica Deutschland Finanzierungs GmbH

Munich

Statement of Changes in Equity
for the Financial Year from 1 January 2017 to 31 December 2017

	Nominal capital	Net income for the year	Equity
	EUR	EUR	EUR
As of 1 January 2017	**25,000.00**	**0.00**	**25,000.00**
As of 31 December 2017	**25,000.00**	**0.00**	**25,000.00**
As of 1 January 2016	**25,000.00**	**0.00**	**25,000.00**
As of 31 December 2016	**25,000.00**	**0.00**	**25,000.00**

O2 Telefónica Deutschland Finanzierungs GmbH, Munich

Notes to the Financial Statements for the 2017 Financial Year

I. GENERAL INFORMATION ON THE ANNUAL FINANCIAL STATEMENTS

Telefónica Deutschland Finanzierungs GmbH, Munich, was established by notary deed on 26 February 2013 for the purpose of financing the Telefónica Deutschland Group. The nominal capital was paid in on 6 March 2013. Telefónica Deutschland Finanzierungs GmbH, Munich, was renamed O2 Telefónica Deutschland Finanzierungs GmbH, Munich, (referred to in the following as "TDF" or the "Company") with effect from 7 November 2013. The Company is registered in the commercial register of the local court in Munich under registration number HRB 204122.

In November 2013, TDF issued a five-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 600,000 thousand and a maturity of 22 November 2018 in the regulated market of the Luxembourg Stock Exchange.

Furthermore, in February 2014, TDF issued a seven-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 500,000 thousand and a maturity on 10 February 2021 in the regulated market of the Luxembourg Stock Exchange.

The net proceeds from each bond were directly passed from TDF to Telefónica Germany GmbH & Co. OHG, Munich.

The annual financial statements of TDF for the financial year 2017 have been prepared in accordance with the accounting principles of the German Commercial Code (HGB) in the version of the Accounting Directive Implementation Act (BilRUG) as well as the GmbH Act (Act relating to limited liability companies, GmbHG).

As of 31 December 2017, the company is classified as a large corporation in accordance with section 264d in conjunction with section 267 (3) HGB.

The financial year of the company corresponds to the calendar year (1 January to 31 December).

The income statement has been prepared using the nature of expense method in accordance with section 275 (2) HGB.

The figures in the following have been rounded in accordance with established commercial practice. Figures or additions within a table may therefore lead to results other than the totals presented in the respective tables.

II. ACCOUNTING POLICIES

1. Principles and comparability

The accounting policies used in the preparation of the annual financial statements for the period ending 31 December 2017 are in accordance with the provisions of sections 242 to 256a and sections 264 to 288 of the HGB as well as the relevant provisions of the GmbHG. The accounting policies did not change year on year.

2. Fixed assets

Within the financial assets, loans are shown at the lower of nominal value or fair value. Interest-free or low-interest loans are discounted to the present value.

3. Current assets

The receivables and other assets are shown at the lower of nominal value or fair value at the balance sheet date. Adequate allowances have been recognised to take account of all risk positions.

4. Prepaid expenses

This item includes payments made before the reporting date representing expense applicable to a specific period after that date. The entitlement of section 250 (3) of the HGB regarding the presentation of the difference amount was exercised.

5. Equity

The nominal capital is stated with its nominal value.

6. Provisions

Other provisions take account of all identifiable risks and uncertain obligations. They are recognised at the settlement amount considered necessary on the basis of reasonable commercial assessment. Future price and cost increases are taken into account if there are sufficient objective indications that they will occur.

7. Liabilities

Liabilities are recorded at their settlement amount.

8. Deferred income

This item includes payments received before the reporting date representing income applicable to a specific period after that date.

III. NOTES TO THE BALANCE SHEET

1. Financial assets

The financial assets as of 31 December 2017 consist of two loans in the amount of EUR 600,000 thousand and EUR 500,000 thousand respectively, granted by TDF to its shareholder Telefónica Germany GmbH & Co. OHG, Munich. The terms of both loans correspond to the terms of the underlying five- and seven-year bonds which TDF issued on 22 November 2013 and 10 February 2014 respectively. The loans have fixed terms until the date of maturity of the underlying bonds on 22 November 2018 and 10 February 2021 respectively and are repayable in one amount on the due date, including all interest and costs which have not yet been paid. The underlying interest rates are 1.875 % and 2.375 % respectively and are payable annually on 22 November and 10 February respectively.

Statements of Changes in Fixed Assets for the Reporting Period from 1 January to 31 December 2017

	Acquisition costs					Accumulated depreciations				Carrying amounts	
	01.01.2017 EUR	Additions EUR	Disposals EUR	31.12.2017 EUR		01.01.2017 EUR	Additions EUR	Disposals EUR	31.12.2017 EUR	31.12.2017 EUR	01.01.2017 EUR
FinancialaAssets											
Loans to afilliated companies	1.100.000.000,00	0,00	0,00	1.100.000.000,00	0,00	0,00	0,00	0,00	0,00	1.100.000.000,00	1.100.000.000,00
	1.100.000.000,00	0,00	0,00	1.100.000.000,00		0,00	0,00	0,00	0,00	1.100.000.000,00	1.100.000.000,00

Please see the statement of changes in fixed assets for further information.

2. Receivables and other assets

The receivables due from affiliated companies amount to EUR 11,900 thousand (previous year: EUR 11,902 thousand), of which EUR 11,865 thousand (previous year: EUR 11,880 thousand) relates to receivables due from the shareholder Telefónica Germany GmbH & Co. OHG, Munich. These comprise claims to interest from loans issued to the shareholder in the amount of EUR 11,807 thousand (previous year: EUR 11,807 thousand).

The maturity of these receivables is less than one year.

3. Prepaid expenses

This item includes the amortised disagios from the issuance of the bonds for the five-year bond issued in November 2013 and for the seven-year bond issued in February 2014. Issuing fees for the five-year bond and for the seven-year bond are also included. All elements are released on a pro-rata basis over the terms of the underlying bonds until 22 November 2018 and until 10 February 2021 respectively.

4. Nominal capital

The nominal capital remains unchanged, amounts to EUR 25,000.00 and is fully paid. It is held entirely by Telefónica Germany GmbH & Co. OHG, Munich.

5. Provisions

The other provisions in the amount of EUR 57 thousand (previous year: EUR 69 thousand) mainly results from consultancy and audit fees.

6. Liabilities

The liabilities include two bonds with a nominal value of EUR 1,100,000 thousand in total. Thereof the five-year bond amounts to EUR 600,000 thousand with a maturity on 22 November 2018. Besides, the seven-year bond amounts to EUR 500,000 thousand with a maturity on 10 February 2021, constituting a liability with a remaining period of less than five years. Both bonds are guaranteed by Telefónica Deutschland Holding AG, Munich.

The other liabilities include interest payable in relation to the bonds in the amount of EUR 11,807 thousand (previous year: EUR 11,807 thousand).

7. Deferred income

Deferred income results from the updated differences between the nominal values of the underlying loans and the amounts paid out to Telefónica Germany GmbH & Co. OHG, Munich. The deferred items are released over the term of the underlying five- and seven-year loan.

IV. NOTES TO THE INCOME STATEMENT

Other operating income and expenses

Other operating income amounting to EUR 241 thousand (previous year: EUR 276 thousand) mainly results from cost transfers to Telefónica Germany GmbH & Co. OHG, Munich. Other operating expenses that relate to the transferred costs amount to EUR 241 thousand (previous year: EUR 276 thousand) and mainly consist of bank charges, audit and consultancy fees.

Financial result

Other interest and similar income in the amount of EUR 25,100 thousand (previous year: EUR 25,088 thousand) mainly result from interest income from the loans granted to Telefónica Germany GmbH & Co. OHG, Munich, EUR 23,125 thousand (previous year: EUR 23,287 thousand). Furthermore, EUR 1,801 thousand (previous year: EUR 1,801 thousand) result from the release of the deferred income.

Interest and similar expenses in the amount of EUR 25,100 thousand (previous year: EUR 25,088 thousand) include interest expense from the bonds of EUR 23,125 thousand (previous year: EUR 23,287 thousand) and the release of prepaid expenses in relation to the two disagios of EUR 1,801 thousand (previous year: EUR 1,801 thousand) until the date of maturity of the bonds.

V. SUPPLEMENTAL DISCLOSURES ON THE NOTES

Supplemental disclosures on the cash flow statement

Cash and cash equivalents ("Finanzmittelfonds") comprise solely cash and cash equivalents. Cash equivalents include all other short-term highly liquid investments that can be converted into cash any time and that is held as a cash reserve. Cash equivalents with original maturities of three months or less relate to cash-pooling receivables due from Telfisa Global B.V, Amsterdam, the Netherlands that are recognised as receivables from affiliated companies.

Employees

In financial year 2017 and in 2016 the company had no employees.

Management

The persons were Managing Directors in the financial year:

Albert Graf, Director Corporate Finance Teléfonica Germany GmbH & Co. OHG, Fahrenzhausen.
Markus Haas, CEO Telefónica Deutschland Holding AG, Munich.
Rachel Empey, CFO Telefónica Deutschland Holding AG, Munich (until 31 July 2017)
Markus Rolle, CFO Telefónica Deutschland Holding AG, Munich (since 1 August 2017).

The Managing Directors do not receive any payments from the company.

Audit committee

By resolution of the shareholder as of 28 April 2014 an audit committee for TDF was installed in accordance with section 324 HGB. The audit committee comprises the following members:

Dieter, Gauglitz
Chairman
German public auditor
Munich

Eckart, Kurze
Board member
until 31.01.2017: Director Transformation Implementation; Telefónica Germany GmbH & Co. OHG, Munich
since 01.02.2017: Director Operational Efficiency; Telefónica Germany GmbH & Co. OHG, Munich

Marcel, Ritter
Board member
Director Legal, Telefónica Germany GmbH & Co. OHG, Munich

Remuneration of governing bodies

The members of the Audit Committee received remuneration of EUR 15 thousand for their work in 2017.

Auditor’s fee

In accordance with section 285 no. 17 HGB, the total fee of the auditor of TDF is not disclosed since the company is part of the consolidation group of Telefónica Deutschland Holding AG, Munich, (Telefónica Deutschland Group) and the information is already included in the Consolidated Financial Statements.

Report on Events after the Reported Period

There were no significant events after the end of the financial year 2017.

Consolidated financial statements

The company that prepares the consolidated financial statements for the smallest group of companies in which the Company is included is Telefónica Deutschland Holding AG, Munich. The consolidated financial statements are published in the Federal Gazette and can be viewed there and on the website www.telefonica.de. The consolidated financial statements of Telefónica Deutschland Holding AG, Munich are included in the consolidated financial statements of the Spanish parent company Telefónica S.A., Madrid, Spain. Telefónica S.A., Madrid, Spain prepares the consolidated financial statements for the largest group of companies. These consolidated financial statements are available from Telefónica S.A., Madrid, Spain, and are published online at www.telefonica.com.

Cost reimbursement agreement

There is an agreement between TDF and Telefónica Germany GmbH & Co. OHG, Munich, for costs to be transferred to the shareholder.

Profit and loss transfer agreement

On 20 March 2013, TDF signed a control agreement with the controlling company Telefónica Germany GmbH & Co. OHG, Munich. In addition, on 20 March 2013, TDF also signed a profit and loss transfer agreement with Telefónica Germany GmbH & Co. OHG, Munich. This has been recorded in the Commercial Register on 2 April 2013.

The result at the end of the financial year 2017 will be transferred to or taken over by Telefónica Germany GmbH & Co. OHG, Munich.

Munich, 06. March 2018

O2 Telefónica Deutschland Finanzierungs GmbH

- Management -

Markus Rolle | Markus Haas | Albert Graf

Management Report

O2 Telefónica Deutschland Finanzierungs GmbH, Munich

Management Report for the Financial Year from 1 January 2017 to 31 December 2017

1. Business and general conditions

O2 Telefónica Deutschland Finanzierungs GmbH, Munich (referred to as “TDF” or the “Company”) acts as the financing company for the Telefónica Deutschland Group and its operating entities. The following overall economic and legal conditions for the operating entities are thus indirectly also relevant for TDF.

Solid economic development in Germany

The German economy remains on its growth trajectory: according to calculations by the Federal Statistical Office, the calendar-adjusted gross domestic product (GDP) grew by 0.8% in the third quarter of 2017 compared to the second quarter of 2017. On the whole, the German economy grew by 2.2% in 2017 In comparison to the previous quarter, positive stimulus came from both the domestic situation and abroad. In 2017, German consumer sentiment was high, despite global economic crises. The economic outlook indicator increased for the fifth time in succession in September 2017. This is the highest level it has reached in over two years. A further indicator for this development is that income expectations increased further, which was buoyed by the extremely good state of the German labour market. At the end of 2017, 44.3 million employed persons had their place of work in Germany, according to a report by the Federal Statistical Office.

Trends on the German telecommunications market indicate growth potential

The telecommunications industry is a major trailblazer for digitalisation, a process that is advancing and changing the world for the long term. This is leading to various trends in the telecommunications market:

The use of mobile devices such as smartphones, tablet computers and wearables is extremely important. The smart phone has developed from a pure communications device into a universal mobile companion and the control centre of mobile life. 71% of current smartphone users can no longer imagine life without a smartphone. Numerous services and apps, such as messaging and surfing the Internet, are now considered to be indispensable by a majority of Germans. On the one hand, smartphones are replacing products like digital compact cameras, mobile navigation devices and mp3 players. On the other hand, they are driving development on the market as interconnection with other devices opens up new growth areas. The smartphone is establishing itself as the control centre for other networked devices, and the range of potential applications is growing with every passing year. For example, smartphones can be used for the wireless transfer of music to multi-room systems, or smart TVs can be operated using an app. Household devices can also be activated and controlled remotely by smartphone. Wearables introduce additional functions and intelligent sensors to the smartphone concept. The industry association Bitkom was, for instance, expecting sales of 2.8 million smart watches and fitness trackers in Germany in 2017.

In the end-customer segment, voice assistants – such as Alexa by Amazon or Google Home – and virtual reality devices (glasses) are also playing an increasingly important role even if they are not yet mass-market products.

Last but not least, the television market is undergoing fundamental changes in Germany that also affect the telecommunications industry. Linear television is becoming increasingly less interesting for many people, even if it remains by far the most widespread form of television. On the other hand, new players such as Netflix or Amazon Prime are challenging established companies and media.

In addition to connecting people, the intelligent connection of things via the internet (IoT) offers numerous application and growth opportunities, such as Industry 4.0, connected cars, smart health, smart energy and smart cities. Another trend is the analysis of large quantities of data, which is facilitating new insights as well as new business models.

Demand for mobile data services and increased competition drives market development

With 118 million customers (SIM cards) at the end of September 2017, the German mobile telecommunications market is the largest in the EU. The notional mobile penetration rate was 143%, i.e. each German citizen had an average of 1.4 mobile SIM cards. The customer growth from April to September 2017 was attributable primarily to the more valuable postpaid sector. Overall, postpaid customers accounted for 53.9 % of total connections as of the end of September 2017. This share was 53.0% at the end of September 2016.

The mobile telecommunications market continued to develop dynamically in 2017, driven primarily by the strong demand for attractive smartphones and smartphone tariffs. According to a survey by the industry association Bitkom, 81% of German citizens aged 14 or older currently use a smartphone in 2017. However, a slowdown in the growth of the smartphone device market can be observed, driven by its increasing saturation and the fact that smartphones are being used for longer. According to the German Association for Consumer and Communication Electronics (gfu), around 15.88 million smartphones were sold in the period from January to September 2017, equating to a drop of 4.5% compared with the previous year. According to the same study the average price of smartphones, in contrast, increased by 6.3% to EUR 428. The driver of this development is the increasing demand for high-quality devices.

Mobile media use resulted in growing mobile data usage. According to the German Association of Providers of Telecommunication and Value Added Services (VATM), 1,350 million GB of data will be transmitted over mobile networks in 2017. This is 50% more than in 2016 (902 million GB).

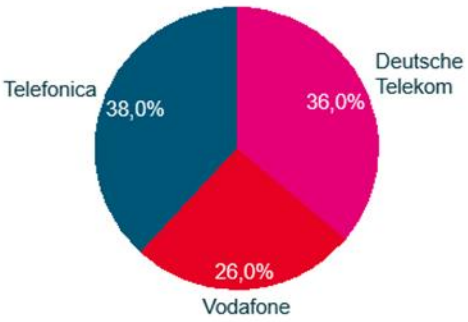
The increasing penetration of mobile end-devices with internet capability, such as smartphones or tablets, and the increasing use of mobile data services are also evident in the strong growth of revenues from mobile data in the German telecommunications market. According to estimates by Ovum, mobile data revenues increased by 10.5% in 2016 compared with the same period in the previous year; further growth of 13.4% compared with the previous year is expected in 2017. By contrast, revenues from mobile telephony and SMS have fallen, driven by price decline, regulatory effects and changes in customer behaviour.

SOURCE: COMPANY DATA, ANALYSYS MASON, BUNDESBANK, BITKOM, VATM, BMWI, FEDERAL STATISTICAL OFFICE, OVUM

The German mobile telecommunications market is an established market

Following the merger of the Telefónica Deutschland Group with the E-Plus Group, the German mobile telecommunications market consists of three network operators and several service providers and mobile virtual network operators (MVNOs). As of the end of September 2017, the Telefónica Deutschland Group had a market share of 38.0% with around 44.8 million connections in total (according to calculations methods customary to the market: 48.4 million). It is therefore the largest German mobile telecommunications network operator in terms of number of customer connections.

Market share in the mobile telecommunications market
per customer (in %)
at the end of September 2017



SOURCE: COMPANY DATA/QUARTERLY REPORTS

German fixed-line market characterised by strong competition

Intense competition also still prevails on the German market for fixed-line broadband services. The number of connections increased by approx. 3% year-on-year; the customer base is therefore estimated to have grown to 33.0 million by the end of 2017. The growth is mainly driven by cable and VDSL connections, which is in turn based on changed customer behaviour and the increased demand for high speeds. At the end of 2017, 28.2% of fixed line customers used connections of at least 50 Mbit/s; at the end of 2016 this was still at 23.8%. The increased customer demand for more bandwidth is also reflected in the data volume generated per broadband connection and month. According to VATM, this increased by 33.2% in 2017 to an average of 79 GB per connection.

SOURCE: ANALYSYS MASON, VATM

Regulatory Influences on the Telefónica Deutschland Group

As a provider of telecommunications services and an operator of telecommunications networks, the Telefónica Deutschland Group is required to meet certain regulatory requirements. As such, it is subject to supervision by the Bundesnetzagentur (BNetzA – German Federal Network Agency).

The key regulatory events affecting the Telefónica Deutschland Group in the year under review are discussed below:

Frequencies

<u>BNetzA continues with process to provide new frequencies for the further development of digital infrastructures</u>

Telefónica Deutschland Group and other interested parties submitted statements on the points of orientation for the provision of frequencies for the expansion of digital radio infrastructures provided by BNetzA for comment in March 2017. In the further development of the points of orientation, the BNetzA published a position paper on key elements on 27 June 2017 and, at the same time, initiated a procedure for determining the frequency demand for nationwide assignments in the 2 GHz and 3.6 GHz bands. Among other things, for 2 GHz the key elements adhere to the joint award of the frequencies expiring at the end of 2020 and end of 2025; for 3.6 GHz regional assignments for a part of the frequencies are provided for on the one hand, and, on the other hand, mutual co-usage rights between national and regional assignments as well as a demand-based supply with 5G are planned. The holders of national assignments are to be required to share the use of the capacities and services for the provision of as diverse business models as possible without discrimination. For frequencies above 24 GHz, BNetzA intends to initially develop an application process in the frequency band of 26 GHz. Telefónica Deutschland Group reported its frequency demand by 30 September 2017 and commented on the key elements. The results of the frequency demand determination and the first draft decision in this regard are expected in the first quarter of 2018.

Telecommunications market

EU revises legal framework for telecommunications (telecoms review)

On 14 September 2016, the European Commission presented a proposal for a European Electronic Communications Code that would fundamentally revise the legal framework for the communications industry. The core aspects include extending the regulatory targets to include “encouraging investment in very high-capacity networks” and considerations on the regulation of OTT services. The proposal also contains regulations on frequency usage, access regulation and the future institutional framework. Although it sets out a right course of action, the proposal also involves uncertainties, meaning that a conclusive assessment of the opportunities and risks is not yet possible. The EU regulations are expected to be finalized in June 2018 and will then have to be implemented into national law.

EU issues new Payment Services Directive II

The EU has issued a revised Payment Services Directive II. It supersedes the Payment Services Directive I and must be implemented into national law by 13 January 2018. Particularly relevant areas for the Telefónica Deutschland Group are the revised provisions on billing for third-party digital goods via phone bills. In future, the exemption from payment services supervision in this area will apply for amounts only up to EUR 50 per transaction and a maximum of EUR 300 per month where no payment services licence is held. The new legislation also introduces reporting obligations to the German Federal Financial Supervisory Authority. The new regulations were implemented by the Telefónica Deutschland Group.

BNetzA consults specifications on transparency requirements under the Telecoms Single Market Regulation (TSM-R)

Since 30 April 2016, the TSM-R regulations, among other things on transparency in end customer contracts, must be complied with. BEREC, a body of European regulators, published guidelines for implementing the provisions on 30 August 2016. In this connection, after holding hearings for the affected parties on 12 July 2017, BNetzA published a notification on the definition of unspecified legal concepts in the TSM-R for fixed broadband connections for download in the official gazette (Amtsblatt) in order to make it practicable.

The transparency regulation promulgated by BNetzA enters into force

The legal regulation with measures to increase transparency in telephone and internet services in the mobile and fixed-line segments issued by BNetzA to strengthen consumer interest largely entered into force on 1 June 2017; the remaining parts are to follow on 1 December 2017. Among other things, the regulation includes provisions on cost control, the review and documentation of contractually agreed data transfer rates and the provision of information on contract content to customers prior to conclusion. Telefónica Deutschland Group complies with the new regulations.

Amendments to section 111 of the German Telecommunications Act (TKG) in the context of the Act on Improved Information Exchange in Combating International Terrorism have been valid since 1 July 2017

Section 111 of the Telekommunikationsgesetz (TKG – German Telecommunications Act) stipulates which customer data must be collected and stored before a connection is activated. As from 1 July 2017, this section requires the accuracy of the customer data collected to be checked by means of certain identification documents or other methods now determined by BNetzA before a prepaid SIM card is activated. Telefónica Deutschland Group complies with these amendments in its business processes.

Discontinuation of data retention by BNetzA

In December 2015, a law on the reintroduction of data retention was promulgated, according to which the technical and organisational realisation of groundless retention of certain traffic data had to have taken place as of 1 July 2017. In a decision by the Münster Higher Administrative Court for the State of North-Rhine Westphalia in June 2017, the legality of this groundless retention was questioned. Against this background BNetzA published a notification according to which it will refrain from issuing ordinances and taking other measures to enforce the retention obligations in respect of all companies required to do so until the lawfulness of the retention obligations had been legally clarified. For this reason, Telefónica Deutschland Group has temporarily discontinued the retention.

Access and compensation regulation

Roaming surcharges have in principle been abolished since 15 June 2017

The TSM-R, which came into force in November 2015, sets out changes to the existing roaming regulation. Since 15 June 2017 roaming surcharges have therefore, in principle, been abolished for end customers on their respective domestic tariff ("Roam-like-at-home"); surcharges to the value of the maximum wholesale roaming charges, also effective since 15 June 2017, may now only be charged after a fair use limit has been reached. Details of this fair use limit were finally adopted by the EU Commission in December 2016. BEREC, a body of European regulators, published guidelines for implementing the roaming provisions (valid since 15 June 2017) on 27 March 2017. The Federation of German Consumer Organisations (Verbraucherzentrale Bundesverband e.V. – VZBV) issued a warning to Telefónica Germany GmbH & Co. OHG with regard to individual aspects of the implementation of Roam-like-at-home. As the implementation took place by Telefónica Germany GmbH & Co. OHG in line with the specifications of BNetzA, the warning was not agreed to. The VZBV therefore filed an action.

BNetzA issues final approvals for MTR and FTR

By means of the decision dated 6 March 2017, BNetzA issued the final approval for the mobile termination rates (MTR) initially provisionally approved on 30 November 2016. From 1 December 2016, rates of 1.1 euro cents per minute were valid, which dropped to 1.07 euro cents per minute on 1 December 2017; as of 1 December 2018, the rates will drop further to 0.95 euro cents per minute. These rates were symmetrically approved for all mobile operators. They are effective until 30 November 2019. The rates were approved on the basis of the new cost benchmark, pureLRIC. Overall, the reductions were less than initially expected.

The fixed termination rates (FTR) of 0.24 euro cents per minute expired at the end of December 2016. For the period thereafter, BNetzA provisionally approved rates of 0.1 euro cents per minute with its provisional decision dated 25 January 2017 and final decision dated 20 October 2017. These charges were approved symmetrically for all regulated fixed network operators for the period from 1 January 2017 to 31 December 2018. The FTRs of Telekom Deutschland GmbH (Telekom) serve as a reference benchmark for all the other fixed line operators. Telekom has filed an action against their FTR approval.

BNetzA initiates consultation and market studies on fiber optic infrastructures

On 14 March 2017, BNetzA initiated a consultation process entitled "Issues in rates regulation for FttH/B-based wholesale products with a view to the development of fiber optic infrastructures capable of high performance". The study will investigate how the accelerated development of fiber optic networks can be supported by regulations. The consultation deals with the rate-related aspects of regulation. The future could hold a departure from the current cost-based regulation. Any changes to the regulatory standard are expected by the end of 2018 at the earliest. In a parallel process, BNetzA initiated a market study on the requirements for regulation and the existence of significant market power relating to markets 3a (= wholesale local access provided at a fixed location) and 3b (= wholesale central access provided at a fixed location for mass-market products). The key aspect of this study will be the question as to whether FttH/B-based wholesale products will continue to be assigned to the nationwide connection market in which copper-based connections and cable-based connections can also be found. This study is a pre-requisite for any rate regulation. Initial decisions are expected to be made in the second quarter of 2018 at the earliest.

Introduction of a regulated wholesale product "Super Vectoring" by Telekom

Telekom Deutschland GmbH announced that it expects to expand its product offering as part of the regulated wholesale service "Bitstream Access" through "Super Vectoring" connections from August 2018. This would significantly increase the potential bandwidth of VDSL connections compared to today. Telekom is required to offer competitive prices on the wholesale service market; however, it is not yet known what these are. An improvement in Telefónica Deutschland Group's competitive position in the fixed line market is expected due to the planned introduction as competitiveness versus cable network operators and FTTB/H providers can be improved.

2. Areas of operation

TDF was established as a wholly owned subsidiary of Telefónica Germany GmbH & Co. OHG, Munich, on 26 February 2013. It is thus part of the Telefónica Deutschland Group. TDF handles major financing activities of the Telefónica Deutschland Group. The necessary resources can be financed and procured by way of issuing bonds eligible for trading on the capital market. The Company is authorised to carry out all activities and measures which appear to be appropriate to directly or indirectly serve the business purpose of the Telefónica Deutschland Group. In particular, TDF is authorised to establish and acquire other companies, to obtain equity participations in other companies, to manage such companies or restrict its activities to managing such participations.

On November 2013, TDF issued a five-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 600,000 thousand and a maturity on 22 November 2018 in the regulated market of the Luxembourg Stock Exchange. The annual nominal interest of the bond is 1.875 %. Furthermore as of 10 February 2014 and in the same regulated market of the Luxembourg Stock Exchange, TDF issued a seven-year unsecured bond (Senior Unsecured Bond) with a nominal value of EUR 500,000 thousand, an annual nominal interest of 2.375% and a maturity on 10 February 2021.

The bonds represent unsecured and senior liabilities of TDF, which are of equal ranking with each other and with all other unsecured and senior liabilities of TDF, unless these liabilities enjoy priority as a result of mandatory stipulations. Each bond is repaid on the due date in the amount of its specified denomination, unless it has been previously repaid or purchased and invalidated.

The bonds are guaranteed by Telefónica Deutschland Holding AG, Munich.

The net proceeds from each bond were directly passed from TDF to Telefónica Germany GmbH & Co. OHG, Munich, based on loan agreements with concurrent terms and conditions.

3. Net assets, results of operations and financial position

Net assets

The assets are presented in the following table:

Balance sheet item	**31 Dec. 2017 EUR thousand**	**31 Dec. 2016 EUR thousand**	**Change EUR thousand**
Financial assets	1,100,000	1,100,000	0
Receivables and other assets	11,900	11,902	-2
Prepaid expenses	2,697	4,497	-1,801
Total Assets	**1,114,597**	**1,116,399**	**-1,802**

The financial assets as of 31 December 2017 consist of two loans in the amount of EUR 600,000 thousand and EUR 500,000 thousand respectively, granted by TDF to its shareholder Telefónica Germany GmbH & Co. OHG, Munich. The terms of both loans correspond to the terms of the underlying five- and seven-year bonds which TDF issued on 22 November 2013 and 10 February 2014 respectively. The loans have fixed terms until the date of maturity of the underlying bonds on 22 November 2018 and 10 February 2021, respectively. The loans are repayable in one amount on the due date, including all interest and costs which have not yet been paid.

The receivables and other assets of EUR 11.900 thousand (previous year EUR 11,902 thousand) consist mainly of interest receivables from the loans granted to Telefónica Germany GmbH & Co. OHG, Munich, in the amount of EUR 11,807 thousand (previous year: EUR 11,807 thousand) and remained on the previous year level. The underlying interest rates are 1.875 % and 2.375 % respectively and are payable annually on 22 November and 10 February respectively

As of 31 December 2017, prepaid expenses included the amortised disagios from the issuance of the bonds for the five-year bond issued in November 2013 and for the seven-year bond issued in February 2014. Furthermore the amortised issuing fees are also included. The change in prepaid expenses results from the straight line reversal of the components over the terms of the underlying bonds until 22 November 2018 and 10 February 2021 respectively.

Equity and liabilities are presented in the following table:

Balance sheet item	**31 Dec. 2017 EUR thousand**	**31 Dec. 2016 EUR thousand**	**Change in EUR thousand**
Equity	25	25	0
Bonds	1,100,000	1,100,000	0
Other provisions	57	69	-12
Trade payables	10	0	10
Other liabilities	11,808	11,808	0
Deferred income	2,697	4,497	-1,800
Total Equity and liabilities	**1,114,597**	**1,116,399**	**-1,802**

The company’s share capital remains unchanged at EUR 25 thousand and is fully paid. It is held entirely by Telefónica Germany GmbH & Co. OHG, Munich.

The other provisions of EUR 57 thousand (previous year: EUR 69 thousand) mainly relate to consultancy and audit fees.

The liabilities include two bonds with a nominal value of EUR 1,100,000 thousand in total. Thereof the five-year bond amounts to EUR 600,000 thousand, with a maturity on 22 November 2018. Both bonds had a remaining term of less than five years as of 31 December 2017 and are guaranteed by Telefónica Deutschland Holding AG, Munich.

The other liabilities include current interest liabilities relating to the bonds that will not be paid until the following year.

Deferred income results from the amortised differences respectively between the nominal values of the underlying loans and the amounts paid out to Telefónica Germany GmbH & Co. OHG, Munich. The deferred items are released over the term of the underlying five- and seven-year loan.

Results of operations

In the financial year ending 31 December 2017, TDF reported a loss before profit-and-loss transfer of EUR 0.01 (previous year: EUR 2.80 before profit-and-loss transfer), which was assumed by Telefónica Germany GmbH & Co. OHG, Munich, as a result of an existing domination and profit and loss transfer agreement. As expected a result for the year of EUR 0.00 was realized.

The main profit and loss items are as follows:

Profit and loss item	**1 Jan. 2017 - 31 Dec. 2017 EUR thousand**	**1 Jan. 2016 - 31 Dec. 2016 EUR thousand**	**Change EUR thousand**
Other operating income	241	276	-35
Other operating expenses	-241	-276	35
Other interest and similar income	25,100	25,088	12
Interest and similar expenses	-25,100	-25,088	-12
Result before profit-and-loss transfer	**0**	**0**	**0**
Income from profit-and-loss transfer	0	0	0
Result	**0**	**0**	**0**

The other operating income amounting to EUR 241 thousand (previous year: EUR 276 thousand) mainly results from cost transfers to Telefónica Germany GmbH & Co. OHG, Munich. The other operating expenses that relate to the transferred costs amount to EUR 241 thousand (previous year: EUR 276 thousand) and mainly consist of bank charges and consultancy and audit fees.

Other interest and similar income in the amount of EUR 25,100 thousand (previous year: EUR 25,088 thousand) mainly result from interest income from the loans granted to Telefónica Germany GmbH & Co. OHG, Munich, EUR 23,125 thousand (previous year: EUR 23,287 thousand). Furthermore, EUR 1,801 thousand (previous year: EUR 1,801 thousand) result from the release of the deferred income over the term of the underlying loan.

Interest and similar expenses in the amount of EUR 25,100 thousand (previous year: EUR 25,088 thousand) include interest expense from the bonds of EUR 23,125 thousand (previous year: EUR 23,287 thousand) and the release of prepaid expenses in relation to the two disagios of EUR 1,801 thousand (previous year: EUR 1,801 thousand).

Financial position

Principles and objectives of the finance management

The risk control and a central steering are core principles of the TDF finance management. The objective of the finance management are to permanently provide sufficient financial liquidity and stability. Risk monitoring is used to anticipate potential risks and counteract them with according measures. We are not aware of any circumstances which would hinder TDF to meet its financial obligations.

The development of cash and cash equivalents as well as the corresponding cash flows are presented in the separately disclosed cash flow statement.

Cash and cash equivalents contain receivables from cash pooling with Telfisa Global B.V., Amsterdam, Netherlands.

During the financial year 2017, TDF reported a positive cash flow from operating activities in the amount of EUR 8 thousand, in previous year TDF reported a negative cash flow from operating activity in the amount of EUR 12 thousand. The positive cash flow from operating activities results mainly from the increase of trade liabilities and the reduction of intercompany receivables. The reduction of other provisions partial compensated the effect.

In the financial year 2017 as well as in previous year, TDF reported a positive cash flow from investing activities in the amount of EUR 23,125 thousand that resulted from the interest payments from the borrower Telefónica Germany GmbH & Co. OHG, Munich.

The outgoing payments in the cash flow from financing activities amounted to EUR 23,125 thousand as of 31 December 2017 and resulted from the interest payments for the bonds issued.

As of 31 December 2017, TDF had an unused credit facility amounting to EUR 6 thousand (previous year: EUR 6 thousand).

4. Opportunity and risk report

TDF currently restricts its activities exclusively to financing the Telefónica Deutschland Group. The main elements of the assets of TDF are the loans granted to Telefónica Germany GmbH & Co. OHG, Munich. The economic existence of TDF is thus primarily dependent on whether Telefónica Germany GmbH & Co. OHG, Munich is able to meet its obligations in relation to these loans. All interest and capital payments relating to all debt securities currently issued by TDF are secured by a full and unlimited guarantee by the guarantor Telefónica Deutschland Holding AG. These guarantees are enforceable in accordance with the law of the Federal Republic of Germany.

Accordingly, the risks and opportunities of O2 Telefónica Deutschland Finanzierungs GmbH, Munich, as well as the measures and processes for handling risks and opportunities are essentially the same as those applicable for the Telefónica Deutschland Group, which are summarised in the following.

General financial market risks

The Telefónica Deutschland Group is exposed to various financial market risks as part of its business activity. In the context of the above-mentioned the risk management process, these risks are regarded as low. Should these financial market risks occur, they could have a negative effect on the net assets, financial position and results of operations of the Group and are therefore presented individually below.

The Telefónica Deutschland Group has developed guidelines for risk management processes and for the use of financial instruments including a clear separation of tasks with respect to financial activities, invoicing, financial reporting and associated controlling. Derivative financial instruments are used solely to manage interest rate and currency risks. The Telefónica Deutschland Group has developed guidelines derived from established standards for the evaluation of risks and monitoring with regard to the use of financial derivatives.

Market risk

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

Interest rate risk

Interest risks arise predominantly from floating-rate cash pooling accounts and deposits of the Telefónica Deutschland Group at Telfisa Global B.V., Amsterdam, Netherlands, as well as through loan agreements as borrower and interest swaps.

In November 2013 and February 2014, interest rate swaps were signed by Telefónica Germany GmbH & Co. OHG, Munich, in each case in connection with the issue of bonds for a partial amount of the bonds' nominal values. On the basis of these interest swaps contract, the Telefónica Germany GmbH & Co. OHG, Munich pays a variable interest rate on a nominal amount and receives a fixed interest rate on the same amount in return. These interest rate swaps compensate, to the level of their nominal amounts, the effects of future market interest rate changes on the fair value of the underlying fixed-interest financial liabilities from the bond issues (fair value hedge).

Credit risk

Credit risk describes the risk of financial losses due to the inability of contractual partners to repay or service debts in accordance with the contract. The Telefónica Deutschland Group's maximum credit risk initially corresponds to the carrying amount of its financial assets (excluding any guarantees or securities).

The Telefónica Deutschland Group considers the management of the commercial credit risk to be critical in order to achieve its goals for sustainable growth of the business and the customer base in harmony with its risk management guidelines. Suitable processes have been established for the management and the monitoring of the credit risk. These include the ongoing monitoring of the expected risks and the level of default. Particular attention here is paid to the customer, which could have significant effects on the Consolidated Financial Statements of Telefónica Deutschland Group. For these customers, credit management instruments such as credit insurance or collateral for limiting the default risk are used, depending on the business area and type of business relationship. To control credit risk, the Telefónica Deutschland Group regularly conducts an analysis of the maturity structure of trade receivables and recognises adjustments on doubtful receivables with a credit risk.

In accordance with Telefónica corporate policy, the Telefónica Deutschland Group has concluded cash pooling and deposit agreements with Telfisa Global B.V., Amsterdam, Netherlands, a subsidiary of the Telefónica S.A. Group, with regard to its cash surpluses and deposits its cash surpluses there. Telefónica S.A. is rated by international rating agencies with an investment grade rating.

Liquidity risk

Liquidity risk encompasses the risk that the Telefónica Deutschland Group may be unable to sufficiently comply with its financial obligations. To safeguard liquidity, cash inflows and outflows are permanently monitored and controlled centrally on the basis of detailed financial planning. The Telefónica Deutschland Group works on its liquidity management closely with the Telefónica S.A. Group and, in accordance with the corporate policy, has concluded cash-pooling and deposit agreements with Telfisa Global B.V., Amsterdam, Netherlands. In addition to operating liquidity, the opportunities arising on the financial markets are continuously examined with a view to ensuring the financial flexibility of the Telefónica Deutschland Group. A risk regarding the repayment of the loans paid out to Telefónica Germany GmbH & Co. OHG, Munich are rated as low due to sufficient free credit lines on the level of Telefónica Germany GmbH & Co. OHG, Munich.

Capital management

The Telefónica Deutschland Group strives to guarantee the sustainability of its business and to maximise its enterprise value by permanently monitoring its capital costs, equity ratio and OIBDA (Operating Income before Depreciation and Amortization, interest and tax).

Risk management and risk reporting

In the course of our business activities, we are confronted with various business, operational, financial and other (global) risks. We provide our services on the basis of the organisational, strategic and financial decisions made and precautions taken by us.

Every business activity involves risks that can prejudice the process of goal-setting and goal fulfilment. These risks arise from the uncertainty of future events – often due to insufficient information – and can result in objectives being missed. If risks are not recognised and dealt with, they can endanger the successful development of the company. In order to respond appropriately to this fact, the company's management has introduced a risk management process. This is intended to guarantee timely and complete transparency with regard to new risks or changes to existing risks.

Risk management is a component of the decision-making processes within the Telefónica Deutschland Group. The procedure ensures that risk evaluations are taken into account in decision-making and measures to minimise and deal with risks are taken at an early stage. This is based on the evaluation, communication and management of risks by all of the company's managers. A lower limit for the recognition of risks is generally not set. The risk management department compiles the company's Risk Register, which also covers the subsidiaries. As part of the creation of the Risk Register, it is ensured that risks of a similar type or of cumulative effect are aggregated and thus provided for overall consideration. In addition, this bottom-up approach, i.e. the identification of risks by the operating units, is complemented by a top-down approach in order to ensure a cross-business risk perspective. The purpose of the top-down approach is to ensure that risks that can only be identified at the highest management level or on the basis of a group-wide consideration, are discussed with the operationally responsible units. This is intended to enable full classification and integrated management as well as the evaluation of relevance for future reporting. Risk management is in continuous contact with all areas of the company and our risk coordinators in order to continuously pursue and evaluate risks and their management and development. Responsible employees are trained individually in order to ensure a uniform, structured process of risk identification and evaluation. In addition, fundamental training is available to all employees in order to raise their general awareness of risk management.

Risks are evaluated with regard to their impact on our business goals from an operational and financial point of view. The Risk Register is supported by a database that contains all identified risks, their status, the measures already taken and defined action plans.

In a formal forward-looking process, the Risk Register of Telefónica Deutschland Group is subject of regular reporting to the Management Board. The Supervisory Board (Audit Committee) is regularly informed about risks and their development.

Opportunities are not recorded in the risk management system.

Risk evaluation

The following section illustrates the risks that can substantially impact our financial situation, our competitiveness or our ability to realise our objectives. They are presented in line with the net principle, i.e. risks are described and evaluated net of the risk mitigation measures performed.

Based on the combination of the potential level of impact and the estimated likelihood of occurrence, the individual risks are divided into three categories (significant, moderate and minor risks). All risks with a very high potential level of impact are seen as significant for the company; this does not take into account the estimated likelihood of occurrence. With a growing likelihood of occurrence, risks with a high or medium potential level of impact also fall into this category. Risks with a very low potential impact are assessed as minor risk, regardless of the estimated likelihood of occurrence.

Minor risks are not included in the reporting to the Management Board and therefore are not included in the risk summary in the following section. Such risks are identified, documented and administered by the relevant management levels as part of the risk management process.

For internal use and reporting within the group, risks are divided into business risks, operational risks, financial risks and other (global) risks. This division also forms the basis of this section of the report. The risks are presented in the relevant category in the order of their rating.

In addition, our company can be influenced by other or additional risks of which we are presently unaware or that we do not consider significant based on the current state of knowledge. Moreover, the possibility cannot be precluded that risks currently evaluated as minor will change within the forecast period in such a way as to have a potentially greater effect than the risks currently evaluated as more material.

We have summarised the risks according to their risk areas as follows:

- Business risks
  - Competitive markets and changing customer demands
  - Market acceptance and technological transformation
  - Regulatory environment
  - Insurances
- Operational risks
  - Service quality
  - Supplier defaults
  - Dependence on the major shareholder Telefónica S.A. and of KPN
  - Legal risks
- Financial risks
  - Taxes
- Other (global) risks

Opportunity management

The consistent use of entrepreneurial opportunities with respect to future revenue and OIBDA potential, as well as their early and continuous identification, analysis and management, are significant tasks of the management of the Telefónica Deutschland Group.

The opportunities and growth potential identified in the strategic goal-setting process are prioritised as part of an annual planning process in close cooperation with the individual business areas and relevant strategic goals are derived from this. To measure the strategic implementation, concrete financial objectives in the form of finance-related key performance indicators (KPIs) are defined at the level of the organisation units.

Opportunity management is a significant component of the entire process for strategic goal setting. It occurs both as part of budget creation for the coming twelve months as well as within long-term planning.

Opportunities are neither recognized in the risk register nor quantified.

Mayor opportunities are summarized as follows:

- Greater demand for mobile data and LTE
- Expansion of our LTE network
- Cooperation with Telekom Deutschland GmbH in the fixed network
- Digital innovation
- Digitalisation of service processes
- Membership of to the Telefónica S. A. Group

Accounting-Related Internal Control and Risk Management System

The following statements contain information in accordance with section 289 (5) HGB.

The primary goal of the accounting-related internal control and risk management system of the Telefónica Germany Group is to ensure proper financial reporting in the sense of ensuring that the Financial Statements comply with all relevant requirements.

The risk management system also includes an accounting-related perspective with the aim of ensuring the reliability of financial reporting. The accounting-related internal control system ("ICS") introduced by Telefónica Germany Group for all subsidiaries also complies with the German Commercial Code (HGB). Establishing and effectively maintaining appropriate internal controls for financial reporting is the responsibility of the Management Board and is performed taking company-specific requirements into account.

New regulations, accounting principles and other official statements are continuously analysed for their correctness to and effects on the financial statements.

Employees involved in the financial reporting process are already examined in terms of their professional suitability before they are hired, and are provided with regular training. The financial statement information must go through certain approval processes at every level. Critical task areas in the financial reporting process are divided appropriately in order to ensure the effective separation of duties, and the dual control principle generally applies. Further control mechanisms include target/performance comparisons and analyses of the composition of content and changes in individual items. The accounting-related IT systems are used to control IT security, change management and IT operations in particular. For example, access authorisations are defined and established in order to ensure that accounting-related data is protected from unauthorised access, use and change.

The appropriateness and effectiveness of the ICS of Telefónica Germany Group are assessed annually by the Management Board of Telefónica Deutschland. Our Internal Audit department continuously reviews compliance with guidelines, the reliability and functionality of our ICS and the appropriateness and effectiveness of our risk management system and reports on this to the Management Board of Telefónica Deutschland.

The Audit Committee of the TDF is involved in the ICS. In particular, the Audit Committee is responsible for monitoring the accounting process, the effectiveness of the ICS, the risk management and internal audit systems, as well as the audit of the financial statements. It also reviews the documents for the Annual Financial Statements of TDF and discusses the financial statements with the Management Board and the external auditor.

As part of its risk-oriented audit approach, the external auditor expresses an opinion on the effectiveness of the parts of the ICS that are relevant for financial accounting and reports to the Supervisory Board in the course of the discussion of the financial statements.

For the company conceptual framework described above is supplemented by a HGB chart of accounts.

The O2 Telefónica Deutschland Finanzierungs GmbH is included in the aforementioned Group-wide accounting-related internal control system.

5. Employees

The Company did not have any employees in the financial year 2017.

6. Essentials of the remuneration system

The Managing Directors do not receive any payments from TDF.

7. Forecast report 2018

The forecast report describes the probable development of TDF in the course of the financial year 2018. The report contains comments and information regarding future events. Forward-looking comments and information are based on expectations and assumptions of the Company at the time when this management and forecast report is published, on the basis of known and unknown opportunities and risks. The success of the Company, the business strategy and also the results of the Company are influenced by a wide range of factors outside the control of the Company.

If such opportunities or risks occur or if uncertain factors materialise, or if it becomes apparent that one of the underlying assumptions was not correct, the actual development of the Company may differ (positively as well as negatively) from the expectations and assumptions in the forward-looking comments and information set out in this forecast report. Forecasts available in the public domain regarding the development of the overall economy and the sector have only been detailed to an extent which is relevant for understanding the comments regarding the probable development of the Company. They must not impair the perception of the comments regarding the probable development of the Company.

As a result of the close personnel and economic links between TDF and the Telefónica Deutschland Group, TDF is subject to the same business and framework conditions as well as the same regulatory environment as the Telefónica Deutschland Group. The future development of TDF is very much dependent on the capital requirements and the form of financing chosen by the Telefónica Deutschland Group. The assessment of the future development of TDF is therefore based on forecasts of the business developments of the Telefónica Deutschland Group, which is summarised as follows.

Economic outlook

On the whole, the German economy grew by 2.2%, price and calendar adjusted even by 2.5% in 2017. The growth forecasts were essentially be confirmed and even improved compared with earlier forecasts. According to calculations by the Federal Statistical Office, gross domestic product (GDP) grew by 0.8% in the third quarter of 2017 – calendar adjusted – compared to the second quarter of 2017. According to the economic institutes, private and public consumer spending will remain the pillars of the German economy in 2018. The main reasons for this are the increasing purchasing power of households and a continued positive development in the labour market.

Any escalation at international trouble spots still poses a risk to the consumer economy, and thus also to overall economic development in Germany. It remains to be seen how the planned withdrawal of the United Kingdom from the European Union (Brexit) will affect the European, and above all the German, economy.

SOURCE: GFK KONSUMKLIMA, BUNDESBANK, BMWI, STATISTISCHES BUNDESAMT, HERBSTGUTACHTEN DER WIRTSCHAFTSFORSCHUNGSINSTITUTE

GDP growth 2016 –2018 Germany (calendar adjusted)

in %	**2016**	**2017**	**2018**
Germany	1.8	2.2	2.1

Market expectations

In addition to connecting people, the intelligent connection of things via the internet (IoT) offers numerous applications and growth opportunities, such as Industry 4.0, connected cars and autonomous driving, smart health, smart energy and smart cities. Another trend is the analysis of large quantities of data, which is facilitating new insights as well as new business models.

Smartphones and tablets are becoming the trailblazers for the digital revolution of an all-round digital lifestyle in Germany. At the same time, the growing proliferation of databased communications services, i.e. “over-the-top” (OTT) applications such as WhatsApp, Skype, Facebook or Apple Facetime, as well as music and video streaming providers, is increasing data usage.

This all means further growth in the transmitted data volume. This means that the monetisation of mobile data business will remain a strong focus of mobile telecommunications providers. Analysts expect that revenues from data will increase by 13 percent in 2018.

At the same time, the negative trend for mobile voice and SMS in the “traditional telecommunications sector” will continue as a result of further price pressure and changing customer behaviour.

SOURCE: OVUM, ANALYSYS MASON, BITKOM, BMWI

Financial outlook 2018: Telefónica Deutschland Group enters next chapter

Telefónica Deutschland Group achieved a solid operational result in 2017, while also progressing with the integration activities according to plan. After a period of significant headwinds to Mobile Service Revenue, Telefónica Deutschland Group achieved flat mobile service revenue (excluding regulatory effects) year-on-year in 2017. The delivery of approx. 75% or EUR 670 million of the total synergy target of cumulated Operating Cash Flow savings of EUR 900 million in 2019 also drove growth of OIBDA (adjusted for exceptional effects) of 2.6% year-on-year. Telefónica Deutschland Group also invested EUR 950 million in CapEx in 2017. The company will continue to build on these achievements in 2018.

In 2017 the German mobile market remained rational, yet dynamic. There was a strong focus on profitable growth by stimulating customer data usage. Telefónica Deutschland Group successfully introduced large data bundles to its O2 Free portfolio, thereby setting a new standard for mobile freedom. We consider large data bundles as the next logical step in an increasingly digital world and an important driver for data monetisation, helping to counteract gradually declining legacy base and OTT effects on mobile service revenue. Telefónica Deutschland Group will continue to invest in the positioning of the

O_2 brand and the O_2 Free portfolio in the premium segment of the German market in 2018 to maintain a fair market share.

Telefónica Deutschland Group will continue to focus on its successful multi-brand and multi-channel strategy. While we expect pricing to further stabilise in 2018, trading in the partner business will likely remain strong due to a focus on larger data buckets and 4G in this segment also. In the prepaid segment, we saw lower demand from customers in the second half of 2017 driven by the introduction of legitimisation checks and the RLH-regulation. We expect this trend to continue in 2018 and beyond. In reported terms, regulatory changes (termination rate cuts and RLH) remained headwinds for revenue and OIBDA performance in 2017 and will continue to have an impact in 2018.

Telefónica Deutschland Group will also continue to leverage new business opportunities in the areas of Advanced Data Analytics (ADA) and the Internet-of-Things (IoT). In the mid-term, we expect especially the IoT business to generate additional growth opportunities. We expect significant device and sensor growth which we expect to monetise through cross- and upselling into our owned customer base, which includes more than 80% of our total customer base.

We measure the success of these new business areas by their positive contribution to the development of our revenues. Therefore, we have decided to introduce revenues as a key financial performance indicator as of 2018, so as to better reflect the above-mentioned opportunities. Revenues are mainly driven by mobile service revenues. Additionally, revenues include revenues from the sale of mobile handsets as well as from the sale of fixed-line services. For 2018 we expect revenues to remain broadly stable year-on-year, excluding a regulatory drag in the amount of approx. EUR 30-50 million. This drag results mainly from the annualisation effect of the European Roam-like-home regulation in the first half of the year and to a lesser extent the next mobile termination rate cut from EURc 1.1 per minute to EURc 1.07 as of 1 December 2017 and to EURc 0.95 as of 1 December 2018. Handset revenues depend on market dynamics as well as the launch cycles and availability of new device generations. Fixed revenues will continue to show the implications of the progressive decommissioning of our ULL broadband access infrastructure. At the same time, we continue to market fixed broadband and converged products based on our wholesale access to competitors' networks. Our assumptions are based on a sustained rational competitive environment as well as stable economic conditions.

From a strategic perspective, OIBDA adjusted for exceptional effects remains a crucial key financial performance indicator. We re-iterate our cumulated synergy target of approx. EUR 900 million Operating Cash Flow synergies in 2019 and aim to reach a total savings level of approx. EUR 800 million or close to 90% of the total target by year-end 2018. Additional in-year savings of approx. EUR 80 million at OIBDA level are mainly related to savings from the consolidation of our network which we expect to largely complete by the end of 2018, as well as some roll-over effects from the restructuring of 1600 FTE, which we completed with year-end 2017. At CapEx-level we expect additional in-year savings of approx. EUR 50 million as a result of the roll-out of one LTE network. Against this background, we expect

OIBDA adjusted for exceptional effects and adjusted for negative regulatory effects in the amount of approx. EUR 40-60 million to remain broadly stable to slightly positive year-on-year. We expect the before-mentioned integration savings to balance our continued market investment. Our estimation of regulatory impacts and market investment needs are based on the expectation of a continued rational customer response to the roaming legislation and a rational market structure. We expect handsets margins to continue to be broadly neutral.

In the context of our focus on revenue as a key performance indicator, we consider the CapEx to sales ratio (C/S) as the more meaningful indicator in terms of industry standards and comparability. As such, we are replacing total CapEx by C/S as a key performance indicator for the financial year 2018. Telefónica Deutschland Group will continue to focus on network consolidation, the further roll-out and densification of LTE and the digital transformation of our business this year. We expect C/S to come to approx. 12-13% for the financial year 2018.

Our leverage[1] target of at or below 1.0x Net Debt/OIBDA remains unchanged, but will be subject to continual review, as will be the case with the implementation of IFRS16 from 1 January 2019. We maintain a strong confidence in our ability to generate solid Free Cash Flow. We continue to support a high dividend pay-out ratio in relation to Free Cash Flow. We also reiterate our dividend outlook with a projected dividend growth over 3 years (2016-18), including the proposal for a dividend of EUR 0.26 per share for the financial year 2017 to the Annual General Meeting scheduled for May 2018. We remain committed to generating superior shareholder return and expect our dividend to be covered by Free Cash Flow (pre dividend and spectrum payments) in the mid-term.

In 2017 Telefónica Deutschland Group has again proven its execution ability. The company is now looking towards the next chapter: The digital transformation into Germany's Mobile Customer Champion with a clear focus on improving customer experience and making our operations simpler, faster and better for our customers. By 2019 we are building Germany's largest and most modern mobile network, with a focus on access and reliability for the majority of German customers. We will continue to drive data usage in an economically stable environment and a rational, yet dynamic telco market with significant further data and device growth potential. In this environment, we expect to grow our revenues with the market in the mid-term, particularly driven by additional growth opportunities in IoT. Our own customers are our biggest asset and we are looking to reward and develop them, while serving many more customers based on our successful multi-channel, multi-brand approach. We aim to innovate with a fast and flexible go-to-market approach as well as future-proof products, services and solutions across our different business segments. At the same time, we will continue to focus on operational efficiency. We expect the digital transformation to enable us to further reduce cost, while keeping CapEx stable in the mid-term. Finally, we will maintain an attractive shareholder return on the back of a conservative financing profile supported by a solid FCF trajectory.

[1] Leverage is defined as net financial debt divided by the OIBDA of the last twelve months before exceptional effects.

Management summary

Currently, TDF in its capacity as a financing company restricts its activities exclusively to financing the Telefónica Deutschland Group. In 2013 and 2014 and in line with its business purpose, TDF successfully issued two bonds with a nominal value of EUR 600,000 thousand and EUR 500,000 thousand and a maturity on 22 November 2018 and 10 February 2021 respectively. TDF transferred the proceeds based on the same conditions in the form of two loans to Telefónica Germany GmbH & Co. OHG, Munich. The bonds are guaranteed by Telefónica Deutschland Holding AG, Munich. TDF does not currently employ any staff itself. Due to the close personnel and economic links, the probable business development of the Company as well as the main opportunities and risks correspond to those applicable for Telefónica Deutschland Holding AG. The management of TDF overall consider a positive business development on the basis of the carried out emission. Based on the fact that the bond with a nominal amount of EUR 600,000 thousand and the corresponding loan granted to Telefónica Germany GmbH & Co. OHG, Munich will become due on 22 November 2018 a potentially significant reduction in the balance sheet will emerge if no equivalent refinancing will be implemented. Further material changes in the net assets, results of operations and financial positions compared to 2017 are not expected.

Furthermore, we expect that due to existing cost sharing and loan agreements with Telefónica Germany GmbH & Co. OHG, Munich, we will be able to achieve a current year net income, prior to profit transfers, similar to the prior year, which will subsequently be paid in accordance with the control- and profit and loss transfer agreement. Fixed Assets and Investments are also expected to remain fairly unchanged.

Munich, 06 March 2018

O2 Telefónica Deutschland Finanzierungs GmbH

- Management –

Markus Haas　　Markus Rolle　　Albert Graf

Declaration of the Statutory Representatives

To the best of our knowledge, and in accordance with the applicable reporting principles and with generally accepted accounting principles, the Annual Financial Statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and the Management Report includes a fair view of the development and performance of the business and the position of the company, together with a description of the material opportunities and risks associated with the expected development of the company.

Munich, 06 March 2018

O2 Telefónica Deutschland Finanzierungs GmbH

- Management -

Managing Director	Managing Director	Managing Director
Markus Haas	Markus Rolle	Albert Graf

"**INDEPENDENT AUDITOR'S REPORT**

To O2 Telefónica Deutschland Finanzierungs GmbH, Munich

REPORT ON THE AUDIT OF THE ANNUAL FINANCIAL STATEMENTS AND OF THE MANAGEMENT REPORT

Audit Opinions

We have audited the annual financial statements of O2 Telefónica Deutschland Finanzierungs GmbH, Munich, which comprise the balance sheet as at 31 December 2017, and the statement of profit and loss, statement of cash flows and statement of changes in equity for the financial year from 1 January to 31 December 2017, and notes to the financial statements, including the recognition and measurement policies presented therein. In addition, we have audited the management report of O2 Telefónica Deutschland Finanzierungs GmbH for the financial year from 1 January to 31 December 2017.

In our opinion, on the basis of the knowledge obtained in the audit,

- the accompanying annual financial statements comply, in all material respects, with the requirements of German commercial law and give a true and fair view of the assets, liabilities and financial position of the Company as at 31 December 2017 and of its financial performance for the financial year from 1 January to 31 December 2017 in compliance with German Legally Required Accounting Principles, and

- the accompanying management report as a whole provides an appropriate view of the Company's position. In all material respects, this management report is consistent with the annual financial statements, complies with German legal requirements and appropriately presents the opportunities and risks of future development.

Pursuant to § [Article] 322 Abs. [paragraph] 3 Satz [sentence] 1 HGB [Handelsgesetzbuch: German Commercial Code], we declare that our audit has not led to any reservations relating to the legal compliance of the annual financial statements and of the management report.

Basis for the Audit Opinions

We conducted our audit of the annual financial statements and of the management report in accordance with § 317 HGB and the EU Audit Regulation (No. 537/2014, referred to subsequently as "EU Audit Regulation") and in compliance with German Generally Accepted Standards for Financial Statement Audits promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW). Our responsibilities under those requirements and principles are further described in the "Auditor's Responsibilities for the Audit of the Annual Financial Statements and of the Management Report" section of our auditor's report. We are independent of the

Company in accordance with the requirements of European law and German commercial and professional law, and we have fulfilled our other German professional responsibilities in accordance with these requirements. In addition, in accordance with Article 10 (2) point (f) of the EU Audit Regulation, we declare that we have not provided non-audit services prohibited under Article 5 (1) of the EU Audit Regulation. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions on the annual financial statements and on the management report.

Key Audit Matters in the Audit of the Annual Financial Statements

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the annual financial statements for the financial year from 1 January to 31 December 2017. These matters were addressed in the context of our audit of the annual financial statements as a whole, and in forming our audit opinion thereon; we do not provide a separate audit opinion on these matters.

In our view, the matter of most significance in our audit was as follows:

❶ Recoverability of loans to affiliated companies

Our presentation of this key audit matter has been structured as follows:

① Matter and issue

② Audit approach and findings

③ Reference to further information

Hereinafter we present the key audit matter:

❶ **Recoverability of loans to affiliated companies**

① In the Company's annual financial statements loans to affiliated companies amounting to EUR 1.1 billion (99% of total assets) are reported under the "Financial assets" balance sheet item. These relate to two loans granted to the sole shareholder Telefónica Germany GmbH & Co. OHG, Munich, with a nominal amount of EUR 500 million and EUR 600 million, respectively, falling due in February 2021 and November 2018, respectively. The conditions and amounts for both loans are identical to the conditions for the underlying seven- and five-year bonds, which are presented on the liabilities side under the balance sheet item "Bonds" in the amount of EUR 1.1 billion (99% of total assets). Loans to affiliated companies are measured in accordance with German commercial law at cost or, if there are indications of impairment, the lower fair value. There are indications that the other loans may be impaired if there are signs that the economic position of Telefónica Germany GmbH & Co. OHG, Munich, has deteriorated, resulting in a restriction of its liquidity and its ability to repay the bonds. The impairment test is carried out mainly on the basis of the assessment of the operating business and solvency of Telefónica Germany GmbH & Co. OHG, Munich. In view of the estimates required to be made by the executive directors for the purpose of measuring the loans, as well as their material significance for the Company's assets, liabilities, and financial performance, this matter was of particular significance in the context of our audit.

② As part of our audit, we assessed and evaluated the methodological procedures for the measurement of the loans to affiliated companies and for the assessment of whether there are indications that the loans to affiliated companies are impaired, among other things. In particular, we also assessed the information on which the executive directors' estimation is based. Moreover, we evaluated the expected future income from the operating activities on the basis of the business plan of Telefónica Germany GmbH & Co. OHG, Munich. For this purpose, we assessed the appropriateness of the assumptions and expectations underlying the business plan, including with respect to the further implementation of planned measures and the anticipated growth rate, and examined whether the business plan was drawn up properly on this basis. Furthermore, we assessed the options available for financing the Telefónica Deutschland Group, specifically Telefónica Germany GmbH & Co. OHG, Munich, particularly in light of the availability of lines of credit not drawn upon (unutilized credit facilities). The audit procedures we carried out enabled us to satisfy ourselves that the information on which the executive directors' measurement assumptions are based are appropriate overall for the purpose of appropriately estimating whether there are indications that the value of the loans to affiliated companies are impaired.

③ The Company's disclosures regarding financial assets are contained in the "III/1. Financial assets" section of the notes to the financial statements.

Responsibilities of the Executive Directors and the Audit Committee for the Annual Financial Statements and the Management Report

The executive directors are responsible for the preparation of the annual financial statements that comply, in all material respects, with the requirements of German commercial law, and that the annual financial statements give a true and fair view of the assets, liabilities, financial position and financial performance of the Company in compliance with German Legally Required Accounting Principles. In addition, the executive directors are responsible for such internal control as they, in accordance with German Legally Required Accounting Principles, have determined necessary to enable the preparation of annual financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the annual financial statements, the executive directors are responsible for assessing the Company's ability to continue as a going concern. They also have the responsibility for disclosing, as applicable, matters related to going concern. In addition, they are responsible for financial reporting based on the going concern basis of accounting, provided no actual or legal circumstances conflict therewith.

Furthermore, the executive directors are responsible for the preparation of the management report that as a whole provides an appropriate view of the Company's position and is, in all material respects, consistent with the annual financial statements, complies with German legal requirements, and appropriately presents the opportunities and risks of future development. In addition, the executive directors are responsible for such arrangements and measures (systems) as they have considered necessary to enable the preparation of a management report that is in accordance with the applicable German legal requirements, and to be able to provide sufficient appropriate evidence for the assertions in the management report.

The audit committee is responsible for overseeing the Company's financial reporting process for the preparation of the annual financial statements and of the management report.

Auditor's Responsibilities for the Audit of the Annual Financial Statements and of the Management Report

Our objectives are to obtain reasonable assurance about whether the annual financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether the management report as a whole provides an appropriate view of the Company's position and, in all material respects, is consistent with the annual financial statements and the knowledge obtained in the audit, complies with the German legal requirements and appropriately presents the opportunities and risks of future development, as well as to issue an auditor's report that includes our audit opinions on the annual financial statements and on the management report.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with § 317 HGB and the EU Audit Regulation and in compliance with German Generally Accepted Standards for Financial Statement Audits promulgated by the Institut der Wirtschaftsprüfer (IDW) will always detect a material misstatement. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these annual financial statements and this management report.

We exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the annual financial statements and of the management report, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our audit opinions. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

- Obtain an understanding of internal control relevant to the audit of the annual financial statements and of arrangements and measures (systems) relevant to the audit of the management report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an audit opinion on the effectiveness of these systems of the Company.

- Evaluate the appropriateness of accounting policies used by the executive directors and the reasonableness of estimates made by the executive directors and related disclosures.

- Conclude on the appropriateness of the executive directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in the auditor's report to the related disclosures in the annual financial statements and in the management report or, if such disclosures are inadequate, to modify our respective audit opinions. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to be able to continue as a going concern.

- Evaluate the overall presentation, structure and content of the annual financial statements, including the disclosures, and whether the annual financial statements present the underlying transactions and events in a manner that the annual financial statements give a true and fair view of the assets, liabilities, financial position and financial performance of the Company in compliance with German Legally Required Accounting Principles.

- Evaluate the consistency of the management report with the annual financial statements, its conformity with German law, and the view of the Company's position it provides.

- Perform audit procedures on the prospective information presented by the executive directors in the management report. On the basis of sufficient appropriate audit evidence we evaluate, in particular, the significant assumptions used by the executive directors as a basis for the prospective information, and evaluate the proper derivation of the prospective information from these assumptions. We do not express a separate audit opinion on the prospective information and on the assumptions used as a basis. There is a substantial unavoidable risk that future events will differ materially from the prospective information.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with the relevant independence requirements, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, the related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the annual financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter.

OTHER LEGAL AND REGULATORY REQUIREMENTS

Further Information pursuant to Article 10 of the EU Audit Regulation

We were elected as auditor by the annual general meeting on 25 November 2016. We were engaged by the audit committee on 21 December 2017. We have been the auditors of the O2 Telefónica Deutschland Finanzierungs GmbH, Munich, without interruption since the financial year 2017.

We declare that the audit opinions expressed in this auditor's report are consistent with the additional report to the audit committee pursuant to Article 11 of the EU Audit Regulation (long-form audit report).

GERMAN PUBLIC AUDITOR RESPONSIBLE FOR THE ENGAGEMENT

The German Public Auditor responsible for the engagement is Stefano Mulas."

Munich, 6 March 2018

PricewaterhouseCoopers GmbH
Wirtschaftsprüfungsgesellschaft

Stefano Mulas
Wirtschaftsprüfer
(German Public Auditor)

ppa. Gabor Krüpl
Wirtschaftsprüfer
(German Public Auditor)