

Terms of the draft agreement - Summarised

Option	Section 2 (April 1986 to April 2001)	Section 3 (pre April 1986)
Option 1 (default option)	Contributions increase from 6% to 10%. No other changes.	Contributions increase from 6% to 10%. No other changes.
Option 2	<p>Contributions increase from 6% to 7.5%</p> <p>Benefits for future service are reduced as the accrual rate changes from 60ths to 80ths.</p> <p>The change in accrual rates will also flow through to other benefits such as dependents pensions, redundancy etc.</p>	<p>Contributions increase from 6% to 7.5%</p> <p>Benefits for future service are reduced. The current arrangement of 1/80th and 3/80th automatic cash per year of service is reduced to 1/80th with no automatic cash.</p>
Option 3	<p>Leave Section 2.</p> <p>If you take this option the company will pay you 21% of salary for 5 years and 10% of salary thereafter.</p> <p>This payment can be:</p> <ul style="list-style-type: none"> ○ Paid in part, or in full, into Section 1 of the Plan – which is the defined contribution section. ○ Taken as cash 	<p>Leave Section 3.</p> <p>If you take this option the company will pay you 21% of salary for 5 years and 10% of salary thereafter.</p> <p>This payment can be:</p> <ul style="list-style-type: none"> ○ Paid in part, or in full, into Section 1 of the Plan – which is the defined contribution section. ○ Taken as cash

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Wednesday 8th December 2010

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Dear Mr Panto,

O2 Pension Plan – Final Salary Sections

As you know we have been involved in a number of discussions together as part of the Pensions Review which impacts Sections 2 and 3 of the O2 Pension Plan, the two final salary sections of the O2 Pension Plan. This letter summarises our proposed changes to these sections. I would ask that you consider these proposals and respond to indicate your agreement to and support for these changes, which we understand will be subject to further consultation with the wider membership. On the basis of your agreement and support it is our intention to communicate these proposals to impacted members on 13 December 2010 when we begin an open consultation period.

Factors influencing the review

We have discussed the costs of the final salary pension, the level of pensions offered by our competitors and the risks of the final salary pension plan. In light of these factors we are confident that the proposed changes are firmly at the less severe end of the spectrum of changes we are seeing amongst UK industry.

Cost

Since inception Company contributions have more than doubled from 11% to the current rate of 26.7%. There are also the ongoing deficit funding contributions, which are a significant cost (£187m at the last valuation). While we are committed to funding the final salary pension plan, we also need to manage these costs and try and contain them before they reach an unmanageable level and threaten the competitiveness of the business.

Expectations of members

The companies in our industry and beyond are either closing their schemes or making severe benefit changes. Since the "Pension Review" has been announced, it has become clear that many members now expect the O2 Pension Plan to close. A change where members can keep their benefits for a 4% increase in contribution would be a good outcome, relative to other companies and expectations, for many members.

Long term management of the Plan

It is our intention to continue discussions with you given that auto-enrolment is on the horizon, a valuation is due over the next two years and that we are intending to offer choice to members as part of this exercise and the result will need to be reflected upon.

It is important that we maintain a continuing dialogue about the future of the plan so that we can deal with the long term risks associated with the continued operation of the Plan. For example we will need to take full account of the Government's requirement for companies to auto-enrol their people into pension from 2012. We recognise the importance of the Defined Benefits section of the Pension plan to those employees who elect to continue membership and we fully commit to the principle that any future changes be made with the consent and agreement of employees and their representatives.

Tax changes

*A **Telefonica** company*



There will be some changes to taxation arrangements for pensions in 2011 which will reduce the amount of tax efficient pension savings. This is most likely to impact higher earners but we envisage scenarios where it could impact lower paid members too. This is another reason why the company wants to offer choice to members including the ability to opt out.

Options for members

We have outlined the proposed options below. The focus below is on how these changes/options will be perceived by members. In relation to cost and stability benefits to the Plan and company, these changes are the minimum that are required today for the company. The benefit to the company will depend on which choices the members opt for but the most important factor in our discussions should be the perceived fairness and value in each of the options. Overall we would anticipate that these changes would contribute a 3% contribution to funding over the next 2 years, then 4%-5% from then onwards based in a weighted average of members choosing between the 3 options. This would help support the company's increasing cost which has risen as outlined earlier in the letter.

Options and member analysis (overleaf):

Section	Current benefits/contributions	Future Options
Section 2	<p>Accrue benefits at a 1/60th pension per year of service.</p> <p><i>e.g. over 10 years a member with a salary of £20,000 would earn a pension of $10/60 \times £20,000 = £3,333$ pa from age 60.</i></p> <p>Members pay contributions at 6% of salary</p> <p><i>e.g. the same member above would pay £1,200 pa in contributions (equivalent to £840 take home pay for basic rate tax payers).</i></p>	<p><u>Option 1 (default option)</u> Remain on the current benefit basis and pay 4% more contributions (total 10%).</p> <p><i>e.g. under the example left, the pension would continue to earn £3,333 but the contribution would increase to £2,000 pa (equivalent to £1,400 take home pay).</i></p> <p><u>Option 2</u> Move to a 1/80th for future service and pay 1.5% more in contributions (total 7.5%).</p> <p><i>e.g. under the example left, the pension would be lower for the future at £2,500 and the contribution would increase by less than in option 1 to £1,500 pa (equivalent to £1,050 take home pay).</i></p> <p><u>Option 3</u> Opt out of the final salary plan and have a pension allowance of 21% of basic salary available for the next 5 years that can be paid into Section 1 or taken as extra cash. After that period, a pension supplement of 10% of pay</p>
Section 3	<p>Accrue benefits at a 1/80th pension and tax free cash of 3/80th per year of service.</p> <p><i>e.g. over 10 years a member with a salary of £20,000 would earn a pension of $10/80 \times £20,000 = £2,500$ pa from age 60 and one off lump sum of £7,500.</i></p> <p>Members pay contributions at 6% of salary</p> <p><i>e.g. the same member above would pay £1,200 pa in contributions (equivalent to £840 take home pay).</i></p>	<p><u>Option 1 (default option)</u> Remain on the current benefit basis and pay 4% more contributions (total 10%).</p> <p><i>e.g. under the example left, the pension would continue to be £2,500 and the tax free cash £7,500 but the contribution would increase to £2,000 pa (equivalent to £1,400 take home pay).</i></p> <p><u>Option 2</u> Move to a 1/80th for future service and pay 1.5% more in contributions (total 7.5%).</p> <p><i>e.g. under the example left, the pension would be the same at £2,500 but the tax free cash would stop in relation to future service. The contribution would increase by less than in option 1 to £1,500 pa (equivalent to £1,050 take home pay).</i></p> <p><u>Option 3</u> Opt out of the final salary plan and have a pension allowance of 21% of basic salary available for the next 5 years that can be paid into Section 1 or taken as extra cash. After that period, a pension supplement of 10% of pay.</p>



We would like to draw your attention to the fact that whether the members choose option 1 or 2 they will see very similar level of value (i.e. the amount of pension they buy per pound of member contribution), see box below for this explained as a worked example.

EXAMPLE.

Under Option 1 for the Section 2 member - A contribution of 10% buys a 1/60th pension for the member, in the example this would be £3,333 worth of pension over 10 years.

Under Option 2 for the same members, 7.5% would buy a 1/80th pension, in the example this would be £2,500 worth of pension over 10 years.

£2,500, is 75% the value of £3,333 and an 7.5% contribution rate is 75% of the 10% contribution rate.

Therefore we have no hesitation in saying these options are fair and balanced for members.

It is important to provide a set of options that are easy to communicate, implement and administer and whilst we have been clear in our desire of an approach where we have only two options (Options 1 and 3 noted above), we are able to accommodate option 2 above to meet your request for an option that allows members to stay in the final salary plan without a full 4% increase in contribution as it makes use of the current 1/80th accrual rate and introduces no further subdivisions.

Detail on benefit changes

Past service

Under all 3 options members' past service benefits are fully protected and unaltered. Under Options 1 and 2 benefits will remain linked to final pensionable salary whilst members remain in active service. Under Option 3 members' final salary pensions will be treated under the leaving service provisions currently enshrined in the O2 Pension Plan rules.

Other benefits

We have also discussed some of the key benefits that are part of the current final salary sections and specifically we would like to note the following:

- We plan to make the changes detailed in this letter from 1 May 2011.
- If a member does not make any selection in this process they will remain in their current Section of the Plan and their contributions will increase by 4% from 1 May 2011.
- If members choose an option that leads to a change in accrual rate (Option 2), this would impact their benefits for future service only.
- Option 2 will impact all benefits under the O2 Pension Plan rules where the accrual rate is used – for example, the future accrual of spouses' pensions.
- If members chose the opt out, the 21% uplifted contributions for 5 years will become a contractual right so would transfer as an obligation under TUPE and would count towards notice period payment from the company.
- In respect of redundancy for someone over 50 who takes the opt out option, we propose that they would have a right to a payment that is actuarially equivalent to the cost the company would have paid should the member have stayed in the final salary plan under Option 1. Such a redundancy payment would be integrated within the redundancy package as it currently is.
- If members are buying added years then this arrangement may continue under Options 1 or 2 but not 3. Should a member wish to cease their current added years commitment as a result of the changes then this will be allowable.
- Members opting out would be treated as deferred members in the final salary sections of the Plan.
- Unless otherwise noted in this letter, all other benefits would remain unaffected.



Option 3 "Pension Allowance"

The Pension Allowance of 21% (for the first 5 years) and 10% (for the on-going period after 5 years) is an employee allowance that can be paid into Section 1 or taken as cash via the company payroll. It is calculated as 21% of basic pay and is subject to the earnings cap. If it is paid into Section 1, no matching company contribution will be paid. In the event that the company is required to auto-enrol someone who has taken Option 3 in the future, any auto-enrolment contributions will be offset against the pension allowance.

Revaluation of pensions

Benefits in the final salary sections of the O2 Pension Plan revalue in line with inflation. Following government announcements, there is much general coverage and commentary of which measure of inflation will be used in the future for pension schemes and you have asked that we clarify our current understanding of the impact of the Government's announcements on the O2 Pension Plan. Currently the O2 Pension Plan uses the RPI measure in both revaluing deferred benefits (being the revaluation of benefits for those people leaving service before age 60 from the date of leaving until they draw their benefits) and increases to pension in payment (being simply the increments in annual pensions once in payment). Taking into account the government announcements, legal advice and the current rules of the Plan, we understand that the CPI measure will be the effective measure of inflation for the revaluation of deferred benefits and RPI will remain the measure used for pensions in payment. As you know the government is due to make further announcements on this matter and we will update if the position changes due to those announcements.

We are not seeking to actively make changes in this area of the Plan other than to reflect Government requirements.

Implementing these options

We have together commenced a timetable to discuss and make changes to the Plan. We will issue a consultation letter to members on the 13 December 2010 and this will close on 18 February 2011. During this period, the unions have indicated they will run a ballot with a "recommendation to accept". Subject to a satisfactory outcome of the ballot, we will operate a program of support to members - the focus being to give members opportunity to attend presentations and take independent financial advice as we believe the advice and help that people receive is fundamental to ensuring that everyone can make decisions on an informed basis. For those members who choose Option 3 we will require they confirm they have taken financial advice.

For the avoidance of doubt, the Company will give all Section 2 and 3 members access to Independent Financial Advice via a designated supplier and members will not be required to pay for this advice.

We appreciate that some of the people we intend to ask to make choices may wish reconsider their flexible benefits options for 2011 (which they will have made during November and December 2010). We will make it possible for those affected by these pension changes to reconsider their flex options where reasonably possible. You specifically asked if we could provide flexibility on holidays and additional voluntary contributions and we can confirm that we will accommodate this.

I can also confirm that we will not proceed with any changes until the Trustees have been fully consulted about any issues that fall within their remit.

Transfers of employees within the Telefonica Group

You asked us to provide reassurances on potential future TUPE projects. I can confirm that in the circumstances that the Company is proposing to enact a TUPE involving current employees we would discuss such proposals fully with the Employee Representatives well in advance of any transfer taking place. A priority area for these discussions would be to reach agreement on employee Terms and Conditions including Pension benefits. The management of any TUPE proposals in the future will be dealt with separately from the Pension plan changes agreed to here, based on the circumstances that prevail at that time and we can confirm that the Company will not use any future TUPE projects for the purposes of making changes to the membership of the Pension plan.

Yours sincerely



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Head of Employee Relations

Cc James Kirkland
Nigel Cotgrove

