

Letter from the Chairman

César Alierta

Executive Chairman, Telefónica S.A.

Dear shareholder,

I am very pleased to give you this brief account of Telefónica's performance in 2007. This has been a record-breaking year, yet another year with results that highlight our company's distinct profile, its ability to deliver and its vision in such a high growth industry as telecommunications.

At the same time, I'd like to take this occasion to convey to you our ambition to keep on excelling, to maintain and even enhance Telefónica's leadership and discuss the huge opportunities that the new digital environment affords.

The best results ever

2007 was an historic year for the company, in which its net profit climbed by 43% to a record 8,906 million euros. That figure means that Telefónica earned a higher net income than any other integrated operator in the world.

Similarly, earnings per share grew by 43.5% in 2007 to 1.872 euros, for an impressive track record of fourteen consecutive quarters of uninterrupted growth.

And that growth was reflected in each and every caption on the income statement. Revenues, operating income before depreciation and amortisation (OIBDA) and operating income (OI) all rose significantly in 2007 by 6.7%, 19.3% and 42.1%, respectively. In 2007 operating revenues amounted to 56,441 million euros, 37% of which was earned by Telefónica España, 36% by Telefónica Latinoamérica and 26% by Telefónica O2 Europe. At the same time, all the lines of business made a positive contribution to the company's organic revenue growth, which, excluding the effects of exchange rates and changes in the consolidation perimeter, came to 7.4%. Year-on-year organic revenue growth in Telefónica Latinoamérica was 13.0%, in Telefónica España 4.6% and in Telefónica O2 Europe 4.5%.

This upward trend reflects on Telefónica's organic growth potential, the high value of its regional and business diversification and its efficient cost structure.

Moreover, progress in the integrated management of our businesses translated into synergies during the year worth over 1,600 million euros.

Similarly, good business performance in 2007 enabled us to raise operating cash flow (OIBDA-Capex) by 33%, to 14,797 million euros.

This high growth rate in terms of results is based especially on a very healthy 12.5% rise in our customer base to nearly 229 million accesses, driven by the mobile and Broadband businesses. At year-end 2007 we had 169.2 million mobile, 10.3 million retail Broadband and 1.7 million pay TV customers, with increases in 2007 of 16.6%, 28.9% and 64.3%, respectively.

In a word, these results go to show that ours is a growth company able to combine global scope with a regional and local focus, whose credibility rests on its consistent compliance with all its market commitments.

We reinforce shareholder earnings

In financial year 2007 Telefónica completed its share buy-back programme for a total of 2,700 million euros, and has proposed to pay a dividend of 0.75 euros per share, up 25% from the preceding year.

In addition, thanks to the favourable performance of our businesses, we can reinforce our shareholder remuneration policy in 2008. As a result, in October 2007 we proposed to pay a dividend of 1.0 euro per share against financial year 2008, for a 33% increase over the preceding year. Proposals for the necessary corporate resolutions in this regard will be put forward in due time. With this measure, the commitment undertaken by the Company in May 2006 to double its 2005 dividend by 2009 will be met in advance.

Similarly, the new share buy-back programme announced on 27 February 2008 for 100 million shares, representing approximately 2.095% of the company's share capital, is now underway and will be in place throughout 2008 and the first half of 2009. This stands as further proof that at Telefónica we strive to continue to be the best investment option in the industry: the company best positioned to transform high organic growth into profitability and higher shareholder value.

Telefónica, a global leader

Our vision and the effectiveness of our performance have made us a telecommunications industry leader in terms of size, pace of growth and results, as well as upward market value and shareholder returns. Indeed, Telefónica:

- Is the world's largest integrated operator by number of customers, with 229 million.
- Is the world's second largest integrated operator by asset value, assessed at 151,351 million euros on 31 December 2007.
- Is an operator with higher organic revenue growth than any of its peers in Europe or the United States.
- Is the integrated operator that posted the highest earnings world-wide in 2007.

With a 37.8% rise in its share price, our company recorded a higher increase in market value than any of its peers in Europe or the USA, and more than doubled the annual growth of the world-wide benchmark Dow Jones Telco index. On the Spanish market, Telefónica accounted for 80% of IBEX 35 growth in 2007.

Finally, Telefónica earned a higher total return for its shareholders (TSR) than any of its peers in Europe or the USA in 2006-2007, with a TSR of 86.1%. But Telefónica's leadership stretches beyond the telecommunications industry, for in 2007 it was among the world's 50 largest companies by market capitalisation. Telefónica has progressively advanced in this respect over the last decade, rising from 198th position in 1995 to 72nd in 2000 and 37th at year-end 2007.

In such a scenario of leadership, we can face the future with an inherent advantage, renewed ambition and a clear goal: to continue to be leaders in the long term.

Our challenge: to continue to be leaders in the long term

In the years to come Telefónica, as industry leader, will enjoy huge growth opportunities.

Firstly, telecommunications is expanding and its customer base is growing. And Latin America, a region where Telefónica has a sound position, is the area where highest growth is expected in the near future.

Opportunities are also being created by ever increasing customer needs: there is a growing demand for personalised services and a desire to be "always connected", regardless of place or kind of device. And customers' greater involvement in content generation, distribution and promotion will fuel demand even further.

In a word, households and businesses are becoming more and more digital and connected, as is the time devoted to work, information or leisure; and the industry's extraordinary growth potential is driven by its customers.

We, at Telefónica, are technology and connectivity leaders, we have physical and commercial access to customers, and we are confident that technological advances in our fixed and mobile networks will enable us to satisfy our customers' expectations with standards of excellence and introduce them to the benefits of the new digital environment.

Telefónica is facing the possibility of capturing a major share of access growth, as well as the wide range of new services, applications, content and business models arising in the new stage on which the industry is embarking.

In this regard, our confidence in the future has enabled us to commit to a strong increase in our customer base, to 290 million by late 2010.

I can assure you that in the years to come we will continue to pursue our own transformation and turn the enormous opportunities afforded by industry dynamics into value for the company. To achieve this objective, in the next few years we are going to dedicate our resources to four major priorities:

- To provide our customers with the best service experience, transforming the company into an organisation where customers not only are, but are made to feel that they are, the centre of attention. This will be achieved by improving customer support and service, along with enhancing our understanding of customer expectations in order to meet their needs with segmented offerings that deliver added value.
- To encourage both in-house and third party innovation as the key to building our domain in the new digital environment, capitalising on the new growth opportunities afforded.
- To continue to transform our operating model as an indispensable tool to provide an integrated, excellent and efficient delivery.
- And to make Telefónica the best employer, able to attract and retain the best talent.

We have the opportunity to lead social progress

In future, societies are going to experience unprecedented progress, and information and communications technologies (ICTs) will be the key to this brisk pace of development.

From our leadership position, at Telefónica we are faced with the opportunity and at the same time the responsibility to play a decisive role in the societies where we operate.

Our new generation networks and services will improve people's quality of life, companies' competitiveness and governments' efficiency. Telefónica, as a world leader engaging in a key industry for social development, assumes this social responsibility, which is written into the values by which the company is governed.

To sum up, ours is the best Telefónica in history, with a unique position and huge opportunities ahead which, I assure you, we will not miss. We are prepared to attain the next level of leadership: such is our ambition and our commitment.

I would like to take this opportunity, yet another year, to thank our shareholders for their support and confidence in facing a future rife with opportunity, in which all our effort and our full attention will be focused on our customers.



César Alierta

Executive Chairman, Telefónica S.A.