## Letter from the Chairman

#### Dear Shareholder,

I would like to express my gratitude for having every year the opportunity of explaining in this letter the results of Telefónica in 2008, a year in which we have seen again the advantages of Telefónica's differential profile: the high diversification of our businesses, the integrated nature of our operations, our competitive strength in key markets, our high capacity for execution and our sound financial position.

In a difficult period for the economic activity, Telefónica has distinguished itself by its solid growth and at the same time it has increased its customer base, its capacity for innovation and its operational flexibility.

Let me share with you some of the key points and figures behind this performance, as well as my confidence in Telefónica, that will continue to overcome, reinforcing its leadership as a company and as an investment deserving your trust.

#### Differential results

In the 2008 financial year, Telefónica achieved an income of 57,946 million euros. In terms of organic growth, income increased by 6.9%, with positive developments in all countries and with spectacular performance in Latin America. Thanks to greater efficiency in cost management, the Operating Income Before Depreciation & Amortisation (OIBDA) and the Operating Income (OI) grew 14.7% and 28.7% excluding capital gains, respectively. Likewise, there was a significant rise in Operating Cash Flow (OIBDA-CapEx) of 20.2% that reached 14,159 million euros. In 2008, in absolute terms, consolidated net profit amounted to 7,592 million euros, which, in comparable terms, meant a year-on-year increase of 38% and a growth of basic net profit per share of 41.4% to 1.63 euros.

The achievements in economic-financial matters meet all our market commitments, reinforcing the Company's credibility and highlighting the value of the high diversification of its operations.

### Priority to pay shareholders

Shareholder remuneration is a priority to which we have dedicated 69% of the cash flow in 2008, through the combination of a payment of dividends and the repurchase of treasury shares. In 2009 we are reinforcing our shareholder remuneration with a proposal to increase the dividend to 1.15 euros per share. In this regard, Telefónica expects to increase consolidated operating cash flow within a range of between 8% and 11% in 2009, assuming constant exchange rates. Furthermore, the Company maintains its objective of reaching a net profit per share of 2.304 euros and a cash flow per share of 2.87 euros in 2010.

By the end of 2008, Telefónica was the third largest telecommunications company in the world by firm value (market capitalization plus net debt) and the 32<sup>nd</sup> largest company of any sector by market capitalization.

### The strength of a global leader

The best proof of our dynamism and strength for the future is the continued increase in the number of customers who trust us to meet their telecommunications requirements. Our customers increased 13.2% in the past year, to reach 259 million accesses, approaching our goal of 290 million in 2010.

In terms of business units, I would like to emphasize Telefónica España's 13.7% increase in the broadband retail accesses, which reached over 5.2 million. Rather more than 85% of these accesses are included in a double or triple offer package which, together with the net gain of 923,076 mobile lines within the post-paid segment, is evidence of Telefónica's commercial strength in Spain. Furthermore, mobile devices with 3G capacity among our customers already amount to 6.2 million, opening up great prospects for the growth of mobile Internet.

In 2008, Telefónica Latinoamérica was consolidated as the driving force behind the Group's growth, with an outstanding yearon-year increase of 22.7% of mobile accesses to which all the operations contributed and which meant a total figure of 123.4 million accesses. Our fixed broadband accesses in the region surpassed 6 million, which was accompanied by remarkable progress in the process of transforming operations. In Brazil alone, Telefónica reached more than 60 million accesses, 24% more than in 2007.

And finally, Telefónica Europe has recorded a 9% rise in the number of accesses, reaching 45.8 million, maintaining its leading position in the United Kingdom both in its financial and operating parameters and in mobile and Internet customer satisfaction.

### Letter from the Chairman

# A solid company in a resilient and promising sector

The deployment of digital services in a society is as essential for prosperity as mass transport or industrial production have been in the past. Telecommunications, together with IT, becomes a driving force for fostering a new and necessary growth cycle.

In today's complex macroeconomic environment, our sector, thanks to the multiplier effect that broadband has in the generation of employment and wealth, as well as its own growth and weight on the economy, is becoming an essential part in any proposal for stimulating the economy and creating sustainable employment worldwide. The deployment of high capacity fixed and mobile networks is, therefore, the key for competitiveness and wealth in the new world economic order that is being created.

On the other hand, the business model for telecommunications can not be more robust. We have direct access to our customers, we offer them continuously value and we receive recurrent incomes from them. Telecommunications are already essential for people who are not going to dismiss the benefits of being connected and for Public Administration and companies because they enhance productivity and competitiveness. nnovation continues and exceeds in its scope that of any other industry. Mobility and broadband continuously contribute to new possibilities of value added services around economic transactions, health, education, contents or e-administration, ust to mention some of the areas where Felefónica is already present. As a result, life is already irreversibly digital and will pecome more and more so.

Telecommunications companies have also been maintaining a high level of transparency and financial discipline for a long time, with one of the lowest ratios of debt over EBITDA of any industry.

The telecommunications sector is a sector of growth and figures like those of Telefónica show this. However, it would be an error to think that it is immune to the economic environment. Without legal security and a predictable regulatory framework it will not be possible for the private sector to address the huge amount of required investments to continue increasing communications capacity in every country. At the same time, the consumers will be more demanding, and that will require an increasing emphasis on maintaining close relations with them, on innovation and on efficiency.

In Telefónica, we have the optimum scale and diversification to compete at global level, to benefit from cost and investment savings, to offer convergent solutions and to share best practices. Our industrial alliance with Telecom Italia, our global agreement with China Unicom and other alliances with some of the main agents of the digital environment are clear examples of the benefits of scale and our capacity for cooperation. The efficiency and financial discipline of our management model have always been one step ahead from those of our competitors, being the point of reference for the sector. In 2008, Telefónica reduced its average debt by 7.6%. The debt ratio (net debt over OIBDA) was 1.89 times, reflecting the positive progress in the financial solidity of the Company. The composition of our investments is another factor of sustainability for Telefónica, because only around 25% of the investment is recurrent and the rest intended for transformation and innovation, which offers sufficient flexibility of management to maintain cash flow growth if required

As I have already pointed out in other occasions, in Telefónica we have been addressing our transformation very seriously for years,. We keep on moving forward and finding new opportunities to extend our capacity for innovation in order to do things better and more efficiently, and to improve the satisfaction of our customers as well as our knowledge of them. Every day these activities open new paths for making us better and therefore more solid.

Telefónica has the confidence from the market and from its customers and we continuously contribute responsibly to Society not only through our integrity and transparency policies, but also with social action programmes as those run by the Fundación Telefónica. From these programmes we should emphasize Proniño, through which we contribute to the eradication of child labour in Latin America, and Educared, which aims to improve the quality of education and access to it through Information and Communications Technologies (ICT). Telefónica also maintains a determined commitment for ensuring that its networks are efficient in terms of power consumption and that environmental aspects are managed responsibly in all its operations, creating a culture of sustainability within the Company. A clear example of this is that our own headquarters have the largest solar platform on the roof in all of Europe and one of the biggest in the world. Telefónica also works for increasing power efficiency in its customers' operations through ICT, a key tool in the reduction of polluting emissions.

#### The Telefónica of the future

Nobody is better placed than Telefónica to face the challenges of the future. All in all, and with our recognized team of professionals, I am confident in telling you, certainly and with no arrogance, that we are certain to have, in the present context, the opportunity to emerge stronger. There is no doubt at all that Telefónica will have a more and more decisive role in the future of telecommunications and digital services, in particular, and of the global economy in general. This is a leadership responsibility that we welcome with enthusiasm and that we will meet with high standards and effort Thank you again on behalf of Telefónica and ts Board of Management for your support and confidence.

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**César Alierta Izuel** Chairman of Telefónica, S.A