



Dear Shareholder,

It gives me great satisfaction to share with you the results of Telefónica's management for 2005, and our vision of the future of the telecommunications business.

This year has been especially positive, and I believe we have reason to be satisfied, given both the exceptional results achieved, and the impact of the operations carried out.

Undoubtedly, 2005 was a milestone financial year, not only due to the consolidation of our leadership and the strengthening of our Company's competitive advantages, but also due to our short- and long-term outlook.

The current state of the telecommunications sector is at once promising and challenging. The challenges and opportunities are bigger than in the past. Today the market is more global; and our competitors, more dynamic and varied. Technology is doing away with frontiers between sectors, opening up new opportunities for us and for companies in sectors adjacent to ours, in the face of which our main strength will be, once again, to remain one step ahead.

#### **A new Telefónica**

Two years ago, we embarked on an important process of change, which is translating into an excellent combination of scale and diversification, with a view to one aim: maximising value for the shareholder. Every year, Telefónica sets itself further apart from the rest of operators in the sector, because it grows more than the rest, and because, at the same time, it has the best balance in terms of geography and business.

In addition, Telefónica is generating new business opportunities and reaching higher levels of efficiency, derived from its integrated management model. Its local sales strength, the integration of solutions for each customer segment, the advantages of being an international brand, together with the adoption of best practices and the coordination of networks and services, define the features of a Telefónica that is increasingly strong and flexible, based on three pillars:

- Customer-orientation.
- Innovation.
- Operational Efficiency.

Not only our profile is different; our results are too. Telefónica's unique profile is due both to its singular features as a telecommunications operator and to the solidity of its results, which is reflected in the constancy of its growth, profitability, cash flow generation and shareholder remuneration.

In 2005, Telefónica's results have shown, once again, that the company is capable of growing within an increasingly competitive environment. Net profit rose by 40%, reaching the record mark of 4.45 billion euros and net profit per share of 0.913 euros, 43.4% above that achieved in 2004. These figures are proof of the robust organic growth of our businesses and of the efficiency of our operations.

Revenues for operations exceeded the substantial growth registered in the previous year, with a year-on-year growth of 25.1%, comparing favourably with any of the main European operators, which, together, registered a weighted average growth of 5.8%. At constant exchange rates and excluding changes in the consolidation boundary, our revenues would have increased at a rate of 9.3%.

In addition, this financial year has allowed Telefónica to achieve operating earnings before and after amortizations of 15.28 billion euros and 8.56 billion euros respectively, with increases of 25% and 30.5% with regard to 2004.

These figures have been compatible with a 42.3% increase in investment, which reached 5.36 billion euros, whereas free cash flow generation reached 7.11 billion euros, which implies a conversion ratio of 18.7% of our revenue.

Telefónica and each of its lines of activity fulfilled all the financial aims established for financial year 2005.

These results are only the foretaste of the potential provided by combining scale, balanced diversification and integration in our sector.

### **The integrated operator with the most international profile.**

Together with the improvement registered in results, it has also been important to position Telefónica as the company with the most international profile of all the large integrated operators. 59% of our revenues are now generated outside our original home market, as well as 77% of our accesses.

FY 2005 has contributed decisively to this process of internationalisation, with transactions such as the acquisition of 69.4% of the operator Cesky Telecom, the fixed and mobile telephone services leader in the Czech Republic, or the completion in January of the process of integration of all the operators acquired from BellSouth in Latin America. Telefónica closed the financial year with mobile operations in a position of leadership in 15 countries, with a total combined population of almost 500 million.

Also worthy of note is the strategic investment of 5% in China Netcom, which gives Telefónica access to a region with great potential and opens a fruitful path for the collaboration between both companies.

And, lastly, I would like to draw your attention to the purchase of the British mobile operator O2, announced in October 2005, which, with over 27 million customers at the close of last financial year, and relevant operations in Great Britain, Ireland and Germany, brings to Telefónica a quality asset, a new source of growth, as well as profitability from day one.

Whereas the purchase of O2 brought Telefónica European scale, the announcement in 2006 of the purchase of a controlling stake in Colombia Telecom, with 50% of shares plus one, strengthens our commitment as a long-term investor with Latin America.

At year-end 2005, Telefónica had a total of 153.5 million accesses, of which 99.1 million corresponded to mobile accesses, 40.9 million to fixed telephone services accesses and the rest, to data, Internet and pay-TV accesses. With the addition of O2, the total base of accesses of Telefónica reaches 180.9 million, exceeded worldwide only by two Chinese companies. This growth in the number of accesses is also reflected in the presence of Telefónica in new markets, with relevant operations in 19 countries at the end of year 2005, of which 10 have been incorporated in the last two years, and which amount to a total combined population of 670 million.

### **Investment in growth.**

One of the distinctive features of Telefónica's approach is anticipation in all aspects of its operations.

This factor, together with technological evolution, leads Telefónica to permanently increase investment in new businesses and growth initiatives: the deployment of broadband and the improvement of fixed telephone lines, the pioneering development of TV over IP, the increased capacity of mobile networks and the adoption of 3G in Spain, or the regionalisation of infrastructures and systems to favour efficiency of our operations in Latin America.

In 2005, Telefónica devoted over 2.9 billion euros to items associated with technological innovation, a figure 21% above that of 2004. Of this amount, 533 million corresponded to research and development activities, amounting to 1.4% of our turnover, positioning Telefónica among the first companies in the Telecommunications sector worldwide in terms of investment in innovation. During 2005, the European Commission recognised Telefónica as the first Spanish company in terms of R&D efforts, and in terms of participation in European projects.

This investment in growth and profitability is validated by the growth in broadband accesses and services, both in Spain and in Latin America, by the increase in penetration of mobile services and by the positive advances in our offer of solutions.

We are creating the broadband market in Spain, the Czech Republic and Latin America. We chose to believe in DSL technology and worldwide trends confirm that we were right to do so: 66% of consumers worldwide have also chosen this option.

At the end of 2005, Telefónica had almost 5.9 million DSL lines (3.5 million in Spain). Especially worthy of note is the 52.1% growth of broadband in Latin America, reaching 2.2 million lines, as well as the performance of Imagenio, the pay-TV service over DSL that in Spain, reached a coverage of 33% and over 200,000 users.

### **We know what we want to be.**

We want to be among the best in anticipating wants and needs of consumers and in making technological advances essential elements of day to day life.

To this aim we have carried out an in-depth transformation of our structures with a clearly defined goal: to reorientate our entire organisation towards interaction, collaboration and synergies between all the people and business areas that make up Telefónica. With one priority -the consumer, as the main focus-, and one goal -the offer of integral solutions-.

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Through different transformation programmes covering all our service and management areas, with a clear vision of the company: we aim to be the integral operator that is the most competitive, the most capable of providing solutions to the customer, and at the same time, of offering the best combination of growth and profitability for our shareholders.

Within this framework, Telefónica is ideally positioned to obtain value from added-value products, emerging markets or new possibilities of an extended sector, and in fact, it is already doing so.

### **The best combination of growth and shareholder remuneration.**

Our performance and our evolution have allowed us to offer, one more year, the best combination of growth and shareholder remuneration in the sector. A growth that, as I mentioned above, reached 25.1% in revenues this year. As regards shareholder remuneration, in 2005, a dividend corresponding to FY 2004 of 0.5 euros per share was paid out, own shares in the proportion of 1x25 corresponding to 4% of share capital were distributed, and progress has continued in the share buyback programme.

It is in this direction that the changes in the company are geared to, increasing our focus on core activities and lightening the structure of assets and costs. In May 2005, the absorption of Terra Networks by Telefónica S.A. was approved, thus enabling access to the advantages of operational integration of the fixed telephone network and Internet, increasingly necessary with the development of broadband. In 2006, the merger of Telefónica Móviles and Telefónica S.A. has been proposed, strengthening a strategic model that benefits from the economies of scale and scope, as well as from an integrated offer, and is coherent with a technological development that softens barriers between fixed and mobile networks and services.

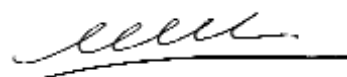
The results and decisions of 2005 improve Telefónica's positioning in the face of coming years. The outlook is still favourable, both for Europe and Latin America, on the macroeconomic front, as well as for the ICTs sector. Information and Communication Technologies are proving to be essential to increase competitiveness and productivity of economies, as well as citizens' quality of life. Telecommunications are a key tool to bring to life the Information Society, whose development they are already driving, and that is why our sector has a very positive growth outlook, associated with increases in use, penetration and new services and markets.

### **Telefónica's Commitment.**

I believe we have more than enough reasons to be optimistic.

We are prepared for a new phase, where strategy will be measured by success in execution. That is why, to this aim, we will continue our work. With a threefold commitment: towards our team of professionals, towards society in general and, of course, towards each and every one of our shareholders.

On behalf of the Board of Directors of Telefónica and in my own name, I wish to thank you, once again, for the trust you have placed in us, and assure you that we will make every effort to continue deserving it.



**César Alierta**  
Executive Chairman, Telefónica, S.A.