04 Risk management

Telefónica

INTRODUCTION

The Telefónica Group is exposed to diverse risks on the financial market due to (i) its ordinary business, (ii) the debt acquired to finance its business, (iii) shareholdings in companies, and (iv) other related financial instruments related to the previous points.

The main market risks that affect the companies in the Group are:

1. Exchange rate risk
   This arises mainly due to the international presence of Telefónica, with investments and business in non-euro currency countries (mainly in Latin America), and due to the existence of debt in currencies other than those of the countries where business is conducted, or where the companies that have taken the debt are based.

2. Interest rate risk
   This is embodied in the variation in (i) the financial costs of variable rate debt (or that with short term maturity, and foreseeable renewal), due to fluctuation in the interest rates, and (ii) the value of the long term liabilities with fixed interest rates (the market value of which rises when the interest rates drop).

1. Share price risk
   This is due to the variation in value of the stakes that are not consolidated globally or proportionally, or which may be sold, of products derived from these, of own shares in portfolio, and of those derived from shares.

Moreover, the Group faces the risk of liquidity, which arises due to the possibility of imbalance between the needs of funds (due to operating and financial expenses, investment, debts that have matured and dividends committed) and the sources of these (revenue, divestments, financing commitments with financial institutions and operations on capital markets).

Lastly, it is important to highlight the so-called "country risk" (mixed with market and liquidity risks), which consists of the possibility of loss of value of the assets or decreased flows generated or sent to the parent company, due to political, economic and social instability in the countries in which the Telefónica Group operates, particularly in Latin America.

The Telefónica Group actively manages the risks mentioned, in order to stabilise:

- The cash flows, to facilitate financial planning and take advantage of investment opportunities.

- The Profit Account, to facilitate its understanding, and investor prediction.

- The value of the equity, protecting the value of the investment made.

In cases in which these objectives are mutually exclusive, the financial management of the Group will evaluate which must prevail.

In its risk management, Telefónica uses derivative financial instruments, mainly on exchange rates, interest rates and shares.

Exchange Rate Risk

The fundamental objective of exchange risk management is to compensate (at least partially) possible losses of value of assets related to the Telefónica business caused by depreciation of the exchange rate to the euro, with lesser savings in euros on the debt in currency (when this is depreciated).

For this purpose, the aim has been set for the decrease in EUR value of the debt in currency to cover the flows lost over two years due to the lower value of the Latin American currencies. Our estimates show that the loss in value of the Latin American currencies throughout 2003 and 2004 (in comparison to the levels of 2002 in

relation to the euro) has detracted 237 million euros from the flows generated by the Group in these two years. On the other hand, the effects of the depreciation of currency on our debt have brought savings of nearly 1.083 billion euros upon translating the debt in currency to euros. Thus, the accumulated loss of flows over the last two years has been comfortably covered. When this effect is measured against 2004 (compared with the interest rates of 2003 in relation to the euro), lost flows of 18 million euros are observed, more than compensated by savings of 223 million euros in lesser value (when measured in euros) of the debt in currency.

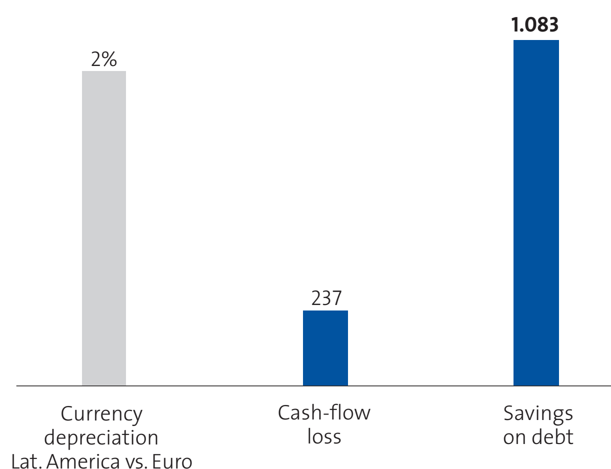
The protection against future depreciations of Latin American currencies in relation to the euro is based, firstly, on the debt in Latin American currencies. Excluding Mexico (which is a net receiver of flows) on 31st December, the debt in Latin American currencies (other than the Mexican peso) reached nearly 3.38 billion euros and was equivalent to 2.1 times the flows generated in Latin America (excepting Mexico).

However, this debt is not uniformly distributed as a proportion of flows generated in each country, so their future effectiveness in terms of protection against exchange rate risks will depend on where the eventual depreciations may take place. The greatest potential problem may arise in Venezuela, with a net cash position (instead of a net debtor position), which is subject to losses due to devaluation, and as such, does not offer coverage against potential cash flow losses.

Moreover, protection against losses of value of the Latin American assets due to currency effects is complemented by indebtedness in dollars in Spain, associated with investment, while the coverage is considered to be effective. On 31st December, this debt came to the equivalent of 2.4 billion euros, excluding USD-Eur derivatives which created a composite loan in dollars (for the equivalent of 0.96 billion euros) to finance the acquisition of the Argentinean and Chilean subsidiaries of Bell South (this acquisition took place in January 2005).

YEARS 2003 - 2004

(Data in % and millions of euros)



Another core strategy in exchange rate management has been to minimise negative financial results caused by variations in exchange rates without affecting the possibility of maintaining open positions in currencies in the future (under strict monitoring of the risk). Difficulties presented in minimising risk have arisen due to the virtual impossibility of covering the external debt in dollars of the Argentinean subsidiaries through derivatives, which totalled the equivalent of 652 million euros at 31st December 2004. The loss suffered in 2004 due to exposure to the Argentinean peso was limited to 11 million euros. In the future, the adoption of international accounting principles will allow the Group's internal loans to be eliminated in the consolidation process, in order to calculate exchange rate results. The combination of external debt in currency and the use of derivatives will enable the compensation, at least in part, of the exchange rate effects of the intra-group loans on the profit account.

Interest Rate Risk

The financial costs to Telefónica are exposed to fluctuations in interest rates, mainly the Euribor, the Brazilian SELIC rate, the Chilean UF, and the dollar Libor. On 31st December 2004 , 59.2% of the total debt (or 83.3 % of the long term debt), had its rate set for a period exceeding one year, an identical proportion to that on 31st December 2003 (that represented 68.9% of the long term debt).

The financial costs in 2004 came to 1.1834 billion euros, 12% greater than those in 2003. However, excluding profits due to movements of the Argentinean peso and the positive exchange rate results in 2003 due to debt in dollars, the figures would be 1.173 billion euros in 2004 and 1.463 in 2003, which would entail a 19.8% decrease in adjusted financial costs in 2004 with respect to 2003. This figure of financial expenses in 2004 amounted to an average cost of 6.1% on the average net debt of the year. The strong increase in the Brazilian SELIC rate (with an average rate of 16.25% in 2004, against 23.53% in 2003), low euro rates and the average net debt decrease (around 7%) explain the reduction in financial costs.

Throughout 2004, the proportion of debt at variable rate in euros was reduced by taking advantage of low interest rate levels, and rates were fixed at around 4 billion euros of debt with maturity after 2004. The debt in dollars taken by the Group (and not transformed to other currencies by exchange rate derivatives) was maintained at fixed rates practically throughout. The new debt in dollars taken to finance acquisitions in Latin America was covered by interest rate options or swaps, in anticipation of a dollar interest rate increase which was already underway. Additionally, the dollar Libor influenced only the formation of prices of coverages for purchase in dollars on term, against sale of Latin American currencies, which is especially relevant in the case of Chile and Peru.

However, options were sold on a nominal of 400 million euros in swaps which, if exercised by the counterpart, would have caused the interest rates to be fixed in some cases, paying levels lower than those in effect at the time of sale of the option, while in other cases, it would have involved receiving rates higher than those in effect at the time of sale of the option (in exchange for paying a variable rate). Two hundred million euros of these options were exercised at a rate of 3.80%.

Share Price Risk

One of the variable yield risks to which Telefónica is exposed is that due to the price of its own shares, as a result of the share repurchase scheme announced in October 2003, for an estimated amount of 4 billion euros up to 2006 (inclusive), linking the cash flow generation and the evolution of the share price.

On 31st December 2004, Telefónica S.A. held more than 207 million own shares. Under

international accounting principles applicable in 2005, these shares will reduce private equity and effects on the consolidated profit account will not be recognised.

Telefónica held purchase options for 8 million own shares, with maturity in the first quarter of 2005. Thus, there is a certain protection in that if the listed value rises, purchases become more expensive and fewer shares may be acquired for the pre-set amount. The maximum economic loss that may be experienced in this case is the premium paid on the option, if at maturity the price of the share is below the exercise price; however, in such case, Telefónica may purchase its shares on the market at a lower price.

Telefónica is also exposed to the fluctuations in the prices of shares in subsidiary companies, especially to the extent that these are not integrated in its core business and may be subject to divestments. In 2004, the most significant divestment was the sale of the 4.88% stake in Pearson Plc, for an approximate sum of 350 million euros, which generated a decrease of 33 million euros in consolidated accounts (although after taxes a profit of 56.5 million euros was obtained, since prior to the sale provisions due to goodwill depreciation were non-deductible).

Liquidity Risk

Telefónica aims to adapt the maturity profile of its debt to its capacity to generate cash flows to pay it, maintaining a certain margin. In practice, that has led to the monitoring of two criteria:

1. The average maturity of Group debt must be higher than the time required to pay the debt (assuming fulfilment of the internal projections, and all the flows generated being allocated to payment of the debt, and not to dividends or acquisitions).

2. The group must be able to pay off all its commitments in the coming 12 months, without having to resort to further loans or the capital markets (but maintaining the credit lines already firmly committed by financing institutions), assuming budgetary fulfilment.

On 31st December, the average maturity of the net financial debt – 20.982 billion euros- was 4.9 years. At the Investor Conference in October 2003, the Telefónica Group announced that it expects to generate more than 27 billion euros from 2003 to 2006, assuming exchange rates are maintained at 2002 levels. In spite of the weakness of the dollar and its impact on the exchange rates of Latin American currencies with respect to the euro, the existing cash flow margin allows confidence that the first criteria was being fulfilled on 31st December 2004.

The gross maturity of debt in 2005 (9.413 billion euros) was proven to be less than liquid assets, with the sum of (i) the liquid assets on 31st December in the amount of 3.579 billion euros (temporary financial investments in the amount of 2.724 billion euros and cash and bank balances in the amount of 855 million euros), (ii) the annual cash generation (which amounted to 6.743 billion euros in 2004), (iii) divestments agreed upon in 2004 carried out in the first quarter of 2005 (sale of Infonet for 139 million dollars) and (iv) the lines of credit committed by banking firms with initial maturity exceeding one year, or extendable on option by Telefónica (7.213 billion euros on 31st December, of which 3.831 billion euros reached maturity in 2006 or subsequent years, while others, totalling more than 1.1 billion euros, were renewed beyond the end of 2005 at the beginning of the year). The existing margin allows the accommodation of dividend payment of 50 cents per share (about 2.4 billion euros) and the acquisition of the Latin American mobile phone companies of Bell South in Chile and Argentina made in January 2005 (by which the entire acquisition transaction would be completed).

Despite the measures put into place to guarantee its liquidity, Telefónica considers the

possibility of easy access to the capital markets to be of high importance for the development of its business plans and strategy, and for the management of its liabilities, and therefore, the legal or tax restrictions on such access can have a negative effect on the Company. Likewise, to maintain access to swift credit, on good conditions in price and terms, Telefónica keeps watch on the balance between the risk of its business and its financial structure, as well as the main credit ratios[1]. The following table shows these ratios and the variables involved in their calculation.

2004 Operating figures

I	EBITDA	13,215.4
II	Free Cash Flow	7,180.0
III	Capex	3,771.9
IV	Dividends of Telefónica S.A.	1,924.2
V=II+III-IV	Cash Flow Withheld (before capex)	9,027.7

Liabilities at December 2003

A	Financial Debt	20,982.2
B	Guarantees	608.7
C	Net commitments for staff reduction	3,022.8
D=A+B+C	Total debt + Commitments	24,613.7
E	Preferred Shares	2,000.0

Financial ratios

Financial Debt / EBITDA	1.59
Total debt + Commitments / EBITDA	1.86
Cash Flow Withheld (before apex) Total Debt + Commitments + Pr. Shares	34%

1. Credit scoring agencies also adjust ratios due to operational leasings and other commitments.

Country Risk

The perception of sovereign risk in the majority of Latin American countries ended 2004 at the best levels in the last 5 years (with the exception of Argentina). Thus, the margin of profitability required by investors for the sovereign debt of Latin American countries over the United States debt reached minimum levels on 31st December 2004: 3.83 percentage points for Brazil, 1.67 percentage points for Mexico, 2.20 percentage points for Peru, 4.12 percentage points for Venezuela, 6.90 percentage points for Ecuador and 3.32 percentage points for Colombia. As a reference, it is fitting to mention that between 1999 and 2004, the debt of all of these countries was valued, at some point, at more than 9 additional profitability percentage points over United States treasury bonds[2]. At the end of 2004, Argentina maintained a situation of non-payment on close to 82 billion dollars (105 billion if we add unpaid accrued interest), offering a bond exchange in 2005 to resolve this situation.

The main cause for the improvement in sovereign risk lies in the continuation throughout 2004 of macroeconomic stability which has been in effect since the previous year in Latin America, due to the substantial improvement in balances of payments and the historic 5.5% growth, the highest in the past 24 years. The historic current account surplus achieved in the region would suffice to explain the improvement in the credit ratings, following a continual 3-year period of improvements in trade figures, but the use of this surplus is what is most outstanding on this front. Thus, the region made an early debt repayment for the amount of 18 billion dollars, allowing the reduction of its external indebtedness by nearly 1 GDP percentage point which, combined with the accumulation of close to 10 billion dollars in reserves, entailed a substantial improvement in the aforementioned country risk indicators.

2. According to the EMBI index by JP Morgan.

Although the macroeconomic outlook suggests stability and the economic policies are adequate, it is essential to bear in mind certain risks still present on the microeconomic front which continue to divert the countries in the region with respect to other more economically developed countries. Among these risks are regulatory discretion, the large number of bureaucratic procedures required in the corporate environment and the rigidity of certain productive factor markets, data which prevents growth greater than that recorded via investment and productivity. Similarly, an additional effort is required in the way of reform of the tax and education systems that would further promote the human development achievements attained in the past few years in the region.

Telefónica took advantage of the situation to increase exposure in the region through the acquisition of the Bell South subsidiary mobile phone companies, for a company value equivalent to 5.85 billion dollars. Most of this acquisition was performed during 2004, with the exception of that of the subsidiary companies in Chile and Argentina, which closed in January 2005. A significant part of the assets acquired is located in countries with great sovereign risk (Argentina, Venezuela, Ecuador and Colombia), although diversification increases upon increasing the number of countries in which the Group is present and balancing the fixed -mobile composition.

The improved setting and positive expectations are no obstacle for Telefónica to continue with its strict monitoring of the risk of unforeseen loss of value of Latin American assets due to possible social, economic or political instability. In this respect, Telefónica has continued to act along two major lines (apart from ordinary management of the business):

1. To partially compensate the assets with liabilities in Latin American companies not guaranteed by the parent company, so an eventual loss in assets is accompanied by a reduction in liabilities, and

2. To repatriate the funds generated in Latin America that are not expected to be put to profitable use in the future, through business opportunities in the region.

The acquisition of the Bell South companies entailed the assumption or guarantee of the debt of these companies, without the undertaking to date of a refinancing exercise, which should largely be addressed in 2005.

As to repatriation of funds, in 2004, 2.016 billion euros were received from Latin America, most in dividends or capital reductions (1.573 billion) and the rest in interest and principal on loans to the Latin American subsidiaries and for management fees. The flow of funds continued in the opposite direction toward Mexico, where Telefónica Móviles made material investments amounting to 377 million euros to launch the GSM network and had operational needs arising from a negative EBITDA of 144.9 million euros.

Derivative Policy

On 31st December 2004, the nominal amount of derivatives exposure came to 38.660 billion euros. This volume is so high because derivatives may be applied several times to the same debt for an amount equal to its face value; for example, a debt in currency may be transferred to euros at a variable rate, and then on each one of the interest rate periods, rate fixing may be performed using an FRA. Even so, it is necessary to exercise extreme caution when using derivatives so as to avoid problems due to errors or lack of knowledge of the real position and its risks.

The policy followed in use of derivatives has placed emphasis on the following points:

i. Existence of a clearly identified underlying value, on which the derivative is applied, as a valid possibility for coverage accounting.

Among the acceptable underlying values are the results, revenue and flows expected in currency other than the euro, which is reasonably secure or foreseeable, even if these do not adapt to the criteria required by the accounting regulations for treatment as coverages. The coverages with economic sense in the Group's opinion do not always fulfil the requirements and effectiveness tests established by the different accounting regulations to be treated as such coverages; the decision to maintain them once the effectiveness test is not passed leads to entering the results in the Profit and Loss Accounts. For the purpose of recalculating the 2004 financial costs under the new international accounting principles applicable in 2005, a large part of the derivative portfolio has been treated as speculative, for the sake of simplicity (to avoid costly retrospective documentation and for ease in calculation), given that the vast majority of the derivatives matured during the year or had symmetrical treatment with the covered item (impacting the profit account measured at market value). In this sense, coverage relationships have been modified according to changes in treatment that the IFRS gives to certain transactions with respect to previous regulations, such that with the economic sense of the coverages remaining completely valid, the impact on the profit account, together with the underlying values to which they were assigned, was limited.

ii. Adjustment between the underlying value and one of the sides of the derivative, with the greatest possible precision.

This adjustment is aimed especially at the debt in foreign currency and derivatives of coverage of payments in foreign currency; however, even when a perfect coverage of the flows is sought, the scarce depth of the Latin American derivative markets has led to historical imbalances between the characteristics of the coverages and the debts covered. It is the intention of the Telefónica Group to reduce these imbalances, so long as this does not involve disproportionate transaction costs. On other occasions, the coverages have been made in holding firms (Telefónica S.A., Telefónica Móviles S.A. and TISA) while the debt was maintained at other subsidiaries, which has led to the operations not fulfilling the coverage criteria required by the accounting regulations and the results being entered in the Profit and Loss Accounts. The main reasons for that separation between the coverage and the underlying value have been the possibility of differences in the legal validity of the local coverages against the international ones (due to unforeseen legal changes) and the different credit quality of the counterparts (of the companies in the Group involved as well as the banking institutions). On the other hand, interest rate derivatives may also suffer imbalances with the underlying values covered, especially when these are of shorter terms, as when Telefónica goes into long term swaps, caps, or collars to protect itself against rises in interest rates that may raise the financial costs generated by the promissory notes and commercial paper, with maturity in a few months, although the successive renewal of which is very probable.

iii. Capacity to evaluate the derivatives at market prices, using the value calculation systems available in the Group.

Telefónica uses several tools to evaluate and manage the risks of derivatives and of the debt. Of particular importance among these tools is the Kondor+ system, licensed by Reuters and widely used by numerous financial entities.

iv. Sale of options only when there is an underlying exposure (recorded in the balance or associated with a highly probable external flow) that counters the potential loss of exercising the option.

In 2004, Telefónica sold short term options on swaps at euro interest rates, which gave the counterpart the right to enter a swap receiving a specific fixed interest rate, lower than the prevailing level at the time of selling the option; thus, if the rates dropped, Telefónica would transfer part of its debt at variable rate to fixed rate, at lower levels to the initial ones, having collected a premium.

The directives for risk management are issued by the General Management of Corporate Finance of the Telefónica Group and implemented by the financial managers of the companies (ensuring they are in keeping with both the individual interests of the companies and those of the Group). The General Management of Corporate Finance may authorise deviations on this policy for justifiable reasons, normally due to the narrowness of the markets or clearly limited, reduced risks. Likewise, the entry of companies in the Group through acquisitions or mergers, requires time to adapt.