

LETTER TO SHAREHOLDERS

Dear shareholder,

With a renewed commitment to our clients and to Spain in general, last year the company spontaneously took on fresh challenges. The first of these related to quality upgrading and service expansion in the rural community, aimed at providing equal opportunities in telephone service access to all of Spain's citizens, no matter where they reside, under the same price and quality conditions. Further achievements related to the radical fall in the waiting time for the installation of new lines, the introduction of the itemized bill service, the maintaining of average tariff rises below the consumer price index, the constant network modernization and the development of new services. Naturally, these achievements met with the full approval of our clients, who are well aware that we have honoured our pledges. To them we now renew this commitment to carry on working towards the provision of greater and better services. We are greatly encouraged by the fact that satisfaction levels with Telefónica services rose considerably throughout the past year, evidence that our efforts of the last years have received due recognition.

The placing of greater demands on ourselves last year coincided with the severe slump in Spain's economy. This was reflected, among other things, in the marked increase in the number of service cancellations, in the repeated fall in net demand for lines and in the lowest revenue growth rate of the last few years. However, the development of internal policies aimed at restraining operating costs, improving productivity and adapting the rate of investment to the new levels of demand led to an increase in profit before tax and the continuing improvement in the structure of our Profit and Loss Account. There were two particularly significant milestones in the company's development last year: the final elimination of the waiting list and the achievement of over a 110% rate of self-financing of investments, which resulted in a fall in the borrowing rate of over one point. These figures are proof in themselves of the level of maturity reached by Telefónica in its role as Spain's telecommunications operator.

Together with the strengthening of Telefónica's financial base (which will be enhanced in the immediate future by the falling trend in interest rates), with the highest service quality and customer care levels in the Company's history, with the consolidation of our international presence, which, in just five years, has transformed Telefónica into Spain's leading multinational company, with the bringing forward of the liberalization of voice telephone services (other services have already been liberalized by law) and with the acceleration in the incorporation rate of technological innovations, we are witnessing a growing demand for advanced services, especially those arising from the convergence of telecommunications, computer technology and the audiovisual world.

At this crucial time when Spain should be promoting itself towards the future via multimedia services, following in the wake of the world's most advanced countries, Telefónica can confidently state that its basic infrastructures are equipped to gradually advance towards the provision of these new broadband services and to satisfy the telecommunications requirements of Spain's population and the Spanish economy in the decisive years to come. For this purpose, there has been a major deployment of fibre optics between exchanges and user terminals in the form of urban loops in Spain's major cities, to be further expanded under the recent formation of the Fotón Plan and this, together with the ISDN expansion and the imminent introduction of state-of-the-art automatic mobile switching systems, will allow the treatment of all types of signals (voice, data and image). In short, we are well on the way to building the future telecommunications networks of the XXI Century.

With kind regards

Cándido Velázquez-Gaztelu Ruiz
Chairman of the Board of Telefónica de España

