

Dear shareholder,

During the past year it became clear once again that the process of gradual introduction of competition in the telecommunications sector was tending to accelerate. After the liberalization in Spain of public telephony (with the exception, for the moment, of public telephone booths), last October the Government approved a programme of transitory measures until January 1, 1998 which will give a further boost to competition. These include the granting of a second license for operating the GSM mobile telephony system and the bringing forward to January 1, 1995 of the authorization of the resale of leased circuit capacity. European Union Telecommunications Ministers also agreed on the liberalization of infrastructure, coinciding with the total liberalization of voice telephony as from January 1, 1998.

In Telefónica we have closely monitored these regulatory trends, which have come as no surprise to us as for some time now we have been preparing ourselves to act in a competitive market by orienting our organization more and more towards a business area structure, a process which was intensified by the reorganization carried out at the end of last year. In this new scenario of liberalization of telecommunications, this response by Telefónica in the area of its organizational structure is an essential element in the new strategic focus for its activity. This new focus consists of a balanced combination of the delegation of responsibilities, to allow us to react flexibly to the demands of a competitive market, with the necessary degree of corporate control to ensure the correct definition of the Group's strategy, the efficient management of the different business areas and the best possible use of all the synergies we have at our disposal.

Another cornerstone of our action during the past year, and clearly the basis on which we were able to contain rising costs and maintain the competitiveness of Telefónica, was bringing the size of our workforce in



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Chairman of Telefónica de España

to line with our real needs. Through a program of voluntary early retirement we reduced our workforce by more than two thousand, achieving for the first time a level of productivity above two hundred fixed lines per employee. Although this now places us among the leading European companies in this area, the policy should continue and will therefore have to be complemented with other early retirement and voluntary severance programmes, without forgetting the need to transfer personnel to business areas with greater growth potential.

Without underestimating its importance, Telefónica however does not wish to base its future competitiveness solely on cost reduction, but rather to set itself targets for expansion and growth which will strengthen its leadership and increase its profits. The takeover of the companies CPT and Entel Perú (now merged in the new company Telefónica del Perú) and the strengthening of relations with other European operators were significant landmarks during the year, forming part of our strategy of international alliances and the inevitable process of globalization of services. But also of great importance was the development of new domestic and international services, among them the ISDN, which expand the catalog of new services with which the Company measures its potential for growth in the future. All this has brought about a notable increase in the Telefónica Group's turnover and a correlative increase in profits, compatible not only with an improvement in quality, but also with a reduction in nominal terms of the average price of services. We also achieved a new record in the self-financing of our investments, 121%, and reduced our borrowing rate, thus further improving the financial health of our Company.

These are the trends which we want to consolidate in the coming years, to the benefit of our shareholders and employees, and at the service of our clients.

With kind regards

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