

TELEFÓNICA GENERAL SHAREHOLDERS' MEETING
REPORT

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MADRID, JUNE 21ST 2006

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A. INTRODUCTION

Good day to everyone.

I would like to begin by welcoming you to this, the Telefónica General Shareholders' Meeting, and thank you for your participation in this event, one of huge importance for the company.

Each annual meeting represents a unique opportunity to rigorously examine the events of the past year and share, with yourselves, our central lines of action and objectives for the future.

In addition, on this occasion we can feel particularly satisfied, as the results achieved by the company represent a truly historic year.

At the same time, 2005 has also been a key year in the intensive transformation process in which, for over two years, the company has immersed itself. This has allowed us not only to reinforce our leadership, but also to configure a *New Telefónica*, by defining a new differential profile and better expectations in both the short and long-term.

Over the next few minutes I will focus on three main subjects:

- Firstly, the results from 2005 and their positive impact on shareholder remuneration.
- Secondly, our business vision for the coming years.
- And thirdly, the main guidelines that will lead our management over the next years, allowing us to reach our strategic goal of *continuing to be the best combination of growth and profitability within the telecommunications sector*.

B. 2005 RESULTS AND DIFFERENTIAL PROFILE

B.1. 2005 RESULTS

Let's start, then, by reviewing the results of our activity in 2005. I take great satisfaction in letting you know that, in 2005, Telefónica recorded historic results. These results would have been unthinkable a few years ago, and show the company's ability to go one step further, bettering itself in an increasingly competitive market environment.

In 2005 Telefónica recorded a **record net profit of 4.446 billion euros, 40% more** than the figure recorded for 2004. This has been possible due to the strong organic growth of our business, as well as the positive contribution of the acquisitions carried out. In this way, **profit per share increased by 43.4% to 91.3 Euro cents**, the best growth recorded within the sector on the European level.

Income from operations reached 37.822 billion euros, with inter-annual growth of 25%. With constant exchange rates, and excluding changes in the consolidation perimeter, our income would have increased at a rhythm of 9.3%. This exceptional growth in income has been the joint result of the notable **expansion of our client database, which increased by 24.3% over the past year**, and the average income per client, fruit of our significant commercial drive, especially in growing business areas such as mobiles and broadband, and also through innovation in both products and services.

The 2005 financial year closed with over **153 million customers**, of which 99 million corresponded to mobile access, 42 million to landline access and the rest to data access, internet and subscription television. **With the recent incorporation of O2**, the acquisition of which was completed in 2006, **Telefónica closed the 2005 financial year with 181 million customers**, 57 million more than in 2004.

At the same time, **increased efficiency in our operations** has translated into **operating income before amortization** of 15.276 billion euros, 25% more than 2004 figures. This very result, after amortizations, was a 31% increase on 2004, totalling 8.559 billion euros.

When we compare these results with the remaining large operators in Europe, our differential capacity is clear in terms of generating profitable and sustainable growth.

However, as well as this, what particularly qualifies the company is its **ability to transform this income into cash flow, in a profitable and growing way** year after year, business after business and

market after market. **Operating cash flow, calculated as the operating result minus investment, increased to 9.918 billion euros in 2005, 17.3% more than the figures reached in 2004.** It is also important to mention that all the business lines have positively contributed to this figure. Finally, our **free cash flow** reached **7.108 billion euros** in 2005, which represents an investment to cash flow conversion rate of practically 19%, a percentage that is equivalent to cash flow generation of almost **20 million euros per day.**

I would like to highlight the fact that this cash flow generation has been compatible with **a 42.3% increase in investment, a total of 5.359 billion euros,** almost totally destined to **growth projects** relating to the fixed broadband business and the increased capacity of our mobile networks around the world, such as the deployment of UMTS in Spain and GSM in Colombia.

This **investment** has allowed us, among other things, to create significant growth in parameters as important for us as fixed broadband access for our clients, as well as the penetration of our new services that go above and beyond mere connectivity.

In fact, at the end of 2005, Telefónica had **almost 6 million ADSL lines,** more than half of the total in Spain. Of this figure it is important to highlight, on the one hand, **growth of 52% in broadband in Latin America to 2.2 million lines and, on the other hand,** the evolution of our DSL subscription television service **Imagenio** which, with 33% coverage in Spain at the end of last year, **reached more than 200,000 users.**

B.2. SHAREHOLDER PAYOUT POLICY

The positive evolution of results, as already described, has allowed us to offer for yet another year the best combination of the growth/shareholder payout pairing in the sector.

In this spirit, in 2005 we dedicated 4.476 billion euros to shareholder remuneration. This figure can be broken down, on the one hand, into the payment of a dividend of 50 Euro cents per share and, on the other, the distribution of Telefónica S.A.'s own shares, representative of 4% of the total stock capital, in a ratio of 1 for every 25, as well as the advance of the share buyback programme.

In May 2006, the company had already paid an interim dividend on 2005 profits of 25 Euro cents per share.

The company's excellent perspectives today allow us to propose a new improvement to our shareholder retribution policy. Thus, in 2006 we will increase the dividend per share by 20%, up to 60

Euro cent. This quantity will be paid out in two identical amounts: an interim dividend of 30 Euro cents per share relating to results from the 2006 financial year in November of this year, and a second payment of 30 Euro cents per share in the first quarter of 2007.

Finally, and as a complement to this improved retribution in dividend form, I would also like to announce our **commitment** that, at least up until the end of 2007, Telefónica will not emit new shares to carry out acquisitions, and that the approximately **2.7 billion euros** in shares that remain outstanding to meet our commitment of treasury stock generation **will be amortized**.

B.3. DIFFERENTIAL PROFILE

The reason that today we can request you as shareholders to approve this important improvement in retribution is because **we have laid the foundations of a New Telefónica**, one that is bigger, stronger, and ready to remain at the head of the sector in the future.

Over recent years, in particular the last two, there has been a radical change in the profile and dimension of our company. **This new and improved Telefónica** is characterised by:

1. Firstly, **a new dimension and better competitive positioning, thanks to the strengthening of the regional scale of our company.**

At year end 2005, **Telefónica was placed as the third largest telecommunications operator in the world in terms of customer numbers**, after the two Chinese operators “China Mobile” and “China Telecom”.

Thus, I firmly believe that **Telefónica is in the best possible position to make the most of the advantages presented by its new scale**. On the one hand, the company has achieved a **more balanced geographical presence**, reducing the exposure of our international businesses to country-specific risk and, on the other, **we have renewed our growth opportunities, increasing the relevant weighting of results coming from areas with larger growth**, such as the mobile and fixed broadband sectors.

Last year made a decisive contribution to this process of transformation, with the execution of various exceptional operations that I would like to talk to you about. Firstly, the **purchase of 69.4% of operator Cesky Telecom**, leader in mobile and landline communications in the Czech Republic; secondly the **conclusion of the integration process for all the operators acquired from BellSouth in Latin America**, through which Telefónica has achieved a leading

position in 15 countries with a total population of almost 500 million; thirdly the **strategic investment of 5% in China Netcom**, which opened a fruitful collaboration between both companies and allowed Telefónica to access a market with huge potential. Fourthly, I would like to underscore the **purchase of British mobile operator O2**, begun in October 2005 and completed in 2006, which brought over 27 million new clients at the end of last year, with relevant operations in the UK, Ireland and Germany. All these operations have brought Telefónica quality assets and a new source of growth, as well as profitability, right from day one.

Looking towards 2006, we have announced **the acquisition of control of Colombia Telecom**, with 50% of shares plus one, **in this way reaffirming our commitment as a long-term investor in Latin America.**

2. Telefónica's second differential value is its business strength on the local level. In fact, the advantage of being an internationally-recognised brand is combined with the deep knowledge we have of our customers after our extremely direct relationship with them, whether through our customer service or billing services (with over 5 million contacts per day) or through our extensive commercial network, with more than 65,000 points of sale.
3. At the same time, our continued commitment to operating efficiency has set us aside as a reference within the telecommunications sector, both in the landline and the mobile fields. In this way, both types of business display the highest productivity ratios in all of Europe, in terms of lines per employee.
4. A fourth distinctive characteristic of Telefónica's ability for execution is its **various investments in innovation**. In 2005 Telefónica invested **more than 2.9 billion euros in innovation, a figure that was 21% above** that of 2004. In this respect, it is important to highlight the pioneering development in Europe of new **IP television, with the commercial launch of Imagenio**. This capacity for innovation demonstrated by Telefónica will undoubtedly be consolidated with the integration of O2, a prestigious company that is renowned for its innovation. This can be seen in its **Genion** service, which brings together, in just one terminal, all the advantages of landline and mobile services, and was launched in Germany, registering over 3.5 million customers at the end of last year.

All in all, we can clearly state that, today, we have a new and improved Telefónica, having undertaken the transformations demanded by the industry, turning ourselves in the process into **a stronger, more**

flexible company: we have reduced the weight of fixed assets, made our costing structure more flexible, increased the weight of our commercial costs on the total and maintained the focus of our investments on growth businesses.

Not only that, but **Telefónica is much more than a telecommunications service provider - we are a motor for social, technological and economic development in the societies in which we operate.** Our activity generates important social wealth, employment, digital inclusion, education, innovation in products and services and business opportunities for suppliers.

Within this context, our **Corporate Responsibility Report for 2005**, which is available for your consultation, dedicates an extensive section to the impact of Telefónica's activities on the progress of each and every one of the societies in which we operate. This report, drawn up in compliance with the 2002 Global Reporting Initiative Guide, has been verified by Ernst & Young. Additionally, it makes us extremely proud that our commitment to transparency has been recognised by the inclusion of Telefónica in the main indexes of companies with responsible investment.

In this light Telefónica's new profile, derived from its unique characteristics as a telecommunications operator and the growth and solid nature of its results, represents the anticipation of the potential advantages of combining, in a balanced way, both geographical diversification and scale with an integrated management model.

B.4. STOCK MARKET PERFORMANCE

As I have already mentioned, in 2005 Telefónica recorded **historic results** that show a marked difference to the general development of the European sector. This difference has also been reflected in the **different evaluation received by sector companies on the stock markets.**

Between December 31st 2004 and June 1st 2006, while France Telecom, Telecom Italia, Deutsche Telekom and Vodafone recorded drops in their value of 27.6%, 26.4%, 22.2% and 11.3% respectively, **Telefónica only saw an adjustment of 7.8% in its value. We can't be satisfied with this evolution in our share value,** but it is clear that the foreseeable improvement in how our sector is seen by the stock markets will allow us to **start off on an advantageous position in comparison to our competitors.**

Not only that, but our best guarantee that this will happen is that our pledge is, and will continue to be, to offer the best combination of growth and profitability in the sector for our customers. In fact, for

almost four years now Telefónica has recorded the **highest Total Shareholder Profitability in the European sector, with 16%** in annualised terms, compared to the 3% from Deutsche Telekom, Telecom Italia's 5% (matched by Vodafone), France Telecom's 9% and 10% from BT.

C. OUR VISION OF THE TELECOMMUNICATIONS BUSINESS

Ladies and gentlemen, in order to move on to the third part of my speech, allow me to say that the new scale and international dimension of Telefónica are key factors in the continuation of our success in the future.

Our services have the tangible capacity to improve the quality of life for those citizens who use them, with the result that our power for social transformation and the impact of our services on 21st century society are both enormous. In addition, the ability of the remaining economic sectors to generate value and capture efficiency is becoming increasingly dependent on the correct use of ICT. Because of this, telecommunications companies will be the key players in a new expansion stage for the ICT sector, as without them it will be impossible to successfully structure the new digital societies, nor to develop the ICT sector as a whole.

The great challenge faced by the telecommunications industry is that of activity growth, especially in those areas that represent increased added value. **It is our customers that make us grow**, with their demand for fixed broadband, for increasingly advanced mobile communications solutions, and for the expansion of basic communications and the integration of services and solutions.

Analysts' predictions confirm the potential held by each and every one of these motors for growth. According to these specialists, between 2005 and 2009 **profit from broadband in Europe will double, that from mobile services in Latin America will grow by 16% each year, and the new markets, such as IP television (in which our Imagenio services are pioneering) will increase from 3 to 45 million users.**

Obviously, this growth is not going to split equally among all the operators. The opportunities will be much closer to those which, like Telefónica, are **better positioned to anticipate and respond to the trends of the new environment in which the sector finds itself.** In order to take advantage of these opportunities you have to have ambition, something which **Telefónica's vision** has in abundance.

Our **vision** is based on putting **our customers as the focus of everything that we do**. We are going to offer them **innovative solutions** that will turn their desires into reality, in terms of communication, information and entertainment. And all this at the same time as we strive to be **the most competitive in each of the markets in which we operate**. In this effort our **scale** is going to be key, and will help us to make the most of the new **IP networks** and the **latent synergies** in our organisation, as we continue to manage Telefónica as an **integrated operator**.

Throughout all this we will keep in mind the aim of continuing to meet our strategic goal of **supplying the best combination of growth and shareholder remuneration in the telecommunications sector**.

Within our strategy, this vision becomes **execution** through four specific objectives.

The first has to do with revenue growth. **In 2009 the combined population of the markets in which we already operate will reach 708 million inhabitants**. Telefónica will race ahead and increase its penetration in the areas in which the company operates, as well as its clear market leadership, reaching **225 million customers in 2009, 66% more than at the close of 2005**.

At the same time we will **increase revenue from each customer** in both landline and mobile services, through the use of services such as subscription television and broadband. We will be more important for each customer, and we are going to make the effort to get to know them better, focusing our activities in order to provide them with increased value. We will manager **our local commercial strength, our channels and our brand** so that they become the most efficient ways in which to get closer to our customers.

Our second aim is to continue progressing in terms of making our costs and investments structure lighter. The efficiency of the IP network, the evolution of information systems and an integrated purchasing model are all sources of competitiveness.

Thirdly, and in addition to growing, we have to grow correctly, in other words **making our costs and investments structures more flexible**. This point also includes the **preservation of our financial excellence** as one of the key points of our long-term strategy. To do this we have set ourselves the objective of **reducing our debt to a level of no more than 2.5 times the operating result before amortizations**, in an attempt to maintain our financial flexibility and ensure an adequate credit qualification of our debt. Likewise, we will use no more than **1.5 billion euros in financial**

investment and acquisitions between 2006 and 2007, and will not implement any capital increase during this period.

Our fourth objective is to prioritise profits from the integrated management of our abilities and our scale. Within this field Telefónica has undertaken a deep-rooted structural transformation, aimed at re-focusing the entire organisation on interaction, collaboration and the capture of synergies between all the individuals and business units that make up the company.

We have therefore introduced an integrated operating and business process model that will allow us to capture all the latent income, costs and investment synergies in our scale. This area will also see the proposed merger between Telefónica Móviles and Telefónica S.A. that has been brought to this Meeting, with which we hope to introduce a new operating model that will make more use of scale economies and the possibility of creating an integrated offer, coherent with technological evolution, that will break down the barriers between networks and services, and between the landline and mobile sectors.

D. TELEFÓNICA: A SUPERIOR ALTERNATIVE FOR SHAREHOLDERS

Ladies and gentlemen, to sum up and finish my speech, allow me to say that **I am convinced that Telefónica today has a unique profile within the sector, is able to capture the opportunities presented to it** and, as a result, can maintain your trust as investors in our company, as:

- We have a highly diversified group of businesses, both in terms of their nature and their geographical location.
- We have huge potential to extract value from our scale and our integrated business model.
- We have achieved the best combination of growth and shareholder retribution.
- And, with all this in mind, no other company within the sector today can commit to the kind of profitable growth targets we have set ourselves here at Telefónica.

In fact, I have the immense satisfaction to be able to affirm that, firstly, **Telefónica is growing, and will continue to grow over and above all other operators.** We are in a unique, privileged position in the Latin American market, as well as in Europe, thanks to the recent acquisition of O2. In both markets we have high growth potential: our assets in Spain show the biggest revenue growth in the European sector and we are making the most of landline-mobile integration with Cesky Telecom.

This enviable starting position, within the framework of our solid growth and profitability strategy that I outlined beforehand, allows us to set ourselves **ambitious economic and financial goals for the coming years**. In constant currency, and excluding unforeseen circumstances, we predict that **our income and operating result before amortizations will grow on an annual basis by between 10% and 14% between now and 2009, our operating result will increase by between 13% and 19%, and that by 2009 the net profit per share will be double that recorded in 2005**.

Not only that but, for the first time, we have made the commitment to the market to double our profit per share between 2005 and 2009. If this happens, **I can confirm to you that we will propose that the dividend per share will go on to double by 2009, reaching figures of practically 1 Euro per share**.

All in all we are in a magnificent sector, in a great company, at a wonderful moment in time...and we are proud to have the best human capital in the sector. And this is of the utmost importance as, whereas our employees have been an important factor in our past successes, today they are absolutely essential.

I would like to thank each and every one of you for your contribution and commitment to Telefónica, and would like to once again express my appreciation for the trust that you, and all those shareholders who cannot be here with us today, have shown in our company. Likewise I would encourage you to show this same trust in the future, as this New Telefónica will sow new successes for every one of you, something which, personally, I don't think anyone should stop enjoying.

Thank you.