

REPORT OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A. REGARDING THE PROPOSED AUTHORIZATION TO THE BOARD OF DIRECTORS TO INCREASE THE SHARE CAPITAL, WHICH WILL BE SUBMITTED FOR APPROVAL BY THE SHAREHOLDERS AT THE ANNUAL GENERAL SHAREHOLDERS' MEETING (ITEM VI ON THE AGENDA).

1. PURPOSE OF THIS REPORT

The Agenda for the Annual General Shareholders' Meeting of Telefónica, S.A., called for June 20 and 21, 2006, includes in Item VI thereon a proposal –which is submitted for approval at the General Shareholders' Meeting– consisting of authorizing the Board of Directors to increase the Company's share capital up to the maximum limit established by Law as and when required by the Company, which results in the amendment of Article 5 of the By-Laws relative to the share capital amount and the number of shares into which such capital is divided.

This Report is prepared in compliance with the provisions of Sections 144.1.a), 152.1, 153.1.b) and 159.2 of the Business Corporations Law [*Ley de Sociedades Anónimas*] in order to justify the afore-mentioned proposed authorization to the Board of Directors to increase the share capital, including delegation of the power to exclude preemptive rights, and which is submitted for approval by the shareholders acting at the General Shareholders' Meeting.

2. JUSTIFICATION FOR THE PROPOSAL

The volume of funds needed by Telefónica to carry out the investments currently in progress and those contemplated for the coming years requires the ability to access as many financing sources as are available in the market, utilizing every moment that result most convenient for the Company in terms of resources, financial solvency and structure of liabilities.

The Company's aim is to obtain external financial funding preferably from debt markets, both domestic and international, in which Telefónica has a prominent presence due to its rating, size and experience.

However, access to debt markets is sometimes subject to transitory restrictions resulting from economic policy measures which, at times, might reduce or impede the growth of monetary and credit variables and even the development of the financial markets. Therefore, Telefónica wishes to keep open the channels for capital increase such that they may be utilized when market conditions make it advisable in terms of cost of the funding obtained, while preserving at all times the principles of financial solvency, profitability and equity value of the Company's shares.

Consequently, in order to provide the Company with the flexibility and capacity required to access all financing sources available, the shareholders acting at the General Shareholders' Meeting are requested to authorize the Board of Directors to increase the share capital, on one or more occasions, within a five year term and up to an amount not greater than one-half of the share capital as of the date of the authorization, when financial market conditions and the best interests of the Company make such increase advisable.

Pursuant to Section 153.1 b) of the Business Corporations Law, the proposal considers that payment of the issued shares be made in the form of cash contributions, and sees specifically the possibility of an incomplete subscription for shares issued, pursuant to the provisions of Section 161.1 of the aforementioned Law. In addition, the proposal submitted at the General Meeting includes an authorization to the Board of Directors to take all steps required for the new shares covered by the capital increase to be admitted to trading on the Stock Exchanges on which the Company's shares are listed. The proposal is completed with an authorization to the Board of Directors to delegate to the Executive Commission such powers as have been granted by

the shareholders acting at the General Shareholders' meeting and may be delegated.

Additionally, pursuant to the provisions of Section 159.2 of the current Business Corporations Law, the delegation to the Board of Directors the power to increase share capital, which is contained in the proposal to which this Report refers includes, granting the directors the power to exclude the preemptive right accruing to shareholders and to holders of convertible debentures, if any, subject to the provisions of Section 159 of such Law as to the requirements, conditions and formalities established therein and in related provisions of the same Law. The Board of Directors believes that this additional possibility, which allows for more leeway and responsiveness than in the case of a mere delegation of the power to increase the share capital under Section 153.1.b) of the Business Corporation Law, is justified by the fact that promptness and flexibility of action are necessary on many occasions in financial markets in order to profit from the most favorable conditions.

The total or partial exclusion of preemptive rights is, in any event, a power granted to the Board of Directors by the shareholders acting at the General Shareholders' Meeting, and therefore, will be exercised with the discretion of the Board itself, having regard for the circumstances and complying with all legal requirements. In the event that, in the exercise of the aforementioned powers, the Board resolves to exclude preemptive rights in connection with a specific capital increase made under the authorization granted by the shareholders acting at the General Meeting, the Board shall, at the time it resolves upon the increase, issue a report detailing the specific reasons underpinning such measures in furtherance of the corporate interests. This report shall be followed by a corresponding report prepared by the auditor of accounts referred to in Section 159.2 of the Business Corporations Law. Both reports shall be made available to the shareholders and notice thereof shall be given to them at the next General Meeting held after the resolution providing for the increase, as required by the afore-mentioned legal provision.

3. **PROPOSED RESOLUTION SUBMITTED FOR APPROVAL BY THE SHAREHOLDERS AT THE ANNUAL GENERAL SHAREHOLDERS' MEETING**

The resolution that the Board of Directors submits for approval by the shareholders acting at the Annual General Shareholders' Meeting in connection with this matter reads as follows:

To authorize the Board of Directors, as fully and effectively as possible under the Law and pursuant to the provisions of Section 153.1.b) of the Business Corporations Law in effect so that, within a maximum term of five years from the resolution adopted at the General Meeting, and without the need to subsequently hold any such General Meeting or for any resolution to be subsequently adopted thereat, the Board may resolve to increase of Company's share capital, on one or more occasions, as and when required by the Company's needs in the judgment of the Board, by the maximum amount of 2,460,565,198 Euros, equal to one-half of the current share capital of the Company, by issuing and putting into circulation for this purpose the corresponding new shares, be they common shares or of any other kind among those permitted by the Law, including shares with a fixed or variable premium, and in all cases with payment for the issued shares in the form of cash contributions, and expressly providing for the possibility of an incomplete subscription for such shares as may be issued, pursuant to Section 161.1 of the Business Corporations Law. In addition, the Board of Directors is authorized to exclude preemptive rights in whole or in part, pursuant to Section 159.2 of the Business Corporations Law and related provisions.

The delegated powers that thus include the specification of the various aspects and conditions applicable to each issuance, according to the characteristics of each transaction decided to be conducted under the authorization to which this resolution refers, and will include the power to amend the text of the article of the By-Laws relating to share capital, once the increase has been resolved upon and implemented, and the power to carry out all the

formalities required for the new shares covered by the capital increase to be admitted to trading on the domestic and foreign Stock Exchanges on which the Company's shares are listed, in accordance with the procedures established in each of such Stock Exchanges.

Pursuant to Section 141, number 1, second paragraph, of the Business Corporations Law, the Board of Directors is also authorized to delegate to the Executive Commission such powers granted by means of this resolution as may be delegated.

Madrid, May 12, 2006