Telefónica, S.A.

REPORT BY THE BOARD OF DIRECTORS CONCERNING THE PROPOSED INCREASE IN STOCK CAPITAL WITH AN ELIMINATION OF THE PREEMPTIVE SUBSCRIPTION RIGHT WITH A VIEW TO ESTABLISHING AN EMPLOYEE STOCK OPTIONS PLAN (Point VII ON THE AGENDA)

1. PURPOSE OF THE REPORT

Point VII on the Agenda for the Annual General Shareholders´Meeting of Telefónica, S.A., that has been called for April 11 and 12, 2002, includes a proposal to increase the stock capital, with an exclusion of the preemptive subscription right to cover througout 2002 the needs deriving from the establishment of a remuneration system referenced on the quotation value of Telefónica S.A. shares, with delivery of stock options, for the employees of ENDEMOL ENTERTAINMENT HOLDING, N.V., a Dutch company, and its subsidiaries (hereinafter called "ENDEMOL," or "ENDEMOL GROUP" when its subsidiaries are included.)

This report has been prepared by the Board of Directors in compliance with the provisions of Articles 144 and 159 of the Law of Corporations. It includes the actual text of the resolution that will be submitted for deliberation and resolution by the Annual General Shareholderers´Meeting.

2. JUSTIFICATION FOR THE PROPOSAL

2.1. Employee Stock Option Plans have long been the medium customarily used to establish employee compensation and incentive systems. By giving the employees an opportunity to acquire shares of the company for which they work, under advantageous conditions, these plans promote the motivation and integration of the employees, and enable them to share in any increase in the value of the Company.

Telefónica, S.A., agreed to acquire ENDEMOL by means of an increase in capital with non-cash contribution of ENDEMOL shares. This acquisition was approved by the Annual General Shareholders´ Meeting of Telefónica, S.A., on 7 April 2000. The agreements provided that in 2001, 2002, 2003, and 2004 Telefónica, S.A., would give ENDEMOL GROUP employees options each year to acquire Telefónica S.A. stock worth 27,500,000 euros.

In conformance with this provision, Telefónica, S.A., has established an incentive plan (the "EN-SOP Program") under which it will offer Telefónica, S.A., stock options to all GROUP ENDEMOL personnel who are permanent employees as of the date of delivery of said options (hereinafter the “Beneficiaries”). Employees who participate in other stock or options programs of similar nature are expressly excluded.

The EN-SOP Program consists in delivery each year, in 2001, 2002, 2003, and 2004, of a variable number of options to purchase Telefónica, S.A., stock shares (the “Options") to the Beneficiaries. The total number of Options to be delivered each year will be determined by dividing the agreed amount of 27,500,000 euros by the Annual Refence Value of one share of Telefónica, S.A., stock.

To be precise the current capital increase addresses the delivery of 2,180,809 options corresponding to the year 2002, which is intended to be carried out if possible, over the weeks following the Annual General Shareholders´Meeting of Telefónica, S.A. which will approve the resolution derived from this report.

The Annual Reference Value for one share of Telefónica, S.A., stock for the delivery corresponding to the year 2002 has been calculated at 12.61 euros, taking into account the mathematical average of the average weighted changes per share of Telefónica, S.A., on the continuos market during the five trading days prior to the Telefónica, S.A., Board of Directors meeting that approves the within Directors' Report and resolves to call a Annual General Meeting of Shareholders.

The Options delivered each year will remain in effect for four years, and may be exercised in one-half increments on the third and fourth anniversary dates of their delivery.

2.2. The formula chosen to cover the needs deriving from the EN-SOP Program is the formula permitted by Article 159 of the Law of Corporations. This article provides that a Annual General Shareholders´Meeting may approve an increase in stock capital with exclusion of the preemptive subscription right and issue shares at a price higher than the net worth**.** To meet the requirements of law, on the one hand, and the goals sought by incentive plans, on the other hand, the EN-SOP Program will operate as follows:

The Beneficiaries will be offered an opportunity to enter into a stock options purchase agreement that embodies a commitment by Telefónica, S.A., to deliver to the Beneficiaries a number of Telefónica, S.A., stock shares, subject to the existence of specified conditions, when the employees have been with ENDEMOL GROUP for more than three, four, five, and six years.

The shares derived from the delivery of the Options corresponding to the year 2002 would originate in the increase in capital that the Annual General Shareholders´Meeting is being asked to approve. As stated above, it consists in a 2,180,809 euro increase in the stock capital in the form of issuance and placement of an equal number of ordinary shares, represented by accounting entries, that will be issued at their nominal value of 1 euro per share with an issue premium of 11.61 euros per share. Said price of 12.61euros per share complies with the provisions of Article 159.1 c) of the Law of Corporations, in that it exceeds the net worth of Telefónica, S.A. stock, as will be explained below.

The shares to be issued cannot be subscribed to by the Beneficiaries immediately, because the possibility of exercising the options depends, among other requirements, on continuation of their status as permanent employees of ENDEMOL GROUP. It is proposed, therefore, that the new shares to be issued in connection with this stock capital increase be subscribed and distributed by one or more Financial Institutions that will act as Plan Agents, and which will be chosen by the Board of Directors (with power to substitute a Standing Committee or Directors with delegated powers). The Board of Directors will also have the power to set the conditions that will govern the relations between the Institution(s) and Telefónica, S.A., for the actual performance and implementation of the commitments acquired and the EN-SOP Program.

Lastly, once the EN-SOP Program comes to an end, shares that under the terms of the Program could not be offered to the Beneficiaries, and which are not going to be used to cover another stock options plan for Telefónica Group employees, will be purchased by Telefónica, S.A., in all cases fulfilling the legal requirements imposed regarding the acquisition of treasury stock by the aforementioned Company.

2.3. For the purposes specified in Article 159.1 b) of the Law of Corporations, the following statements are made:

a) Interest of the Company: The Board of Directors feels that the resolution being proposed to the General Meeting of Shareholders to increase the stock capital and eliminate the preeptive subscription right is required in the interests of the Company, for the following reasons:

i) the drawing up and implantation of an Option Plan in order to facilitate access by ENDEMOL GROUP employees to the capital of Telefónica, S.A., as parent of the Group of which it now forms part, while, at the same time, establishing a competitive compensation formula similar to that of Telefónica, S.A. peers;

(ii) the aforementioned Option Plan will also create incentives for the Beneficiaries and enable them to participate in the increases in the value of the Company; at the same time, as permiting a beneficial convergence of employee and shareholder interests;

(iii) the Plan also permits the recognition of the work carried out as weel as future projects by the ENDEMOL GROUP workforce as a whole during coming years, and therefore complying with the agreements made for the acquisition of ENDEMOL by Telefónica, S.A.;

(iv) the drawing up and implantation of this option Plan for the Endemol Group´s employees must be fulfilled as it forms part of the commitment undertaken by Telefónica, S.A. by virtue of the agreements signed by the latter in the acquisition of Endemol, as stated in point 2.1. of this Report

(v) lastly, the Board believes that prior experience in the establishment of these incentive plans reflects results that prove their success, a success that has redounded to the obvious benefit of the interests of the Company and, therefore, of all the shareholders of Telefónica, S.A.

b) With respect to the justification of the proposal, we call attention to the considerations set forth in earlier sections of this report. In view of the identity of the ultimate beneficiaries of the increase in capital, it is obvious that the granting of a preemptive subscription right would make this goal unachievable.

c) The price of 12.61 euros per share established for the increase in capital is higher than the net worth of Telefónica, S.A. stock **(**this being a quoted company**)** as will be evidenced in the report by the Company's Auditors that will be made available to the shareholders when the General Meeting notices are sent out, in accordance with Article 159.1.c) of the Law of Corporations. The said per-share price of 12.61 euros is felt to be adequate in view of the goals sought with said increase.

d) With respect to the parties to whom the shares will be offered, we repeat: the shares will be offered to ENDEMOL GROUP employees, who were permanent employees at the corresponding date. All employees who participate in other stock or options programs of similar nature are specifically excluded.

The shares to be issued in connection with the increase in stock capital, ultimately, will be allocated to Beneficiaries, who exercise their options after meeting the conditions of the EN-SOP Program.

As has been stated, however, to facilitate this distribution on the terms and conditions specified in said Program, all the shares issued at this time, initially, will be subscribed to and distributed by one or more Financial Institutions to be designated by the Board of Directors, which is also authorized (with power of substitution by a Standing Committee or by Directors with delegated powers) to set the conditions that will govern the relations between said Financial Institutions and Telefónica, S.A., for the actual performance and implementation of the commitments made to the Beneficiaries.

Without prejudice to the foregoing, the Beneficiaries may exercise the Options in the form of liquidation in installments. For this purpose, the Financial Institutions subscribing the issue would sell the appropriate shares on the market on behalf of the Beneficiaries.

3. PROPOSED RESOLUTION TO BE SUBMITTED FOR APPROVAL BY THE GENERAL MEETING OF SHAREHOLDERS

The resolutions to be presented by the Board of Directors to be approved by the Annual General Shareholders´Meeting regarding this item are outlined below.

A). Capital increase by means of cash- contributions

It is resolved to increase the share capital of "Telefonica, S.A." by a nominal amount of 2,180,809 euros, through the issuance of an equal number of ordinary shares with a nominal value of one euro each, of the same class and series as the existing ones, represented by account entries and with an issue premium of 11.61 euros each. This will result in an issue price of 12.61 euros per share.

The number of shares to be issued has been calculated by dividing the quantity agreed upon with ENDEMOL of 27,500,000 annual euros by the Annual Reference Value of Telefonica, S.A. shares that has been calculated at 12.61 euros, taking into account the arithmetic mean of the weighted average exchanges of Telefonica, S.A. shares in the continuous market over the five preceding stock exchange days prior to the Telefonica, S.A. Board of Directors session that approved the submission of the present capital increase resolution to the Annual General Shareholders´Meeting.

B). Subscriptions of the shares

The capital increase to which this resolution refers has the exclusive purpose of providing coverage so as to be able to satisfy the exercise of options on Telefonica, S.A. shares corresponding to the year 2002 to be granted to employees of the ENDEMOL GROUP under the so-called "EN-SOP Program."

In order to serve this purpose, all the shares will be subscribed to and disbursed initially by one or various Financial Entities that will act as Plan Agents and that will be determined by the Board of Directors, which will likewise be empowered (all this entailing the power of substitution of its Standing Committee and/or any Board members with delegate powers) to set the conditions that will govern the relations between said Financial Entities and Telefonica, S.A. for the effective execution and introduction of the EN-SOP Program for the execution of which this resolution is adopted. For such purpose, among these conditions, the exercise by said entities of the rights inherent in the shares to which they subscribe shall expressly be governed, in terms that correspond to the instrumental function that such entities perform in the process of execution of the EN-SOP Program.

It is resolved that the Beneficiaries may exercise such options by means of their settlement by differences, for the purpose of which the Financial Entities that subscribe to the increase will sell the corresponding shares in the market for the account of the beneficiaries.

In accordance with the stipulations of Article 161 of the Law of Corporations, the incomplete subscription of the capital increase is expressly permitted.

C). Disbursement

The new shares of Telefonica, S.A. issued in the capital increase will be fully disbursed by means of one-time cash- contributions on the date determined by the Board of Directors within the maximum period of one year from the date of this resolution.

D). Representation of the new shares. Rights of the new shares.

The new issue shares will be ordinary shares, equal to those currently outstanding. They will be represented by account entries the recording of which will be conferred on the Spanish Securities Clearance and Settlement Service (SCLV) and its member entities.

The new shares will confer on their holders the same political and economic rights as the Telefonica, S.A. shares currently outstanding from the time of their issuance. With respect to the economic rights, the new shares will entail a right to company dividends, on account or definitive, the distribution of which is agreed upon from that date.

E) Exclusion of the preemptive subscription right

In view of the reasons of company interest that the capital increase obeys, through its aim and intended use, and considering that, due to its own characteristics, these could only be satisfied by a capital increase with exclusion of the right of preemptive subscription, the total exclusion of the preemptive subscription right of the shareholders and holders of convertible bonds of Telefonica, S.A., with respect to the shares issued in the capital increase is resolved, within the scope of that set forth in Article 159.1 of the Law of Corporations.

F) Request for admission for negotiation

Once the capital increase is executed, admission for negotiation of the new shares will be requested from the stock exchanges of Madrid, Barcelona, Bilbao, and Valencia and their contracting in the Automated Quotation Systems (Continuous Market) will be requested, expressly noting the submission of the company to the norms in existence or that may be enacted relating to the Stock Exchange, and in particular, as to the contracting, continued participation, and exclusion from the official quotation as well as admission for negotiation of said shares in any other foreign exchange market where the shares of the company are admitted for negotiation at the time of the closing of the capital increase resolution (including without limitations, the stock exchanges of New York, London, Frankfort, Paris, Tokyo, Sao Paulo, Buenos Aires, and Lima). For these purposes, the Board of Directors shall be empowered with the power of substituting the Standing Committee and/or any Board members with delegate powers, so that, once the capital increase resolution is executed, it may request from all the competent national and foreign agencies admission for negotiation of the new shares of Telefonica, S.A., signing for this purpose all the documents and commitments that are required in the terms they judge to be appropriate.

G). Delegation in the Board of Directors

Within the scope of the provisions of Article 153.1.a) of the Law of Corporations, the Board of Directors shall be empowered with the power of substitution in its Standing Committee and/or of any Board members with delegate powers, so that within the maximum period of one year reckoned from today's date, it may indicate the date on which the capital increase resolution must take effect or its execution abandoned, and in the event that it decides to execute it, to set the conditions for it in everything not provided by the Meeting, including in an indicative manner:

- to provide new wording to Article 5 of the Bylaws to adapt them to the new share capital figure resulting from the execution of the capital increase;

- to determine the procedure, period, starting and ending date of the subscription period;

- to draw up and prescribe all the prospectus and notifications that are required under Spanish and foreign legislation and to resolve on the modifications subsequent to these that it judges to be appropriate;

- to request the admission for negotiation of the new issued shares, with all the powers that prove necessary for such purpose, in accordance with the pertinent legislation, undertaking the necessary procedures and drawing up the documents that are required for this, and to designate the entity responsible for the accounting recording of the shares, and if applicable, the depositaries issuing the deposit certificates representing the documents that were necessary for this;

- to undertake all the procedures that are required and to approve and formalize all the public and private documents that prove necessary or appropriate for the full effectiveness of the capital increase resolution in any of its aspects and contents, and in particular to correct, clarify, interpret, complete, specify, or delimit, if applicable, the adopted resolution, and in particular, correct the defects, omissions, or errors that were ascertained in the verbal or written qualification of the Mercantile Register;

- to determine the Financial Entity or Entities that will have to subscribe to and disburse the capital increase, the number of shares to be subscribed to by it/ them and to set the conditions that will govern their relations with Telefonica, S.A., all in conformity with that set forth in the preceding subparagraph 2.

February 27, 2002