REPORT PREPARED BY THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A.

REGARDING THE PROPOSAL FOR COMPENSATING THE SHAREHOLDERS BY MEANS OF A SCRIP DIVIDEND UNDER ITEM VI.2 OF THE AGENDA FOR THE 2016 ORDINARY GENERAL SHAREHOLDERS' MEETING

April 8, 2016

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1. SUBJECT-MATTER OF THE REPORT

A proposal for compensating the shareholders in the second half of 2016 by means of a scrip dividend or, if the effective receipt of the proceeds from the closing of the sale to Hutchison Whampoa Group of Telefónica's operations in the United Kingdom (O2 UK) has been carried out prior to the Board of Directors resolution to implement the scrip dividend, by means of a distribution of dividends in cash with a charge to unrestricted reserves, is submitted to the shareholders for approval under item VIII.2 on the agenda for the Ordinary General Shareholders' Meeting of Telefónica, S.A. (the "**Company"**) called to be held on May 11 and 12, 2016 on first and second call, respectively.

If the scrip dividend were implemented as described in the preceding paragraph, it would be structured through an increase in share capital with a charge to reserves by an amount to be determined according to the terms of the resolution, by issuing new ordinary shares, each with a par value of one euro, without a share premium, of the same class and series as those currently outstanding, and the assumption by the Company or by another company of its Group of an undertaking to purchase the corresponding free allotment rights that are granted to the shareholders.

Pursuant to the provisions of Sections 286 and 296 of the Companies Act (*Ley de Sociedades de Capital*), the Board of Directors must prepare a report providing a rationale for the proposal in order for the capital increase and the resulting amendment of the By-Laws to be submitted for the approval of the shareholders at the General Shareholders' Meeting.

In order to facilitate an understanding of the proposal being submitted for the approval of the shareholders at the General Shareholders' Meeting, a description is first provided of the purpose and rationale, followed by a description of the main terms and conditions thereof. Lastly, a full verbatim transcription is provided of the corresponding proposed resolution.

2. PURPOSE OF AND RATIONALE FOR THE PROPOSAL

2.1 Purpose of the transaction

The Company has been compensating its shareholders in recent years through the payment of cash dividends, repurchases of shares and, for the first time, in May 2012, by means of a scrip dividend.

In accordance with the information provided by the Company in the notices of significant events (*hechos relevantes*) reporting the sale of the Telefónica Group's operations in the United Kingdom (significant events registered on January 23, 2015, under registration number 217502, and on March 24, 2015, under registration number 220609), and in accordance with the latest submissions of results filed with the National Securities Market Commission (*Comisión Nacional del Mercado de Valores*), it has been deemed appropriate to subject the shareholder compensation program by means of a scrip dividend to the condition that the effective receipt of the proceeds from the closing of the sale to Hutchison Whampoa Group of the Telefónica Group's operations in the United Kingdom has not been carried out. For this purposes, it is expected that no later than November 11, 2016 the necessary resolutions will be adopted.

Thus, in the event that the proposal submitted under item VIII.2 on the agenda for the General Shareholders' Meeting is approved, and if the aforementioned effective receipt of the proceeds has been carried out prior to the date when the Board of Directors resolves the implementation of the scrip dividend, the Company would make a distribution of cash dividends with a charge to unrestricted reserves through the payment of the fixed amount of 0.35 euros to each of the existing and outstanding shares of Telefónica, S.A. entitled to participate in such distribution on the date of payment in accordance with the applicable rules governing the clearing and settlement of securities. The payment will be made on November 17, 2016, through the *Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U.* (IBERCLEAR)

If, on the contrary, the proceeds from the closing of the sale have not been prior and effective received, the Company would again offer its shareholders, the alternative of the scrip dividend, also named "Telefónica Flexible Dividend," a form of shareholder compensation that allows them to receive paid-up shares of the Company as an alternative, without in any way limiting their ability to receive all of their compensation in cash if they so desire.

Therefore, the purpose of the proposal submitted to the shareholders at the Ordinary General Shareholders' Meeting is to allow for the implementation of a new edition of the Telefónica Flexible Dividend program in fiscal year 2016, in the event that the effective receipt of the proceeds from the closing of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited) to Hutchinson Whampoa Group has not taken place beforehand.

2.2. Structure of the transaction and options open to shareholders

This new edition of the Telefónica Flexible Dividend, which would allow shareholders, in their discretion, to receive their compensation in paid-up shares or in cash, would be structured through a capital increase with a charge to reserves, through the issuance of paid-up shares, upon the terms described in the proposed resolution submitted under item VIII.2 of the Agenda.

At the time the Board of Directors decided to carry out the capital increase:

(i) The shareholders would receive one free allotment right for each share they owned. These rights could be traded on the Spanish continuous market for a period of at least 15 calendar days, at the end of which the rights would be automatically converted into newly-issued shares of the Company that would be vested in the holders thereof. The exact number of shares to be issued as a result of the increase and, accordingly, the number of rights needed to receive a new share, would depend on the market price of the Company's share taken as a reference at the time of implementation of the increase (the "**Reference Market Price**") in accordance with the procedure described in this report.

In any event, as explained below, the maximum number of shares, if any, to be issued in the capital increase would be such that the market price of such shares, calculated at the Reference Market Price, would be the result from multiplying the number of shares of the Company at the date in which the Board of Directors resolves to carry out the capital increase by 0.35, with the limit indicated in paragraph 2.3 below.

(ii) The Company or an entity within its Group would assume an irrevocable commitment to purchase the free allotment rights received by the shareholders at a fixed price (the "**Purchase Undertaking**"). This fixed price would be calculated prior to the beginning of the trading period for the free allotment rights, based on the Reference Market Price (such that the price of each right would be the result of dividing the Reference Market Price by the number of rights needed to receive a new share plus one). Thus, the Company would guarantee all its shareholders the ability to monetize the rights received for free, thus allowing them to receive their compensation in cash.

Therefore, upon the implementation of the capital increase that is being submitted to the shareholders for approval at the General Shareholders' Meeting, if such capital increase were approved, the shareholders of the Company would have the option, if they so choose:[1]

(a) not to transfer their free allotment rights. In this case, the shareholders would receive the number of new fully paid-up shares to which they were entitled at the end of the trading period;

(b) to transfer all or part of their free allotment rights to the Company or, if applicable, to the corresponding entity of its Group, pursuant to the Purchase Undertaking.

[1] The options available to holders of shares of the Company that are admitted to trading outside Spain (including those traded in the form of ADSs) may have certain differences with respect to those described herein based on the nature of each market and the terms and conditions applicable to the programs in which such holders participate.

Thus, the shareholders would be opting to monetize their rights and receive their compensation in cash instead of receiving paid-up shares;

(c) to transfer all or part of their free allotment rights on the market. In this case, the shareholders would also be opting to monetize their rights, albeit not at a guaranteed fixed price, unlike in option (b) above.

The gross value received by the shareholder under options (a) and (b) would be the same, given that the Reference Market Price would be used to determine both the fixed price of the Purchase Undertaking and the number of free allotment rights needed to subscribe for one new share. However, the tax treatment of each of the alternatives is different (see section 3.6 below for a summary of the tax regime applicable in Spain).

2.3. Cash amount of the capital increase and price of the Purchase Undertaking

The structure proposed to implement the Telefónica Flexible Dividend Program consists of offering the shareholders paid-up shares with a value, established in accordance with the Reference Market Price that would be the result from multiplying the number of shares of the Company at the date in which the Board of Directors resolves to carry out the capital increase by 0.35, with the limit of 1,850,000,000 euros.

This is in line with the objective –as announced in the dividend policy– of distributing approximately 0.35 euro per share, whether by means of a scrip dividend or by means of a distribution of dividends with a charge to unrestricted reserves (in the event of the effective receipt of the proceeds from the closing of the sale of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited) to Hutchison Whampoa Group has been carried out) .

Given that, as stated above, the purpose of the Purchase Undertaking is to allow the shareholders to monetize their compensation, and considering that under the capital increase each share would give the holder thereof one free allotment right, the gross price per right at which the Purchase Undertaking would be made would be approximately, 0.35 euro per share.[2]

The reference amount and the purchase price of free allotment rights would be established and made public pursuant to section 3.3. below.

3. <u>MAIN TERMS AND CONDITIONS OF THE CAPITAL INCREASE</u>

The main terms and conditions of the Capital Increase are described below.

3.1. Amount of the Capital Increase, number of shares to be issued, and number of free allotment rights needed to receive one new share

[2] This figure will be the resulting by application of the formulas set forth in section 3.1 of this report.

As described in the calculation formulas and in the definitions included in this section, if and when the Board of Directors, decides to implement the capital increase, it will determine the number of shares to be issued as follows:

The number of shares to be issued would be the result of dividing the total number of shares of the Company on that date by the number of free allotment rights needed for the allotment of one new share. The number so calculated would be subject to rounding in order to obtain a whole number of shares.

The number of rights would be the result of dividing the total number of shares of the Company on the date on which it was decided to implement the capital increase by means of a scrip dividend by the provisional number of shares to be issued, rounded up to the nearest whole number.

In turn, the provisional number of shares to be issued would be the result of dividing the Reference Amount determined in accordance with what is stated in paragraph 2.3 above - with a maximum in any case of 1,850,000,000 – by the Reference Market Price.

In addition, the Company (or any company within its Group) would waive the necessary number of free allotment rights in order to obtain a subscription ratio that is a whole number.

Once the number of new paid-up shares to be issued was established, the amount of the capital increase would be the result of multiplying such number by the par value of the Company's shares (1 euro per share). The capital increase would be at par, with no additional paid-in capital.

In accordance with the foregoing, the amount of the increase and the number of free allotment rights needed for the allotment of one new share would be determined using the following formulas.

The number of new shares would be the number that resulted from applying the following formula, rounded down to the nearest whole number

$$\boxed{\text{NAN} = \text{NTAcc} / \text{Number of Rights}}$$

where

"**NAN**" would be the number of new shares to be issued;

"**NTAcc**" would be the number of shares of the Company on the date the Board of Directors resolves to implement the capital increase; and

"**Number of Rights**" would be the number of free allotment rights required for the allotment of one new share, which number would result from applying the following formula, rounded up to the nearest whole number:

$$\boxed{\text{Number of Rights} = \text{NTAcc} / \text{Provisional number of shares}}$$

where

Provisional number of shares = Reference Amount / PreCot.

For such purposes:

"**Reference Amount**" would be the reference market value of the capital increase, which would result from the application of the following formula:

Reference Amount = NTAcc × 0.35 × PreCot / (PreCot -0.35)

with a maximum in any case of 1,850,000,000.

"**PreCot**" would be the Reference Market Price, i.e., the arithmetic mean of the average weighted prices of the shares of the Company on the Spanish Automated Quotation System (*Sistema de Interconexión Bursátil Español*) (Continuous Market) during the 5 trading sessions closed prior to the decision of the Board of Directors, to carry out the capital increase, rounded to the nearest one-thousandth of a euro and, in the case of one-half of one thousandth of a euro, rounded up to the nearest one-thousandth. In any case, PreCot could not be less than the par value of the shares, such that if the result of such calculation were less, PreCot would be equal to one euro.

Examples of calculations of the number of new shares to be issued, the amount of the increase and the number of free allotment rights needed for the allotment of one new share, using different Reference Market Prices:

Examples of calculations of the formulas included in this section are included below, solely for the purpose of facilitating comprehension of how the formula is to be applied. The results of these calculations are provided as examples only, since actual figures will depend on the circumstances prevailing at the time the capital increased is implemented.

a) Example using the Reference Market Price as of April 7, 2016

A PreCot of 9.107 euros (Reference Market Price on April 7, 2016) and a NTAcc of 4,975,199,197 (number of shares into which the capital of the Company is expected to be divided as of the date of execution of this increase[3]) are assumed.

Therefore, applying the aforementioned formulas, it follows that:

- Reference Amount = (NTAcc × 0.35) x (PreCot / PreCot – 0.35) = 1.741.319.718,95 × (9,107/8,757) = 1.810.916.830,02

- Provisional number of shares = Reference Amount / PreCot = 1,810,916,830.02 / 9.107 = 198,848,888.77

[3] Number of shares into which the share capital of the Company is divided as of the date of this report.

- Number of Rights = NTAcc / Provisional number of shares = 4,975,199,197 / 198,848,888.77 = 26 (rounded up)

- NAN = NTAcc / Number of Rights = 4,975,199,197 / 26 = 191,353,815 (rounded down)

Consequently, in this example, (i) the number of new shares to be issued would be 191,353,815, (ii) the nominal amount of the capital increase would amount to 191,353,815.00 euros, (iii) 26 free allotment rights (or existing shares) would be needed for the allotment of one new share, and (iv) the Company, or another entity within its Group, would have to waive 7 free allotment rights to fit the subscription ratio.

b) Example using the Reference Market Price as of April 7, 2016, increased by 5%

In this example, a PreCot of 9.562 euros (Reference Market Price as of April 7, 2016 increased by 5%) and a NTAcc of 4,975,199,197 (number of shares into which the capital of the Company is expected to be divided as of the date of execution of this increase[4]) are assumed

Therefore, applying the aforementioned formulas, it follows that:

- Reference Amount = NTAcc × 0.35 × (PreCot / (Precot – 0.35) = 1,741,319,718.95 × (9.562 / 9.212) = 1,807,479,282.74

- Provisional number of shares = Reference Amount / PreCot = 1,807,479,282.74 / 9.562 = 189,027,325.11

- Number of Rights = NTAcc / Provisional number of shares = 4,975,199,197 / 189,027,325.11 = 27 (rounded upwards)

- NAN = NTAcc / Number of Rights = 4,975,199,197 / 27 = 184,266,636 (rounded downwards)

Therefore, in this example, (i) the number of new shares to be issued would be 184,266,636, (ii) the nominal amount of the capital increase would amount to 184,266,636.00 euros, (iii) 27 free allotment rights (or existing shares) would be needed for the allotment of one new share, and (iv) the Company, or another entity within its Group, would have to waive 25 free allotment rights to fit the subscription ratio.

c) Example using the Reference Market Price as of April 7, 2016, reduced by 5%

In this example, a PreCot of 8.652 euros (Reference Market Price as of April 7, 2016 reduced by 5%) and a NTAcc of 4,975,199,197 (number of shares into which the capital

[4] See previous footnote.

of the Company is expected to be divided as of the date of execution of this increase[5]) are assumed.

Therefore, applying the aforementioned formulas, it follows that:

- Reference Amount = (NTAcc × 0,35) × (PreCot / PreCot – 0.35) = 1,741,319,718.95 × (8.652 / 8.302) = 1,814,731,174.22

- Provisional number of shares = Reference amount / PreCot = 1,814,731,174.22 / 8.652 = 209,747,015.05

- Number of Rights = NTAcc / Provisional number of shares = 4,975,199,197 / 209,747,015.05 = 24 (rounded upwards)

- NAN = NTAcc / Number of Rights = 4,975,199,197 / 24 = 207,299,966 (rounded downwards)

Therefore, in this example, (i) the number of new shares to be issued would be 207,299,966, (ii) the nominal amount of the capital increase would amount to 207,299,966.00 euros, (iii) 24 free allotment rights (or existing shares) would be needed for allotment of one new share, and (iv) the Company, or another entity within its Group, would have to waive 13 free allotment rights to fit the subscription ratio.

3.2. Free allotment rights

In this capital increase, each outstanding share of the Company would grant its holder one free allotment right.

The number of free allotment rights required to receive one new share would be automatically determined according to the ratio existing between the number of new shares and the number of existing shares, calculated in accordance with the formula set forth in section 3.1 above.

In the event that the number of free allotment rights required for the allotment of one new share (26 in the above example a)) multiplied by the number of new shares (191,353,815 in the same example) resulted in a number that is lower than the number of shares of the Company at that time (4,975,199,197 in our example), the Company, or an entity within its Group, would waive a number of free allotment rights equal to the difference between both figures (i.e.,13 rights in the above example) for the sole purpose that the number of new shares to be issued be a whole number and not a fraction.

The free allotment rights would be allotted to the shareholders of the Company who appeared as being entitled thereto in the book-entry records of *Sociedad de Gestión de*

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5 See previous footnote.

los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U. (IBERCLEAR) to take place on November 16, 2016 in accordance with applicable rules governing the clearing and settlement of securities. The free allotment rights could be traded during the term determined by the Board, which term would not be less than fifteen calendar days.

3.3. Purchase Undertaking for the free allotment rights

As explained above, upon implementation of the capital increase, the Company, or such entity of its group as may be determined, would assume an irrevocable commitment to purchase the free allotment rights from the increase so that the shareholders would be guaranteed the ability to sell the rights received free of charge, receiving, in their discretion, all or part of their compensation in cash. The Purchase Undertaking would be in effect during such term, within the period for trading the free allotment rights, as would be established by the Board of Directors.

For such purpose, the proposed resolution would include the respective authorization to acquire such free allotment rights, with a maximum limit of the total number of rights issued, and complying with legal limitations in any case. The purchase price under the Purchase Undertaking would be fixed and would be calculated prior to the commencement of the period for trading the free allotment rights according to the following formula (in which the definitions set forth in section 3.1 above would apply), rounded to the nearest one thousandth part of a euro and, in the case of one-half of one thousandth of a euro, rounded up to the nearest one thousandth part of a euro (the "**Purchase Price**"):

$$\boxed{\text{Purchase Price} = \text{PreCot} / (\text{Number of Rights} + 1).}$$

The final Purchase Price so calculated would be set and made public upon implementation of the capital increase.

The Company would waive the exercise of the free allotment rights acquired by virtue of the Purchase Undertaking and, as a result of the foregoing, it would waive the new shares that would correspond to such rights, such that the share capital would be increased only by the amount corresponding to the free allotment rights that would not have been waived.

3.4 Rights carried by the new shares

The new shares, if any, that would be issued would be ordinary shares, each with a par value of one euro, of the same class and series as those currently outstanding, represented by book entries, the records of which would be kept by *IBERCLEAR* and its participating entities.

Holders of the new shares would have the same dividend and voting rights as the holders of the ordinary shares of the Company that are currently outstanding, from the date of implementation of the capital increase.

3.5 Balance sheet and reserves to which the increase would be charged

The balance sheet used as the basis for the capital increase would be the balance sheet as of December 31, 2015, which was audited by Ernst & Young, S.L. on February 26, 2016 and which is submitted to the shareholders at this General Shareholders' Meeting for approval under item I on the Agenda therefor.

The capital increase would be made in its entirety with a charge to the reserves provided for in Section 303.1 of the Companies Act. When implementing the increase, the Board of Directors, would determine the reserve to be used and the amount thereof in accordance with the balance sheet used as the basis for the transaction.

3.6 Tax regime

The tax regime applicable to shareholders in Spain, based on the tax regulations in force in the common territory and the interpretation provided by the Directorate General for Taxation *(Dirección General de Tributos)* through its answers to several binding consultations would be generally the one described below (without prejudice to the particularities that might apply to certain shareholders, such as non-residents or those subject to taxation in the regional (*foral*) territories, as well as potential future regulatory changes that could affect the applicable tax regime).

The delivery of the paid-up shares as a result of the capital increase will be treated for tax purposes as the delivery of paid-up shares, and will therefore not be treated as income for the purposes of the Personal Income Tax (*Impuesto sobre la Renta de las Personas Físicas*) ("**IRPF**"), Corporate Income Tax (*Impuesto sobre Sociedades*) ("**IS**") or Nonresident Income Tax (*Impuesto sobre la Renta de no Residentes*) ("**IRNR**"), whether or not the shareholders receiving such shares act through a permanent establishment in Spain. In line with the foregoing, the delivery of new shares is not subject to any withholding or payment on account.

The acquisition cost, both of the new shares received as a result of the capital increase and of the shares from which they arise, will be the result of dividing the total cost by the applicable number of shares, both old and new. The acquisition date of such paid-up shares will be that of the shares from which they arise.

If the shareholders sell their free allotment rights on the market, the amount obtained from the transfer of such rights will be taxed as follows:

- For the purposes of IRPF and IRNR without a permanent establishment, the amount obtained in the market for the free allotment rights is subject to the same rules as those applying to preemptive rights. Consequently, the amount obtained on the transfer of the free allotment rights reduces the acquisition cost of the shares giving rise to such rights for tax purposes, pursuant to the current text of Section 37.1.a) of Personal Income Tax Law 35/2006 of November 28, in accordance with the interim regime applicable to this type of transaction established in Final Provision Six of Law 26/2014 of November 27 amending Law 35/2006 of November 28 on Personal Income Tax (applicable through December 31, 2016).

- Thus, if the amount obtained in such transfer is higher than the acquisition cost of the securities from which the rights arise, the difference will be treated as a capital gain for the transferor in the tax period in which the transfer takes place, all without prejudice to the potential application to persons liable to IRNR without a permanent establishment of the double taxation treaties signed by Spain and to which they may be entitled.

- For the purposes of IS and IRNR with a permanent establishment in Spain, provided that a full business cycle has been completed, the tax treatment will be in line with the applicable accounting rules.

In the event that the holders of free allotment rights accept the Purchase Undertaking, the tax regime applicable to the amount obtained in the transfer of the free allotment rights to the Company, or to the relevant entity of its Group, will be that applicable to dividends distributed directly in cash and, accordingly, will be subject to the related withholding tax.

3.7 Delegation of powers

A proposal is made to delegate to the Board of Directors, the power to determine the resolution providing for the increase in capital to be ineffective if the effective receipt of the proceeds from the closing of the sale to Hutchison Whampoa Group of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited) takes place prior to the resolution for implementation of such resolution, and otherwise the power to set the date on which the approved increase in capital by means of a scrip dividend should be carried out, as well as to set the terms and conditions thereof to the extent not provided for by the shareholders at the General Shareholders' Meeting, all pursuant to Section 297.1.a) of the Companies Act. Notwithstanding the foregoing, if the Board of Directors does not consider it advisable to carry out this capital increase, it must report its decision to the shareholders at the next General Shareholders' Meeting. In any event, the increase would be nullified if the Board of Directors did not exercise the powers delegated thereto within the one-year period stipulated by the shareholders for the implementation of the resolution.

Once the Board of Directors decides to implement the capital increase, if at all, stipulating all its final terms where not already stipulated by the shareholders at the General Shareholders' Meeting, the Company will make those terms public. In particular, prior to the beginning of the free-of-charge allotment trading period, if any, the Company would make available to the public a document containing information on the number and nature of the shares and the reasons for the capital increase, all in accordance with Section 26.1.e) of Royal Decree 1310/2005 of November 4, partially implementing the Securities Market Act (consolidated text approved by Royal Legislative Decree 4/2015 of October 23).

At the end of the period for trading the free allotment rights:

(a) The new shares would be allotted to the holders of free allotment rights in the required proportion.

(b) The Board of Directors, would close the free allotment rights trading period and would record the application of an amount of reserves equal to the increase, with the increase thus being fully paid up.

Lastly, the Board of Directors would adopt the resolutions required to amend the By-Laws in order to reflect the new amount of share capital resulting from the increase and to apply for admission of the new shares to trading.

It is proposed to authorize the Board of Directors to in turn delegate to the Executive Commission or the Executive Chairman of the Board of Directors, the powers abovementioned, and in general, those powers referred in this proposed resolutions.

3.8 Admission of the new shares to trading

The Company would apply for admission of the new shares ultimately issued to trading on the Madrid, Barcelona, Bilbao and Valencia Stock Exchanges through the Spanish Automated Quotation System (*Sistema de Interconexión Bursátil*) (Continuous Market), would take such steps and actions as would be needed and would submit the required documents to the appropriate bodies of the foreign Stock Exchanges on which the shares of the Company are listed (currently, London and Buenos Aires and, through American Depositary Shares (ADSs), New York and Lima) in order for the new shares issued under the increase, if any, to be admitted to trading.

4. ***PROPOSED RESOLUTION SUBMITTED FOR APPROVAL BY THE SHAREHOLDERS AT THE ORDINARY GENERAL SHAREHOLDERS' MEETING***

The full text of the proposal in connection with this item on the agenda that is submitted to the shareholders for approval at the Ordinary General Shareholders' Meeting is as follows:

1.- Capital increase with a charge to reserves

The share capital is increased by the amount resulting from multiplying (a) the nominal value of one euro per share of Telefónica, S.A. (the "**Company**") by (b) the number of new shares of the Company to be determined using the formula indicated under item 2 below (the "**New Shares**").

The capital increase is carried out by means of the issuance and flotation of the New Shares, which will be ordinary shares, having a nominal value of one euro each, of the same class and series as those that are currently outstanding, represented by book entries.

The capital increase is carried out in its entirety with a charge to one of the reserves provided for in Section 303.1 of the Companies Act (*Ley de Sociedades de Capital*).

The New Shares are issued at par, i.e., at their nominal value of one euro, without a share premium, and will be allotted without charge to those shareholders who exercise their free allotment rights.

Pursuant to the provisions of Section 311 of the Companies Act, provision is made for the possibility of an incomplete allotment of the Capital Increase, in the event that the Company, a company within its Group or a third party waives all or part of the free allotment rights to which they are entitled at the time of implementation of the increase. In the event of such incomplete allotment, the share capital will be increased by the corresponding amount

2.- New Shares to be issued

The number of New Shares will be the number that results from the application of the following formula, with the resulting number being rounded downwards to the next lower integer:

NAN = NTAcc / Number of Rights

where

"**NAN**" is the Number of New Shares to be issued;

"**NTAcc**" is the number of shares of the Company on the date on which the Board of Directors, resolves to implement the capital increase; and

"**Number of Rights**" is the number of free allotment rights required for the allotment of one New Share, which number will result from the application of the following formula, with the result being rounded to the next higher integer:

Number of Rights = NTAcc / Provisional number of shares

where

Provisional number of shares = Reference Amount / PreCot.

For these purposes:

"**Reference Amount**" will be the reference market value of the capital increase, which will result from the application of the following formula:

Reference Amount = NTAcc × 0.35 × PreCot / (PreCot -0.35)

with a maximum in any case of 1,850,000,000 euros.

"**PreCot**" is the arithmetic mean of the average weighted listing prices of the Company's Shares on Spanish Automated Quotation System (*Sistema de Interconexión*

Bursátil) in the five trading sessions closed prior to the resolution of the Board of Directors, to implement the capital increase, rounded up or down to the closest one-thousandth part of a euro and, in the case of half of one thousandth of a euro, rounded to the next higher one thousandth part of a euro. In any event, PreCot may not be less than the nominal value of the shares, such that if the result of such calculation is less, PreCot shall be equal to one euro.

3.- Free allotment rights

Each share of the Company will grant its holder one free allotment right.

The number of free allotment rights required to receive one New Share will be automatically determined according to the ratio existing between the number of New Shares and the number of shares of the Company (NTAcc). Specifically, the shareholders will be entitled to receive one New Share for as many free allotment rights, determined as provided in Section 2 above (Number of Rights), as are held by them.

In the event that (i) the number of free allotment rights required for the allotment of one share (Number of Rights) multiplied by the number of New Shares (NAN) results in a number that is lower than (ii) the number of outstanding shares (NTAcc), the Company, or an entity within its Group, will waive a number of free allotment rights equal to the difference between both figures, for the sole purpose that the number of New Shares be a whole number and not a fraction.

The free allotment rights will be allotted to the shareholders who appear as being entitled thereto in the book-entry records of Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U. (IBERCLEAR) on the relevant date, in accordance with applicable rules governing the clearing and settlement of securities.

The free allotment rights may be traded on the Spanish continuous market during such term as may be determined by the Board of Directors, which term will not be less than fifteen calendar days. During the period for trading the free allotment rights, a sufficient number of free allotment rights may be acquired on the market in the proportion required to subscribe for New Shares.

4.- Irrevocable commitment to purchase the free allotment rights

The Company, or such company of its Group as may be determined, will assume an irrevocable commitment to purchase the free allotment rights at the price set forth below (the “**Purchase Undertaking**”).

The Purchase Undertaking will be in effect during such term, within the period for trading the rights, as is established by the Board of Directors. For such purpose the Company, or the corresponding company of its Group, is authorized to acquire such free allotment rights up to the maximum limit of the total number of rights issued, in all cases with due observance of any applicable legal restrictions.

The "**Purchase Price**" of each free allotment right under the Purchase Undertaking shall be the amount that results from the following formula, rounded up or down to the closest one thousandth part of a euro and, in the case of one-half of one thousandth of a euro, to the next higher one thousandth part of a euro:

$$\boxed{\text{Purchase Price} = \text{PreCot} / (\text{Number of Rights} + 1)}$$

The Company may acquire the free allotment rights pursuant to the Purchase Undertaking in whole or in part with a charge to one of the reserves provided for in Section 303.1 of the Companies Act.

5.- Balance sheet for the transaction and reserve to which the increase will be charged

The balance sheet used as the basis for the transaction is the balance sheet for the fiscal year ended December 31, 2015, duly audited and approved by the shareholders at this General Shareholders' Meeting.

As noted above, the capital increase is made in its entirety with a charge to one of the reserves provided for in Section 303.1 of the Companies Act. When implementing the increase, the Board of Directors, will determine the reserve to be used and the amount thereof in accordance with the balance sheet used as the basis for the transaction.

6.- Representation of the New Shares

The New Shares will be represented by book entries, the book-entry registration of which is entrusted to *Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U.* (IBERCLEAR) and its participating entities.

7.- Rights carried by the New Shares

Holders of the New Shares will have the same voting and dividend rights as the holders of the ordinary shares of the Company that are currently outstanding, from the date on which the capital increase is declared to be subscribed and paid in.

8.- New Shares on deposit

Once the period for trading the free allotment rights has ended, the New Shares that could not be allotted for reasons not attributable to the Company will be held on deposit for those who provide evidence that they are the lawful holders of the corresponding free allotment rights.

Upon the passage of three years from the end of the period for trading the free allotment rights, the New Shares that are still pending allotment may be sold in accordance with the provisions of Section 117 of the Companies Act, for the account and risk of the interested parties. The net proceeds from such sale will be deposited with the Bank of Spain (*Banco de España*) or with the Government Depository (*Caja General de Depósitos*) at the disposal of the interested parties.

9.- Application for admission to official trading

Application will be made for admission of the New Shares issued to trading on the Madrid, Barcelona, Bilbao and Valencia Stock Exchanges, through the Spanish Automated Quotation System (*Sistema de Interconexión Bursátil*) (Continuous Market), with the taking of such steps and actions as are required or appropriate and the submission of the required documents to the appropriate bodies of the foreign Stock Exchanges on which the shares of the Company are listed (currently London and Buenos Aires and, through American Depositary Shares (ADSs), New York and Lima) in order for the New Shares to be admitted to trading, with an express statement for the record of the Company's submission to the rules that may now or hereafter exist with respect to Stock Exchange matters, and especially regarding trading, continued listing on and delisting from official markets.

It is expressly stated for the record, for appropriate legal purposes, that in the event of a subsequent request for delisting of the Company's shares, such delisting will be carried out with such formalities as apply thereto and, in such event, the interests of the shareholders opposing or not voting on the resolution to delist will be safeguarded, in compliance with the requirements set out in applicable laws and regulations.

10.- Implementation of the increase

Within a period of one year from the date of this resolution, the Board of Directors may resolve, if it so deems appropriate, to implement the increase and set the terms and conditions thereof as to all matters not provided for in this resolution.

However, it is expected that the free allocation rights derived from the increase in share capital will be allocated to the Telefónica, S.A.'s shareholders who appear as entitled thereto in the book-entry records of Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U. (IBERCLEAR) on November 16, 2016.

For these purposes, it is expected that at a Board of Directors's meeting, which will take place no later than November 11, 2016, the necessary corporate decisions are adopted to carry out the implementation of the capital increase released, relating to the shareholder compensation in the via scrip dividend. In this way, the five trading sessions prior to the aforementioned meeting will determine the listing price that applies to the formula for fixing the purchase price of the free allocation rights and the provisional number of shares to issue.

If the Board of Directors does not deem it advisable to implement the capital increase, it may decide not to implement it, in which case it must report such decision to the shareholders at the next General Shareholders' Meeting held. The capital increase to which this resolution refers will be deprived of any and all effect in the event that the Board of Directors does not exercise the powers delegated thereto within the aforementioned period of one year

Once the period for trading the free allotment rights has ended:

(a) The New Shares will be allotted to the holders of the free allotment rights, according to the records maintained by IBERCLEAR and its participating entities, in the proportion resulting from section 3 above.

(b) The Board of Directors, will declare the period for trading the free allotment rights to have ended and will formalize the appropriation of an amount of reserves equal to the amount of the capital increase, with which appropriation such capital increase will thus be fully paid in.

Likewise, once the period for trading the free allotment rights has ended, the Board of Directors will adopt the resolutions required to amend the By-Laws in order to reflect the new amount of share capital resulting from the increase, and to apply for admission of the New Shares to listing on the Spanish and foreign Stock Exchanges on which the shares of the Company are listed.

11.- Condition. Distribution of dividends with a charge to reserves

If the effective receipt of the proceeds from the closing of the sale to a Hutchison Whampoa Group of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited) takes place prior to the Board of Directors decision of implementation of the increase in capital contemplated in this resolution, the increase will be deprived of effect.

If that is the case, a distribution of dividends with a charge to unrestricted reserves is hereby approved through the payment of the fixed amount of 0.35 euros to each of the existing and outstanding shares of Telefónica, S.A. entitled to participate in such distribution on the date of payment.

Payment will be made on November 17, 2016 through the participants in Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.U. (IBERCLEAR).

12.- Delegation of powers for implementation of the increase

Delegation is made to the Board of Directors of the power to declare the resolution providing for the increase in capital to be ineffective in the event that the effective receipt of the proceeds from the closing of the sale to Hutchison Whampoa Group of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited) takes place prior to the implementation of such increase, and otherwise, of the power to set the terms and conditions of the capital increase as to all matters not provided for in this resolution, pursuant to the provisions of Section 297.1.a) of the Companies Act.

In particular, and by way of example only, the following powers are delegated to the Board of Directors, with express power of substitution:

1.- To set the date on which the Capital Increase is to be carried out, which shall be within a period of one year from approval thereof, and to determine the reserves, from among those listed in Section 303.1 of the Companies Act, with a charge to which such increase will be implemented.

2.- To set the reference date and time for allotment of the free allotment rights and the duration of the period for trading the free allotment rights, which shall not be less than fifteen calendar days.

3.- To determine the exact amount of the capital increase, the number of New Shares and the free allotment rights needed for the allotment of New Shares, applying the rules established in this resolution for such purpose.

4.- To establish the terms and conditions of the Purchase Undertaking.

5.- To amend article 6 of the By-Laws regarding the share capital to bring it into line with the result of the capital increase.

6.- To waive the free allotment rights held by the Company or the respective company of its Group at the end of the period for trading such rights as a result of the Purchase Undertaking and, thus, the New Shares corresponding to such rights.

7.- To waive free allotment rights, if appropriate, for the sole purpose of facilitating the number of New Shares being a whole number and not a fraction.

8.- To declare the capital increase to be closed and implemented.

9.- To take all steps required for the New Shares resulting from the capital increase to be included in the book-entry records of IBERCLEAR and admitted to listing on the Spanish and foreign Stock Exchanges on which the Company's shares are listed, in accordance with the procedures established at each of such Stock Exchanges.

10.- To take all such actions as are necessary or appropriate to implement and formalize the capital increase with any public or private entities or agencies, whether domestic or foreign, including acts for purposes of representation or supplementation or to cure defects or omissions that might prevent or hinder the full effectiveness of the foregoing resolutions.

The Board of Directors is expressly authorized to in turn delegate to the Executive Commission or the Executive Chairman of the Board of Directors, the powers referred in this resolution, without prejudice to the powers that may be granted to any person for specific acts of execution.

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