

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

REGARDING THE PROPOSED REDUCTION IN SHARE CAPITAL THROUGH THE CANCELLATION OF SHARES OF THE COMPANY'S OWN STOCK, EXCLUDING THE RIGHT OF CREDITORS TO OBJECT, UNDER ITEM VII ON THE AGENDA FOR THE 2016 ORDINARY GENERAL SHAREHOLDERS' MEETING

April 8, 2016

1. SUBJECT-MATTER OF THE REPORT

A proposal regarding a reduction in share capital by means of the cancellation of the Company's own shares, excluding the right of creditors to object, is submitted to the shareholders for approval at the General Shareholders' Meeting under item VII 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.

Pursuant to the provisions of Sections 286 and 318 of the Companies Act (*Ley de Sociedades de Capital*), in order for the proposed reduction in share capital to be submitted for approval at the General Shareholders' Meeting, the Board of Directors must prepare a report providing a rationale for the proposal.

2. RATIONALE FOR THE PROPOSAL

Within the framework of the shareholder compensation policy established by the Company and in order to contribute thereto, the Board of Directors believes it advisable to proceed to cancel the shares held as treasury stock, with the ensuing reduction of the share capital by an amount equal to the par value of such shares. The Company's treasury stock can in this way be reduced, encouraging the acquisition of own shares and thus contributing to increase the earnings per share of the Company, thereby benefiting its shareholders.

The effectiveness and, therefore, the implementation of the resolution to reduce the share capital submitted to the shareholders for approval at the General Shareholders' Meeting are subject to the condition precedent consisting of 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), carried out through Telefónica UK Limited.

If the proposed resolution providing for a reduction in share capital is adopted and if the condition precedent described in the preceding paragraph is fulfilled, Article 6 of the By-Laws would be amended to set forth the new amount of share capital and the new number of shares into which such amount is divided.

In this regard, it is proposed that the shareholders at the General Shareholders' Meeting authorize the Board of Directors to implement such resolution (with express powers of substitution), once the aforementioned condition precedent has been fulfilled, within a time limit of one year from the date of adoption of such resolution. Furthermore, it is proposed to delegate to the Board of Directors the power to waive the fulfillment of the condition precedent, such that the reduction in capital may be carried out even if such condition has not been fulfilled.

In addition, in order to provide for greater ease of implementation and as permitted by Section 335. c) of the Companies Act, it is deemed appropriate to exclude application of the right of creditors to object provided for in Section 334 of the Companies Act, and to allocate the amount of the par value of the cancelled shares to a reserve for repurchases of share capital, which may only be used by complying with the same requirements as those established for a reduction in share capital.

Based on these premises, it is proposed to the shareholders at the General Shareholders' Meeting to reduce the share capital by the amount of 74,627,988 euros by cancelling 74,627,988 own shares held in treasury (representing approximately 1.5% of the current share capital of the Company) and to authorize the Board of Directors to implement such resolution within a period of one year.

3. PROPOSED RESOLUTION SUBMITTED TO THE SHAREHOLDERS FOR APPROVAL AT THE ORDINARY GENERAL SHAREHOLDERS' MEETING

Set forth below is the full text of the proposal regarding this item on the agenda that is submitted to the shareholders for approval at the Ordinary General Shareholders' Meeting:

(A) To reduce the share capital of Telefónica, S.A. (the "Company") by the amount of 74,627,988 euros, by means of the cancellation of 74,627,988 shares of the Company held as treasury stock (representing, approximately, 1.5% of the Company's current share capital).

The reduction in share capital does not entail a return of contributions to the shareholders, since the Company itself is the owner of the cancelled shares, and is made with a charge to unrestricted reserves, by means of the funding of a reserve for cancelled share capital in an amount equal to the par value of the cancelled shares (i.e. in the amount of 74,627,988 euros), which may only be used in compliance with the same requirements as those established for the reduction of share capital, by application of the provisions of Section 335. c) of the Companies Act.

Accordingly, as laid down in such section, the creditors of the Company will not have the right to oppose the reduction mentioned in Section 334 of the Companies Act in connection with the approved reduction in share capital.

It is hereby stated for the record, in order to comply with the provisions of Section 411.1 of the Companies Act, that the consent of the bondholders' syndicate for the outstanding issues of debentures and bonds is not required, since the approved capital

reduction does not reduce the original ratio between the sum of capital plus reserves and the amount of the debentures pending repayment.

The effectiveness of this resolution is subject to the condition precedent of effective receipt of the proceeds from the closing of the sale to Hutchinson Whampoa Group of the Telefónica Group's operations in the United Kingdom (Telefónica UK Limited).

B) To authorize the Board of Directors, within one year from the date of adoption of this resolution, and once the condition precedent referred to in section A) above has been fulfilled, to determine the other matters that have not been expressly established in this resolution or that are a result thereof, to declare the fulfillment of the condition precedent by means of a mere statement -without the need to provide documentary evidence of such fulfillment- and to adopt the resolutions, take the actions, and execute the public or private documents that may be necessary or appropriate for the full implementation of this resolution, including, without limitation, the publication of the legally required notices, the making of the appropriate applications and the giving of the appropriate notices required to delist the cancelled shares. The delegation comprises the power for amending article 6 of the By-Laws, regarding share capital.

Also, to authorize the Board of Directors to waive the condition precedent referred to in section A) above, in which case this condition shall be deemed not established and the agreement will deploy all its effectiveness from the time of such waiver.

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 to in this resolution, without prejudice to the powers that may be granted to any person for specific acts of execution.
