



REPORT OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A. REGARDING THE PROPOSED REDUCTION OF THE SHARE CAPITAL THROUGH THE CANCELLATION OF SHARES OF TREASURY STOCK, EXCLUDING CREDITORS' RIGHT TO OBJECT, AND AMENDMENT OF THE ARTICLE OF THE BY-LAWS RELATING TO THE SHARE CAPITAL, WHICH IS TO BE SUBMITTED TO THE SHAREHOLDERS FOR APPROVAL AT THE ORDINARY GENERAL SHAREHOLDERS' MEETING (ITEM IV ON THE AGENDA).

1. PURPOSE OF THE REPORT

Item IV of the Agenda for the Ordinary General Shareholders' Meeting of Telefónica, S.A., called for April 21 and 22, 2008, includes a proposal – which is submitted to the shareholders for approval at the General Shareholders' Meeting – regarding a reduction of the share capital by an amount equal to the par value of certain shares of the Company treasury stock that are to be cancelled, and the amendment of the article of the By-Laws relating to the share capital.

In order for the Board to be able to submit the above-mentioned proposal for the reduction in share capital and the amendment of the By-Laws for approval at the General Shareholders' Meeting, it is mandatory, pursuant to the provisions of Section 164.1 and Section 144.1.a) of the applicable Spanish Companies Act [*Ley de Sociedades Anónimas*], that the Board of Directors prepare a report providing the rationale for the proposal, inasmuch as the approval of such proposal and the implementation thereof necessarily entail an amendment of Article 5 of the By-Laws regarding the amount of share capital and the number of shares into which it is divided.

2. RATIONALE FOR THE PROPOSAL

Within the framework of the shareholder compensation policy established by the Company, the Board of Directors believes it advisable to reduce the share capital



by an amount equal to the par value of certain shares held as treasury stock, through the cancellation of such shares, in order to increase earnings per share, which will thus benefit the shareholders.

If the resolution providing for the reduction of the share capital contemplated in this report is adopted, Article 5 of the By-Laws of the Company would be amended to set forth the new amount of the share capital and the new number of outstanding shares into which such amount is divided (after deducting the shares of treasury stock acquired by the Company and whose cancellation is proposed).

In order to expedite the implementation of this resolution, it is further proposed that the shareholders at the General Shareholders' Meeting authorize the Board of Directors to implement such resolution (with the power to delegate, in turn, to the Executive Commission, the Executive Chairman of the Board of Directors, the Chief Operating Officer or to any other person expressly authorized by the Board of Directors for such purpose) within a time limit of one year from the date of adoption of such resolution, without needing to first consult with the shareholders at a General Shareholders' Meeting

In addition, it is deemed appropriate, in order to provide for greater ease of implementation and as permitted by Section 167.3 of the Consolidated Text of the Spanish Companies Act, not to apply the right of creditors to object provided for in Section 166 of such Consolidated Text, 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 complying with the same requirements as those established for a reduction in the 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 68,500,000 euros by cancelling 68,500,000 shares of the Company's treasury stock (representing approximately 1.435% 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

The resolutions that the Board of Directors proposes to the shareholders for approval at the Ordinary General Shareholders' Meeting in connection with this matter are the following:

- A) *To reduce the share capital of the Company by the amount of 68,500,000 euros, by means of the cancellation of 68,500,000 shares of the Company's treasury stock, which were previously acquired in reliance on the authorization previously granted by the shareholders at the General Shareholders' Meeting, within the limits established in Sections 75 et. seq. and in additional provision 1, paragraph 2, of the Spanish Companies Act. Accordingly, Article 5 of the By-Laws regarding the amount of the share capital is hereby amended and shall henceforth read as follows:*

"Article 5.- Share capital

- 1. The share capital is 4,704,996,485 euros, divided into 4,704,996,485 common shares of a single series, with a par value of one euro each, fully paid in.*
- 2. The shareholders at the General Shareholders' Meeting may, complying with the requirements and within the limits legally established for such purpose, delegate to the Board of Directors the power to increase the share capital."*

The reduction of the share capital is made with a charge to discretionary reserves, cancelling the corresponding amount of the restricted reserve mentioned in Section 79.3 of the Spanish Companies Act, and funding a reserve due to capital reduction in the amount of 68,500,000 euros (an amount equal to the par value of the cancelled shares) which may only be used complying with the same requirements as those established for the reduction of the share capital, pursuant to the provisions of item 3 of Section 167 of the Spanish Companies Act. Accordingly, as provided therein, the creditors of the Company shall not have the right to object mentioned in Section 166 of the Spanish Companies Act in connection with the capital reduction resolved to be made.



The reduction does not involve a return of contributions, since the Company itself is the owner of the cancelled shares. The purpose of the reduction will thus be to cancel the shares of treasury stock.

It is stated for the record, in order to comply with the provisions of Section 289.1 of the Spanish Companies Act, that the consent of the Bondholders' Syndicates [Sindicatos de Obligacionistas] for the outstanding issues of debentures and bonds is not required since the capital reduction resolved to be made does not reduce the original ratio between the sum of capital plus reserves and the amount of the debentures pending repayment.

- B) To authorize the Board of Directors, within one year from the date of adoption of this resolution, to determine the other matters that have not been expressly established in this resolution or that are a result hereof, 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; such powers may be delegated by the Board of Directors to the Executive Commission, the Executive Chairman of the Board of Directors, the Chief Operating Officer or to any other person expressly authorized by the Board of Directors for such purpose.*

Madrid, February 27, 2008