

Letter from the Chairman



Dear Shareholder,

Once again another year, the presentation of the 2006 fiscal year annual report gives me the unique opportunity to contribute a brief assessment of the results of our management and some reflections on Telefónica's perspectives.

I should express my optimism and satisfaction because 2006 was a year in which historical records were made at our company, thus marking a before and an after; and this, in an environment of the Information and Communication Technologies sector which is highly favorable for Telefónica, due to the opportunities that it is already offering and the solid starting position that our company enjoys.

Likewise, I would like to share with you the enthusiasm with which the Telefónica team of professionals is working on the transformation that is necessary so that our company guides the future of the sector, by anticipating the trends towards the new digital environment.

Our results, the best in the sector

In 2006, no other operator in the world can demonstrate better results than ours. Said results can be summarized in four basic ideas: more growth, more profitability, greater scale and greater diversity.

In the last year, there has been a quantitative and qualitative drive to continue offering the best combination of growth and return to the sector shareholder. This binomial is supported on some differential management results, which comfortably exceed the commitments made, and once again endorse our recognized credibility.

Organic growth constitutes one of our priority objectives because, among other things, it allows us to demonstrate that we are capable of making our markets and business grow

where we are, taking full advantage of the technological and demand cycles. In 2006 our revenue reached 52,901 million euros, with a 41.5% growth with respect to 2005, which in organic terms represents an inter annual increase of 7.8% . At the same time, the advance made in operating efficiency has made it possible for the Operating Income Before Depreciation and Amortization (OIBDA) to reach a total growth of 27% and an organic level of 6.4%.

On the other hand, I must mention that, for the first time, Telefónica has obtained the largest net profit in absolute value in the European telecommunications sector, in the amount of 6,233 million euros, 40.2% higher than in 2005. The free cash flow generation has grown 12.3% with respect to 2005, totaling 11,122 million euros.

This spectacular growth of the economic-financial variables is the result of the sustained increase in the principle operating variables, and in particular, the expansion of our customer base favored not only by the greater commercial activity developed during the last fiscal year, but also by the effect of the new incorporation of business in Europe and Latin America. All of this enables us to put the total number of accesses at higher than 203 million as of December 2006, 32% higher than that which was registered in December 2005. At the end of 2006, Telefónica had more than 145 mobile accesses, more than 42 million land lines, more than 8 million fixed broadband systems, and already more than a million cable television customers. In net terms, the company's customer base grew by almost 50 million accesses.

A company of greater scale and diversity

In a sector as competitive as ours, the ability to grow is the real challenge, but it is still more important to achieve diverse growth as far as markets and business. Telefónica is the company with the most international profile of all of the large integrated

operators, with a presence in 23 countries. Today, 38% of our revenue comes from Spain, 26% from the rest of Europe and 35% from Latin America.

The major lines of our management reflect this growth and diversification effort based on specific and outstanding facts, such as our consolidation as the first broadband operator in Latin America, and the acceleration of our mobile telephone park in this region, with an annual customer growth above 18%, which exceeds 83 million; the development of the cable television market; and in Europe, becoming the leader in the United Kingdom as far as the number of mobile customers, the launch of ADSL in Germany and, in Spain, maintaining our competitive position in mobile telephone and the reactivation of the ADSL demand driven by a convergent offer. Telefónica's successful development in 2006 in highly competitive markets demonstrates the solidity of our leadership.

Moreover, in 2006 we have moved considerably forward to our integration objectives, with the achievement of synergies valued at more than a billion euros. Around 80% of the previous amount corresponds to the synergies obtained in Latin America, as a result of the regionalization program begun in 2004, and the remaining 20%, comes almost entirely from O2, in its first year with Telefónica.

Our trust in the growth opportunities of the sector brought us to invest 8,003 million euros last year, 55.3% higher in volume than in 2005, clearly oriented at the growth businesses: broadband and mobility.

The best combination of growth and profitability in the sector. The value of these results acquires greater relevancy when compared with the performance of the sector in general. In 2006, Telefónica not only grew more than anyone, but it has also become a management benchmark. So, in 2006 the good results obtained have translated into a significant increase in value for our shareholders in such a way that, in the last year, the earnings per company share grew 43%, to 1.3 euros per share. This means that we are able to move remarkably forward with the commitment we made in 2005 to double the earnings per share in order to reach 1.82 euros per share in 2009.

In line with the previous objective, in 2006 there has been an even more attractive shareholder return policy, consisting of an interim dividend of 0.3 euros per share charged to the 2006 results, and 0.3 euros to be paid in the first semester of 2007, and a share repurchase program for their cancellation to be completed before the end of 2007 at a value of 2.7 billion euros.

Therefore, in 2006 total profitability for the Telefónica shareholder reached 31.16% versus the telecommunications sector average of 22%, represented by the Dow Jones Telco Index.

A world-wide leader

The successful development of our management herein described allows us to state that as of today, it is by the best integrated operator in the world.

From a financial standpoint, Telefónica is a fully privatized company, with more than 1.7 million direct shareholders, and it is included in the Dow Jones Global 50 Titans Index, which includes the 50 most important companies in the world. In aggregate value rankings, Telefónica closed 2006 as the third global telecommunications operator, and occupying the fourth position between the major Telecommunications, Media, Information Technologies and Internet companies.

Even though the global relative position reached is significant, our final objective is to be, not only bigger, but better. For this reason, Telefónica is and intends to continue being an industrial leader and sector benchmark, by taking maximum advantage of the opportunities created.

A new vision: the spirit of progress

Our activity is right in the heart of the sector where the new economic and social model for the XXI century is being developed. Telecommunications are in convergence with the companies that provide technology, content or information services to build the new digital environment; and this, is precisely what sustains our capacity to massively offer mobility and broadband.

We are in a renewed business, in which innovation in net based businesses constitute one of the principal growth engines. Our

role is to facilitate access to all of this innovation, offering customers personalized treatment, simplicity and reliability.

In this sense, in 2006 our vision was defined:

"We want to enhance people's lives and the performance of businesses as well as the progress of the communities where we operate, by delivering innovative services based on information and communication technologies".

Integrated management with a regional focus

At Telefónica, we understood long ago that to face the new dynamics of the business, a profound internal transformation of our culture and organization was necessary.

We have gone forward with integration, the required path to growth. With the union of fixed and mobile services, we have become a unique company, capable of responding to an also unique customer, who expects integral answers from us. We have directed our internal reorganization towards this, from a work model that empowers us and removes internal barriers in order to encourage the creation of value and the exploration of new growth opportunities and increased efficiency.

Generally speaking, it is a regional model with an integrated vision of the business, the processes and technology, which focuses on the customer. Telefónica shall renew its effort to strengthen its distribution network, brand and levels of customer service. We would like to offer the best customer experience in our markets. Furthermore, it will expand the product offering by supporting itself on innovation as demonstrated by services such as Imagenio or the new Telefónica R+D center in Barcelona, a benchmark in its field.

Our commitment, renewed

Telefónica faces 2007 at an excellent moment and with a privileged position in the sector. This, together with the development of the markets in which we operate allows us to set ambitious objectives, in accordance with our current position as leader and which we hope to maintain in the near future, given our forecasts for organic growth rates in the principal economic-financial variables, which are higher than those achieved in 2006.

At Telefónica, we work every day to meet our commitments, focusing on the customer's needs. And also to obtain recognition from the other stakeholder, offering our human capital stimulation and opportunities, ensuring our shareholders the best combination of profitability and growth, and acting as an engine for development in our society on a global as well as on a local level. This is the center of our corporate responsibility.

I believe that if we can boast about anything, it would be that we are a company that delivers. This is what we have always worked for at Telefónica. Therefore we will continue working for this reason.

On behalf of the Telefónica Board of Directors and our entire team, I would like to again, this year, thank you.



César Alierta

Chairman and CEO, Telefónica, S.A.