

REPORT OF THE DIRECTORS OF
TELEFÓNICA, S.A.
REGARDING THE PROPOSED MERGER OF
TELEFÓNICA, S.A. AND TERRA NETWORKS, S.A.

Madrid, April 13, 2005

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1 INTRODUCTION

At meetings held on February 23, 2005, the Boards of Directors of TELEFÓNICA, S.A. (hereinafter, “Telefónica”) and TERRA NETWORKS, S.A. (hereinafter, “Terra”), approved the Merger Plan of Telefónica and Terra, which has been prepared and signed by the directors of each company (with the abstentions and absences indicated in the Merger Plan itself), pursuant to the provisions of Section 234 *et. seq.* of the Spanish Corporations Act, and has been deposited with the Commercial Registries of Madrid and Barcelona on March 2, 2005 and March 3, 2005, respectively.

In compliance with the provisions of Section 237 of the Corporations Act, the directors of Telefónica prepare and approve, upon the terms set forth below, the detailed report of the directors regarding the Merger Plan (hereinafter, the “Report”), which, in accordance with the provisions of such Section, provides a detailed explanation and rationale of the legal and financial aspects of such Plan.

The Report has been divided into three parts. The first part contains the strategic reasons for the transaction (see Section 2 below). The second part contains a review of the legal aspects of the transaction; basically the procedure for the merger (see Section 3 below). The third and final part covers financial aspects, paying particular attention to the calculation of the exchange ratio and particular valuation difficulties (see Section 4 below).

2 STRATEGIC REASONS FOR THE TRANSACTION

2.1 Recent Changes in the Telephony and Internet Businesses.

Like many other Internet companies, Terra has evolved within the context of a strategic model based on a separation between the Telephony business and the Internet service provider (ISP) business. Notwithstanding other prior circumstances, it has recently (more specifically, during the last twelve months) become manifestly obvious, in a clear and distinct manner, that an irreversible crisis is affecting the traditional model of the pure Internet services provider, and that, in parallel, a new model based on the operational integration of the Telephony and Internet businesses has appeared in the telecommunications market.

The root of these changes lies in the emergence, development, and blossoming of broadband technology applied to Internet access, which has led to the blurring – especially in the last year, during which its penetration and growth have accelerated exponentially – of the traditional line of separation between the above-mentioned Telephony and Internet businesses.

In fact, the following phenomena have recently become evident:

- (a) The explosion of broadband technology has fostered a new dynamic in the supply market, with which synchronization can only be obtained based on a complete interweaving of network functions and the provision of services or, put another way, the integrated managed of the connectivity, access and service layers. In this scenario, Internet access providers need to become communications operations in order to compete in the market. For such reason, they must either invest in network infrastructure (which would compromise their viability, given the time required for the maturation of the investment and the high capital cost of addressing it) or else become fully integrated with the network operators, who already have the necessary infrastructure and technical and human resources.
- (b) Moreover, on the demand side, today's customer is not content with Internet access alone. Users' preferences are becoming increasingly oriented towards integrated offerings (voice, images, Internet access, etc.), for which it is necessary to hold a position as operators who can offer all of the services that the market demands, and thereby compete with other entities that are able to provide all of these services to the end customer.
- (c) In addition, the technological evolution of the services – the rapid increase in connection speeds, the technical complexity needed to provide high-quality audiovisual content, the required interoperability of the various elements of the offering (e-mail, messaging, voice mail, content consumption, etc.) – demands increasingly greater capabilities, scale, and resources in order to stay competitive in a market that is growing in size but whose offerings are constantly changing.

All of this explains the activities of competing groups aimed at making bandwidth the center or core of their strategy, and, consequently, at reintegrating the Telephony and Internet businesses. The most recent examples are the mergers of France Telecom and its Internet subsidiary Wanadoo, and of Deutsche Telekom and T-Online. The proposed merger of Telefónica and Terra contained in the Merger Plan obeys the same logic.

2.2 Reasons for and Objectives of the Merger.

As explained in the Merger Plan, the Boards of Directors of Telefónica and Terra believe that it is absolutely necessary to take the path of integrating their Telephony and Internet businesses in order to have any guarantee of success in dealing with the challenges posed by the development of the industry, technological change and customers' new needs. It is thus intended to create a

customer-oriented business segment able to offer customers integrated solutions in the telecommunications market that consolidates access, voice and video over ADSL.

The Boards of Directors of Telefónica and Terra see the merger as a strategic imperative of this highest order, and as an outstanding opportunity for mutual advantage. The shareholders of both Terra and Telefónica will benefit from it.

Although the merger will depend in part on the ability of the directors of the acquiring company to obtain the expected business opportunities and synergies, it can be affirmed that the integration of the businesses of Telefónica and Terra resulting from the merger will make it possible:

- (a) To strengthen the competitive positioning of Terra and Telefónica in the above-referenced markets, which will translate into an increase in customers and an expanded share of the market. This is the case because of (i) the greater capacity of the unified firm to respond to the integrated offerings of competitors; (ii) the improved position for creating new services that optimize the use of the Telefónica's network capabilities (which is critical for services with a need for greater bandwidth, greater security, etc.) and that integrate them fully into the service provided to the end customer; (iii) the strengthening of the offering made to the market, combining the positive attributes of the Telefónica and Terra brand names, which in turn will make it possible to strengthen the leadership of the combined company; (iv) the greater scale of operations, which will make it possible to undertake innovative projects that would now be more difficult to undertake; and (v) the greater leveraging of the commercial resources of the two companies, e.g., proprietary channels, third-party channels, joint advertising, etc. In particular, the integration of Terra and Telefónica will allow for improved positioning of the acquiring company as a leader in the Internet portal market, given that it will be able to extend the use of the portal to Telefónica's customer base, will facilitate the establishment of alliances with leading content providers, and will allow for the provision of highly integrated network services.
- (b) To make better use of current customer bases, through (i) the ability to define and implement a global strategy based on customer segments, beyond the current product-based vision; (ii) increased penetration; (iii) an increase in the loyalty of existing customers, by reducing churn rates through the packaged sale of services; (iv) increased cross-sales of services; and (v) the resulting increase in per-customer earnings.
- (c) To minimize costs and optimize investments, through (i) the integrated management of networks and platforms (provision of services, billing, CRM/customer service, etc.), with the additional benefit of greater quality for the end customer, through end-to-end management; (ii) the rationalization of investments that are particularly relevant, given the growing needs for an ability to manage new services that are broadband intensive; (iii) the total elimination of duplication in the development of new

services; (iv) the streamlining of corporate structures, eliminating duplications and thereby improving management and increasing efficiency; and (v) an increased ability to achieve synergies in the purchases of contents and services. In particular, the integration of Terra and Telefónica will allow for strengthening access to the Internet business, given that, by participating in the Telephony operating business, there will be a reduction in financial risk as well as the risk of acquisition of technical and marketing capabilities associated with the open loop leasing system, and a significantly higher value will be captured as compared to the re-sale of access on a wholesale basis.

- (d) To facilitate the exploitation of the opportunities for growth in new markets, using broadband Internet access as an offering that is more attractive and competitive than fixed-base telecommunications (a factor that is particularly relevant in terms of the expansion of the Brazilian market).
- (e) To develop a single strategy and to promote and create businesses in the e-commerce field and general gateways for access to information and advertising, as a result of the major growth of broadband Internet access in all markets.

3 LEGAL ASPECTS OF THE MERGER PLAN

3.1 Legal Structure of the Merger Transaction

The legal structure selected for the integration of the businesses of Telefónica and Terra is the merger by absorption of Terra (the acquired company) by Telefónica (the acquiring company), with the dissolution without liquidation of Terra and the *en bloc* transfer of all of its assets and liabilities to Telefónica which will acquire, by universal succession, all of the rights and obligations of Terra.

Such *en bloc* transfer entails the acquisition by Telefónica in a single act of all of the elements comprising the assets and liabilities of Terra. Therefore, there will be a transfer all of Terra's rights and obligations and, in general, all of its legal relationships, which shall continue in force even though the holder thereof will change, except in those events in which a change in the holder of the legal relationship entails the termination thereof.

At the same time, the merger entails the shareholders of Terra (other than Telefónica) becoming shareholders of Telefónica through the allocation to them of shares representing a portion of the capital stock of Telefónica in proportion to their respective interest in the capital stock of Terra pursuant to the terms set forth in the Plan.

The basic commercial regulation of merger transactions is contained in Sections 233 *et. seq.* of the Corporations Act and Sections 226 to 234 of the Regulations of the Commercial Registry.

3.2 Analysis of Legal Aspects of the Merger Plan

The absorption Merger Plan has been prepared following the rules of Sections 234 and 235 of the Corporations Act.

In addition to the minimum disclosures required by the Corporations Act, the Merger Plan includes and expands upon other aspects, the inclusion of which has been deemed appropriate by the directors of Telefónica and Terra.

3.2.1. Identification of the Entities Participating in the Merger

Pursuant to the provisions of Section 235(a) of the Corporations Act, Section 2 of the Plan identifies the companies participating in the merger, with each of their corporate names, their respective domiciles, and information identifying their registration with the Commercial Registry and their Tax ID Number.

The choice of Telefónica as the acquiring company is due not only to its larger size and market capitalization or the fact that Terra is a 75%-owned subsidiary of Telefónica, but also to the strategic reason for the transaction, which is to integrate the Telephony business with the Internet business.

3.2.2. Merger Exchange Ratio

Pursuant to Section 235(b) of the Corporations Act, Section 3 of the Plan contains the merger exchange ratio. The exchange ratio has been determined on the basis of the actual value of the assets of the entities participating in the merger, and is two (2) shares of Telefónica, each having a par value of one Euro, for every nine (9) shares of Terra, each having a par value of two Euros. The shares of Telefónica that are delivered in exchange shall have the same characteristics and rights as Telefónica's other outstanding shares. No additional cash compensation is planned.

Section 4 of this report contains a financial analysis of the merger exchange ratio.

3.2.3. Merger Balance Sheets

Section 4 of the Merger Plan specifies that for the purposes set forth in Article 239.1 of the Corporations Act, the balance sheets for the merger shall be deemed to be the balance sheets of TELEFÓNICA and TERRA as of December 31, 2004, which have been verified by their respective auditors and which will be submitted for the approval of the shareholders at their respective General Shareholders' Meetings prior to the adoption of the merger resolution.

Although the reference to the merger balance sheets is not explicitly required by Section 235 of the Corporations Act, it has been deemed that it is supplemental to the information that has been deemed appropriate to mention in the Plan.

3.2.4. Procedure for the Exchange of Shares

Section 5 of the Plan complies with the requirement set forth in Section 235(c) of the Corporations Act that mention be made of the procedure for exchanging the shares of companies that are to be cancelled.

Section 6 of the Plan provides that, if necessary, Telefónica may increase its share capital by the amount necessary and issue the exact number of shares needed to make the exchange for Terra shares in accordance with the exchange ratio established in the Plan, in application of the provisions of Section 249 of the Corporations Act. This section also provides that the increase in capital may be reduced by the delivery to Terra shareholders of old shares held in Telefónica's treasury. In this sense, the Telefónica's Board of Directors has ultimately chosen to satisfy the entire exchange by means of the delivery of old Telefónica shares that are in the company's treasury, and will therefore propose at the General Shareholders' Meeting that Telefónica fully satisfy the exchange by means of the delivery of Telefónica's own shares. Therefore, there will be no proposal at the General Shareholders' Meeting for Telefónica to increase its capital in order to satisfy the exchange of shares arising from the merger.

Therefore, once the merger has been approved by the shareholders acting at the General Shareholders' Meetings of Telefónica and Terra and the merger has been recorded with the Commercial Registry, Telefónica will deliver to Terra shareholders the shares that Telefónica holds in treasury, in accordance with the exchange ratio described above. As referred to above, such exchange shall take place upon the recording of the merger instrument with the Commercial Registry of Madrid, and will be effected by the relevant financial entity and during the period indicated in the announcements to be published in the Official Gazette (*Boletín Oficial*) of the Commercial Registry and in two widely-circulated newspapers in Madrid and Barcelona.

Pursuant to the prohibition established in Section 249 of the Corporations Act, there will be no exchange of Terra shares that it holds in treasury or that are held by Telefónica or by any person acting in their own name but on behalf of Terra or Telefónica. Taking into account that Terra does not expect to reduce its direct holdings of treasury shares, currently 7,000,000 shares of Terra's own stock, and that Telefónica, in order to allow for the total number of Terra shares that are to participate in the exchange to be a multiple of the exchange ratio, plans to acquire seven additional Terra shares prior to the call of Terra's General Shareholders' Meeting, the exchange of Terra shares will require that Telefónica deliver a maximum of 29,274,686 of its own shares, which will be frozen as of the date of adoption of the merger resolution. All of the shares of Terra will be cancelled as a result of the merger.

The exchange of Terra shares for Telefónica shares shall be made through the entities participating in the Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A. (*Securities Registration, Clearing, and Liquidation Systems Management Company, Inc.*) (Iberclear) that are depositories thereof.

Pursuant to the provisions of paragraph (d) of Section 5 of the Merger Plan, those shareholders of Terra who hold shares representing a fraction of the number of Terra shares designated as the exchange ratio may purchase or transfer shares in order to exchange them in accordance with such exchange ratio. Each shareholder must individually make timely decisions for such purpose to either purchase or sell Terra shares in the market in order to reach the number of Terra shares that are a multiple of nine.

Without prejudice to the foregoing, and pursuant to the provisions of Section 5 of the Plan, the Boards of Directors of Telefónica and Terra, after due conversations, will submit for approval at their respective General Shareholder Meetings a mechanism designed to facilitate the exchange with those Terra shareholders who are holders of a number of shares that is not a multiple of nine (9). The basic terms and conditions of such mechanism are as follows:

- (a) Taking into account that the exchange ratio for the merger is equivalent, in singular terms, to the delivery of one Telefónica share for every 4.5 shares of Terra, at the close of the last session for trading in Terra stock on the Spanish stock exchanges (hereinafter, the “Reference Date”), each shareholder of Terra who, by application of such singular exchange ratio of one Telefónica share for each 4.5 Terra shares, is entitled to receive a whole number of Telefónica shares, and who has an odd-lot residue of less than 4.5 Terra shares, may transfer such residue to the odd-lot agent appointed for such purpose (hereinafter, the “Odd-Lot Agent”), all with the understanding that for the calculation of the odd-lot corresponding to each shareholder position, all of the Terra shares forming such position will be calculated.

Likewise, a Terra shareholder who is the owner of less than 4.5 Terra shares will be able to transfer such shares to the Odd-Lot Agent. It shall be deemed that each shareholder of Terra accepts the odd-lot acquisition system, without having to remit instructions to the relevant entity participating in Iberclear, which shall inform the shareholder of the results of the transaction once it has been concluded.

- (b) Given the agreed exchange ratio, and regardless of the number of shares comprising each shareholder’s position, the only circumstances under which the acquisition of odd-lots may take place are the following:

Number of Terra shares	Corresponding Telefónica shares by virtue of the exchange	Odd-lot shares of Terra subject to the odd-lot acquisition system
1	0	1
2	0	2
3	0	3
4	0	4
5	1	0.5

6	1	1.5
7	1	2.5
8	1	3.5
9	2	0

Therefore, in any shareholder position, an odd-lot will range between a minimum of 0.5 Terra shares and a maximum of 4 Terra shares.

- (c) The acquisition price of the odd-lots will be determined based on the arithmetic mean of the average weighted prices of Terra shares on the Automated Quotation System (*Sistema de Interconexión Bursátil*) (continuous market) for the last three trading sessions for Terra stock on the Spanish stock exchanges. If the odd-lot in question is other than one share, its acquisition price shall be calculated based on the same criterion set forth herein, but in a proportion corresponding to the specific amount of the odd-lot.
- (d) The entity appointed as the Odd-Lot Agent, acting on its own behalf, will acquire the odd-lot shares remaining in the positions existing at the close of the trading session corresponding to the Reference Date. The shares or fractions of shares of Terra acquired by the Odd-Lot Agent shall be exchanged for the number of Telefónica shares set forth in the Merger Plan.

3.2.5. Date from which the Shares Delivered in Exchange will Carry the Right to Participate in Corporate Earnings and Date of the Merger for Accounting Purposes

In compliance with the provisions of the second sub-section of Section 235(c) of the Corporations Act, Section 7 of the Plan sets January 1, 2005 as the date from which the shares delivered by Telefónica in exchange will give their holders the right to participate in Telefónica’s corporate earnings under the same terms as the other shares currently in circulation. After the registration of the merger instrument with the Commercial Registry, the holders of Telefónica shares delivered in exchange for Terra shares will participate in distributions paid by Telefónica with rights equal to the holders of all other Telefónica shares. This means that the shares delivered in exchange will participate in the corporate earnings of Telefónica for the fiscal year beginning January 1, 2005.

In addition, and pursuant to the provisions of paragraph d) of Section 235 of the Corporations Act, Section 9 of the Plan sets January 1 2005 as the date from which the Terra transactions are deemed for accounting purposes to have taken place on behalf of Telefónica.

3.2.6. Special Rights and Benefits Extended to Directors and Independent Experts

Pursuant to the provisions of Section 235(e) of the Corporations Act, Section 10 of the Plan provides that the shares to be delivered by Telefónica shall not give special rights to the holders thereof.

Likewise, such section states that there are no special Terra shares or owners of special rights in Telefónica other than the shares, except for those belonging to the beneficiaries (employees, officers and directors of companies in the Terra group) of stock option plans described in the last paragraph of Section 5 of the Plan. Following the registration of the merger with the Commercial Registry, Telefónica will succeed Terra as the entity bound by such plans, which will be amended in accordance with the exchange ratio established in the Plan. Thus, Terra stock option rights shall be automatically converted into Telefónica stock option rights, upon the terms resulting from the exchange ratio established in the Merger Plan. All references to Terra or, as applicable to Lycos Inc. or to Lycos Virginia in such option plans shall be deemed to be made to Telefónica starting on the date of registration of the merger.

In addition, as set forth in Section 5 of the Plan, in order not to prejudice the interests of the beneficiaries of such plans, Telefónica will establish, if necessary, mechanisms to ensure that due attention will be given to the commitments assumed by Terra in connection with such stock option plans. In this regard, no specific mechanism is expected to be established in order to meet the commitments assumed by Terra with respect to the stock option plans outside of the provisions above, given that there is no obligation in such plans to establish specific mechanisms, nor is it considered necessary under the current market situation.

For its part, Section 11 of the Merger Plan, in compliance with the provisions of Section 235(f) of the Corporations Act, provides that no benefits in Telefónica of any type shall be extended to the directors of any of the entities participating in the merger, or to KPMG Auditores S.L., the independent expert appointed by the Commercial Registry to prepare the mandatory report regarding the Plan.

3.2.7. Other Mentions of the Merger Plan

The Merger Plan contemplates other matters, the mention of which, like some of the content already commented on, is not expressly required by applicable legislation. As in the cases already analyzed, these are matters whose importance has caused the directors of the companies participating in the merger to believe that the inclusion thereof would be appropriate. Such matters are summarized below:

- (a) Dividends.- Section 8 of the Plan describes the distributions and dividend payments that Telefónica and Terra expect to make and that have been taken into consideration for the preparation of the Merger Plan and the determination of the exchange ratio.

Telefónica plans to make the following distributions:

- (i) Payment of a dividend based on the earnings for the fiscal year ending December 31, 2004, which will be paid on May 13, 2005. This dividend was announced by the Board of Directors at its meeting held on January 26, 2005. On February 23, 2005, the Board of Directors resolved to set the amount of such dividend at 0.23 Euros per share. As indicated in Section 7 of the Plan, Terra shareholders who become Telefónica shareholders as a result of the merger will not benefit from such dividend. This has therefore been taken into account for the formulation of the exchange ratio.
- (ii) A portion of the reserve for additional paid-in capital will be distributed by means of the delivery of Telefónica's treasury stock, at the ratio of one share of treasury stock for each twenty-five shares owned by the shareholder, charged against the reserve for additional paid-in capital. The proposal for such distribution plan was approved by the Board of Directors at its meeting held on November 24, 2004. The effectiveness of the distribution is subject to the corresponding approval by the shareholders at the Ordinary General Shareholders' Meeting of Telefónica. The payment is expected to be made during the days following the meeting and, in any event, before the merger of Telefónica and Terra is recorded with the Commercial Registry. Terra shareholders who become Telefónica shareholders as a result of the merger will not benefit from such distribution. This has therefore been taken into account for the formulation of the exchange ratio
- (iii) The payment of a dividend with a charge against the reserve for additional paid-in capital, which should be paid on November 11, 2005. This proposal for this dividend was announced by the Board of Directors at its meeting held on November 24, 2004. The effectiveness of the distribution is subject to the corresponding approval by shareholders at the Ordinary General Shareholders' Meeting of Telefónica. The exact amount of such dividend is expected to be 0.27 Euros per share. Unlike the provisions for dividends described above in subsections (i) and (ii), this dividend will be received by both the Telefónica shareholders and the Terra shareholders who become Telefónica shareholders as a result of the merger. This has therefore not been taken into account for the formulation of the exchange ratio

Terra expects to pay a dividend in the amount of 0.60 Euros per share, with a charge against the "Reserve for Additional Paid-In Capital" account. The proposal for such distribution was approved by the Board of Directors at its meeting held on February 23, 2005. The effectiveness of the distribution is subject to the corresponding approval by the shareholders at the Ordinary General Shareholders' Meeting of Terra. Payment is expected to be made during the days following the meeting and, in any event, before the merger

of Telefónica and Terra is recorded with the Commercial Registry. Only the shareholders of Terra will benefit from such distribution. This has therefore been taken into account for the formulation of the exchange ratio

- (b) Tax Regulations.- Section 12 of the Plan provides that the merger transaction will be governed by the special tax regime set forth in Chapter VIII of Title VII of the Restated Text of the Corporate Income Tax Law, for which purpose the merger transaction will be reported to the Government Inspection Office of the Ministry of Finance in accordance with the terms of Section 96 of such Consolidated Text and related provisions.
- (c) Bylaw/Charter Amendments.- Section 13 of the Plan provides that in the context of the merger transaction, the Boards of Directors of Telefónica and Terra may submit for the approval of the shareholders at their respective General Shareholders' Meeting the bylaw/charter amendments of Telefónica that pertain to the Plan itself, and such others that are mutually decided upon.

In this regard, it is expressly stated that the Boards of Directors of Telefónica and Terra have not agreed to submit for approval at their respective General Shareholders' Meetings any amendment to Telefónica's charter/bylaws with respect to the merger. It is noted, however, that Telefónica plans to reduce its capital stock in order to retire shares pursuant to the TIES Program.

- (d) Appointment of Independent Expert.- Section 14 of the Plan provides that the directors of Telefónica and Terra have asked the Commercial Registry of Madrid to appoint a single independent expert for the preparation of the report on the Merger Plan referred to in Section 236 of the Corporations Act.

The Commercial Registry of Madrid appointed KPMG Auditores, S.L. as independent expert, and such expert accepted the appointment on March 3, 2005.

- (e) Administrative Authorizations.- Finally, Section 15 of the Project refers to the notices, authorizations and registrations upon which the effectiveness of the merger between Telefónica and Terra is conditioned.

It is not expected that authorizations or registrations in Spain or the other jurisdictions in which both companies are present need be effected or obtained in order for the merger to become effective, other than with respect to the registration of the "Form F-4" that has been submitted to the United States Securities and Exchange Commission. The National Securities Market Commission has been notified of the submission of this form, as well as the contents thereof, by means of a Communication of Relevant Facts.

3.3. Implementation of the Legal Process for Merger by Absorption

Below is a brief reference to the principle milestones marking the implementation of the merger process, with special mention of the relevant rules of the Corporations Act.

3.3.1. Approval and Signing of the Merger Plan

In order to carry out the merger, Section 234.1 of the Corporations Act requires the directors of the companies participating in the merger to prepare a merger plan.

The Merger Plan, which contains the basis and rules for implementing the merger transaction, was approved and signed by the directors of Telefónica and Terra at meetings held on February 23, 2005 (with the abstentions and absences indicated in the Merger Plan itself). Two signed specimens of such Merger Plan have been deposited with the Commercial Registries of Madrid and Barcelona, respectively, prior to the call of the General Shareholders' Meetings of Telefónica and Terra, the fact of the deposit in Madrid having been published in the Official Gazette of the Commercial Registry on March 14, 2005 and the fact of the deposit in Barcelona having been published in the Official Gazette of the Commercial Registry on March 29, 2005.

3.3.2. Report of the Independent Expert Regarding the Merger Plan

In addition, pursuant to the provisions of Section 236.2 of the Corporations Act, on February 24, 2005, the Commercial Registry of Madrid was jointly requested by Telefónica and Terra to appoint a single independent expert to prepare a single report regarding the Merger Plan and regarding the assets to be received by Telefónica from Terra as a result of the merger.

On March 3, 2005, the Commercial Registry of Madrid appointed KPMG Auditores, S.L. as the independent expert, and such expert accepted the appointment on the same date. On March 29, 2005, KPMG Auditores, S.L., asked the Commercial Registry of Madrid for an extension of the period for issuing its report, with an extension through May 3, 2005 being granted on March 30, 2005. Within such period, the expert has issued the corresponding report regarding the Merger Plan, in which it stated the following conclusion:

In accordance with the work performed, for the sole purpose of complying with the provisions of Article 236 of the Restated Text of the Corporations Act, and taking into account the stated in foregoing paragraph 4, we believe that:

- The valuation methodologies used to determine the actual value of the Companies are proper within the context and circumstances of

the transaction in question, and the exchange rate provided in the Merger Plan is justified.

- The assets reported by the acquired company are at least equal to the acquired company's capital increase as set forth in the Merger Plan.

3.3.3. Report of the Directors Regarding the Merger Plan

In accordance with Section 237 of the Corporations Act, the directors of Telefónica have approved this report on the date hereof, which report gives a rational for and detailed explanation of the legal and financial aspects of the Merger Plan, with special reference to the exchange ratio.

Likewise, in accordance with Section 237 of the Corporations Act, on April 12, 2005, the directors of Terra approved a report that contains their respective rationale for and explanation of the Merger Plan, and that is divided into two sections, one relating to "legal aspects of the merger" and another relating to "financial aspects."

3.3.4. Notice of the General Shareholders' Meetings

On April 20, 2005, the Boards of Directors of Telefónica and Terra are expected to approve the giving of notice of the respective General Shareholders' Meetings to be held in Madrid and Barcelona, respectively. It is expected that the General Shareholders' Meeting of Telefónica will be called for May 24, 2005, on first call, and on May 25, 2005, on second call, and the General Shareholders' Meeting will be called for May 31, 2005, on the first and only call.

Among the items comprising the Agenda of such General Meetings will be debate on and approval, if granted, of the merger between Telefónica and Terra, upon the terms set forth in the Merger Plan.

Pursuant to the provisions of Section 238.1 of the Corporations Act, upon publication of the notice of the respective General Meetings, the documents listed in Section 238.1 and set forth below will be made available to the shareholders, debtholders, and owners of special rights other than shares, as well as labor representatives, for examination thereof at the respective corporate headquarters of Telefónica and Terra.

In addition, from the date of publication of the notices of the respective General Meetings, the shareholders, debtholders and holders of special rights other than shares of Telefónica and Terra may request the free delivery or shipment of such documents, pursuant to the provisions of Section 240.2 of the Corporations Act.

3.3.5. Merger Resolutions and Publication of Announcements

Section 240 of the Corporations Act provides that the merger resolution must be adopted by the shareholders at the General Shareholders' Meetings

of each of the companies participating in the merger process, in accordance with the provisions of the Merger Plan.

Once the merger plan, if any, is adopted, the relevant announcement will be published three times in the Official Gazette of the Commercial Registry and in two widely-circulated newspapers in Madrid and Barcelona, respectively, all in compliance with the requirements of Section 242 of the Corporations Act. Upon publication of these announcements, which shall set forth the right of the shareholders and creditors of Telefónica and Terra to obtain the full text of the merger resolutions and the merger balance sheets, a period of one month will commence for the creditors of the merging companies to challenge the merger until claims which have not expired as of the date of publication are guaranteed, in accordance with Section 243 of the Corporations Act.

3.3.6. Execution and Registration of the Merger Instrument

Once the relevant merger resolutions have been adopted, the announcements have been published, and the legal period has passed without any creditor having exercised its right of challenge or, if applicable, the claims thereof, if enforced, have been duly satisfied or guaranteed, the corresponding merger instrument will be executed.

Prior to the registration of the merger instrument, a notation will be placed on the instrument by the Commercial Registrar of Barcelona stating that there are not impediments to registration of the intended merger. Thereafter, such instrument will be submitted for registration with the Commercial Registry of Madrid, and the Commercial Registry of Barcelona will be requested to cancel the registration entries for Terra.

3.3.7. Performance of the Exchange

Upon the passage of the merger resolutions at the General Shareholders' Meetings of Telefónica and Terra, and the registration of the merger instrument with the Commercial Registry of Madrid, the shares of Telefónica will be exchanged for the shares of Terra upon the terms set forth in the Plan.

3.4. Information Regarding the Planned Merger Transaction

Pursuant to the provisions of Section 238 of the Corporations Act, as from the publication of the call notice of the corresponding General Meeting, the following documents will be made available to the shareholders, debtholders, and holders of special rights other than shares, as well as the labor representatives, for examination thereof at the corporate headquarters of each of the companies participating in the merger:

- (a) The Merger Plan.

- (b) The report of the independent expert, KPMG Auditores, S.L., on the Merger Plan.
- (c) This report of the directors of Telefónica on the Merger Plan, and the corresponding report of the directors of Terra.
- (d) The annual financial statements and management's discussion and analysis for the last three fiscal years of the companies participating in the merger, together with the corresponding auditors' reports.
- (e) The merger balance sheet of each of the companies participating in the merger, accompanied by the corresponding verification report issued by the auditors.
- (f) The charter/bylaws of each of the companies participating in the merger.
- (g) The list of names, surnames, and age, nationality and address of the directors of the companies participating in the merger, as well as the date on which they took office and, if applicable, an indication of those who will be proposed as directors of Telefónica as a result of the merger.

Pursuant to the provisions of Section 240.2 of the Corporations Act, the shareholders, debtholders and holders of special rights other than shares may obtain the free delivery or shipment of the full text of the documents set forth above.

The documents referred to in the preceding paragraphs will be available for consultation on the website of Telefónica (<http://www.telefonica.es>) and Terra (<http://www.terrannetworks.es>) beginning on the date of the notice of meeting.

4. FINANCIAL ASPECTS OF THE MERGER PLAN

4.1. Merger Balance Sheets and Changes

Section 4 of the Merger Plan specifies that the balance sheets of Telefónica and Terra ended as of December 31, 2004, and which have been verified by the respective auditors of these companies, shall be considered the merger balance sheets for purposes of Section 239.1 of the Corporations Act, and will be submitted for approval at the respective General Shareholders' Meetings prior to the adoption of the merger resolution.

It is hereby noted that, with respect to the possibility given by such legal rule to change certain valuations in order to insert alterations that might not appear in the accounting entries, the use of such possibility has not been required with respect to the merger balance sheets of Telefónica and Terra. Therefore, such merger balance sheets do not contain any changes regarding the respective balance sheets ended as of December 31, 2004.

Likewise, it is hereby noted that no significant changes in the assets of Telefónica or Terra have occurred between the date of the Merger Plan and the date of this report.

4.2. Exchange Ratio

Section 3 of the Merger Plan provides that the exchange ratio established for the merger is two (2) shares of Telefónica, each having a par value of one Euro, for each nine (9) shares of Terra, each having a par value of two Euros (with no supplemental cash compensation).

As provided in the Merger Plan, the directors of Telefónica and Terra have not resolved for the shareholders of Terra to receive any supplemental cash compensation.

4.3. Determination of the Exchange Rate

As is also set forth in Section 3 of the Merger Plan, the merger exchange ratio has been determined based on the actual value of the assets of Telefónica and Terra.

In order to determine the actual values of the corporate assets of Telefónica and Terra and to calculate the exchange ratio, Telefónica's directors have used the valuation methods described in Sections 4.3.1 and 4.3.2 below, which are justified and contrasted with other methods in Section 4.3.3 below. In determining the exchange ratio, the directors of Telefónica have also taken into account the forecasts for the payment of dividends by both companies that are described in Section 3.2.7(a) of this Report.

Morgan Stanley & Co. Limited (hereinafter, "Morgan Stanley"), as Telefónica's financial advisor for the merger transaction, has expressed to the company's Board of Directors in its fairness opinion that the agreed-upon exchange ratio is equitable for Telefónica's shareholders. For their part, Lehman Brothers International (Europe), Spain Branch, and Citigroup Global Markets Limited, as Terra's financial advisors for this transaction, have expressed to the latter company's Board of Directors in their fairness opinion that the agreed-upon exchange ratio is equitable for Terra's shareholders other than its majority shareholder, Telefónica.

4.3.1. Actual Net Worth of Telefónica

In the case of Telefónica, the valuation has been based on the listing price of the Company's shares. In the opinion of Telefónica's directors and financial advisors, this valuation method is justified due to the high liquidity of Telefónica's shares and the fact that the shares to be delivered by Telefónica to Terra's shareholders as a result of the merger represent less than one day's volume of listings on the ordinary market, for which reason there will not be a negative impact on the price for those shareholders who decide to sell their securities on the stock market. In any event Telefónica and its financial advisors have used several valuation methods which, by way of comparison, allow reaching the

conclusion that the market quotation value reflects an appropriate valuation of the Company.

On such basis, Telefónica's has been assigned an actual value of €66,361 million, which has been used to set the exchange ratio. As has been stated, such amount has been calculated based on the listed price of Telefónica's shares at the close of the trading session on February 21, 2005 (€14.19 per share), discounting a total of €0.80 per share corresponding to the dividends that Telefónica expects to distribute prior to the registration of the merger, which implies a value of €13.39 per share. The above amount (€66,361 million) results from multiplying the share price by the total number of Telefónica shares, 4,956 million.

4.3.2. Actual Net Worth of Terra

For its part, as regards Terra, the directors of Telefónica and its financial advisors believe that the different methods applied represent different focuses for valuation and are complementary. Among these methods, notable are those based on (i) discounted cash flow, (ii) multiples of the listing prices of comparable companies, (iii) multiples paid in comparable transactions, and (iv) market listings. Although it might be estimated that the discounted cash flow method best reflects the intrinsic value of Terra, the limited access that Telefónica's financial advisors have had to Terra's management team has prevented basing conclusions exclusively on this methodology. In any event, as it could not be otherwise, the directors valued Terra in its current condition, without taking into account historical periods when the share prices were much higher.

The actual value of Terra used to determine the exchange ratio is €1,690 million. This actual value has been chosen from within certain ranges in order to match the exchange ratio of two Telefónica shares for nine Terra shares. The ranges which were used have been calculated using the different valuation methodologies set forth above (a summary thereof is set forth in Section 4.3.3 below), and the dividend of €0.60 that Terra expects to distribute prior to the registration of the merger has been discounted. All of the foregoing results in a unitary value of €2.98 for each share of Terra.

4.3.3. Valuation Methodology and Procedure

Telefónica retained Morgan Stanley to provide it with financial advisory services regarding the merger transaction, the valuation process of the companies participating therein, and the determination of and rationale for the exchange ratio proposed for the merger. As already stated, on February 23, 2005, Morgan Stanley rendered a fairness opinion with respect to the transaction addressed to Telefónica's Board of Directors in which it concluded that, based upon and subject to what is provided in such document, the merger exchange ratio and the extraordinary dividend of 0.60 Euros per share expected to be distributed by Terra to its shareholders pursuant to the Merger Plan, are fair for Telefónica from a financial point of view.

With the advice of Morgan Stanley, Telefónica carried out the corresponding work of evaluating the companies participating in the merger, and based thereon and after arms-length negotiations with Terra, decided upon the financial terms of the merger that are reflected in the Plan.

In performing its financial advisory work for Telefónica, Morgan Stanley carried out various analyses of company valuations in regards to the preparation of its fairness opinion. Set forth below is a summary of such analyses, which are based on prices for the shares of Telefónica and Terra as of February 21, 2005, adjusted for the following dividends that both companies expect to distribute:

- **Telefónica:**

Telefónica's price is adjusted for a total of €0.80 per share in dividends declared by Telefónica (and which will not be payable to Terra's shareholders with respect to the Telefónica shares they would receive in the merger, pursuant to the Merger Plan), as follows: (i) a €0.23 per share dividend based on earnings for the fiscal year ending December 31, 2004, payable to Telefónica's current shareholders on May 13, 2005; and (ii) The distribution of Telefónica's treasury stock, at the ratio of one share of treasury stock for each twenty-five shares owned by the shareholder, from the additional paid-in capital reserve, which is expected to occur following the Ordinary General Shareholders' Meeting (estimated at €0.57 per share at Telefónica's closing share price as of February 21, 2005).

- **Terra:**

Terra's price is adjusted for the €0.60 extraordinary dividend approved by Terra's board of directors on February 23, 2005, which will be distributed to Terra's shareholders prior to the registration of the merger with the Commercial Registry.

(i) Trading Range Analysis

Morgan Stanley has reviewed the range of closing prices for the shares of Telefónica and Terra for various periods ending on February 21, 2005. Morgan Stanley has observed the following:

Period ending February 21, 2005	Telefónica	Terra
Last 90 Days	€12.18 - €13.76	€2.20 - €2.70
Last Six Months	€10.66 - €13.76	€2.17 - €2.70
Last Twelve Months	€10.40 - €13.76	€2.17 - €2.70

Morgan Stanley has calculated that the exchange ratio of 2 Telefónica shares for every 9 Terra shares pursuant to the Merger Plan represents a 15% premium over

the unaffected price of Terra shares as of February 11, 2005, and a 14% premium to the 30 trading days average of Terra shares prior to February 21, 2005.

(ii) Comparable Companies Analysis

Morgan Stanley has compared certain financial information of Telefónica and Terra to financial estimates published in financial analysts’ reports for certain companies with business models similar to those of Telefónica and Terra, respectively. The companies used in this analysis are the following:

- (a) With respect to Telefónica: Belgacom, British Telecom, Deutsche Telekom, France Telecom, KPN, Hellenic Telecommunications (OTE), Portugal Telecom, Swisscom, Tele Danmark (TDC), Telecom Italia, TeliaSonera, Telekom Austria y Telenor; and
- (b) With respect to Terra: using as a reference the unaffected closing share price of T-Online as of October 8, 2004 (prior to Deutsche Telekom’s announcement of a minority buy-out tender offer followed by a merger with T-Online).

For the purposes of this analysis, Morgan Stanley has used the ratio of aggregate business value (defined as market capitalization plus total debt less cash and cash equivalents, plus other adjustments) to estimated 2005 earnings before interest, taxes, depreciation and amortization for Telefónica and to estimated 2006 earnings before interest, taxes, depreciation and amortization for Terra. Morgan Stanley has applied these multiples to Telefónica’s 2005 and Terra’s 2006 earnings, utilizing as information sources for Telefónica, financial forecasts published in financial analysts’ reports, and for Terra, financial forecasts prepared by such company’s management team.

Based on the number of Telefónica’s and Terra’s shares, Morgan Stanley has estimated the implied value per share of Telefónica and Terra, respectively, as of February 21, 2005, as follows:

Financial Statistic	Financial Statistic Amount	Multiple Based on Analysis of Comparable Companies	Implied Value per Share
Telefónica’s business value to 2005 earnings before interest, taxes, depreciation and amortization	€14,301 MM	5.6x – 6.6x	€10.89 - €13.77
Terra’s business value to 2006 earnings before interest, taxes, depreciation and amortization	€60 MM	12.6x	€2.67

No company utilized in the comparable companies analysis is identical to Telefónica or Terra. In evaluating comparable companies, Morgan Stanley has made judgments and assumptions with regard to industry performance, general business, economic, market and financial conditions and other matters, many of which are beyond the control of Telefónica or Terra, such as the impact of competition on the businesses of Telefónica or Terra and the industry generally, industry growth and the absence of any significant changes in the financial condition and prospects of Telefónica or Terra or the industry or in the financial markets in general. Mathematical analysis (such as calculating the average or median) is not in itself a representative method of using comparable company data.

(iii) Discounted Cash Flow Analysis

Morgan Stanley has calculated the range of equity values per share for each of Telefónica and Terra based on a discounted cash flow analysis. With respect to Telefónica, Morgan Stanley has relied on financial forecasts published in financial analysts' reports for 2005 through 2010 and extrapolations from such projections for 2011 through 2014. In arriving at a range of equity values per share of Telefónica, Morgan Stanley has calculated the residual value by applying a range of perpetual growth rates ranging from 1.0% to 1.5%. The unleveraged free cash flows from 2005 through 2014 and the residual value were then discounted using a range of average weighted capital cost rates from 8.0% to 9.0%. With respect to Terra, Morgan Stanley has relied on financial projections for Terra provided by Telefónica's management team (as received by them from Terra), for 2005 through 2008 and extrapolations from such projections for 2009 to 2014. With respect to those financial projections and other information and data relating to Terra, including information as to Terra's tax situation, Morgan Stanley has been advised by Telefónica's management team that such financial forecasts and other information and data were prepared based on bases reflecting the best current estimates and judgments of Telefónica's management team as to the future financial performance of Terra and the judgment of Telefónica's management team regarding the financial performance and tax situation of Terra. In order to determine the equity value per share of Terra, Morgan Stanley has calculated the residual value by applying a range of perpetual growth rates from 3.0% to 4.0%. The unleveraged free cash flows from 2005 through 2014 and the residual value have been discounted using a range of average weighted capital cost rates of 11.5% - 12.5%. The unleveraged free cash flows include the benefits to Telefónica resulting from the business or tax or other savings as well as payments to be received by Terra arising from its strategic alliance with Telefónica.

The following table summarizes the results of Morgan Stanley's analysis:

Key Assumptions	Implied Market Value (€MM)	Implied Market Value per Share
Telefónica: 1.0% - 1.5% perpetual growth rate; 8.0% - 9.0% discount	€69,928 - €88,215	€14.11 - €17.80

rate		
Terra: 3.0% - 4.0% perpetual growth rate; 11.5% - 12.5% discount rate	€1,448 - €1,522	€2.55 - €2.68

(iv) Financial Analysts' Price Targets

Morgan Stanley has reviewed and analyzed future public market trading price targets for Telefónica and Terra published by financial analysts. These targets reflect estimates of future public market trading prices for the shares of Telefónica and Terra. The range of target prices for Telefónica and Terra is €13.70 - €15.70 and €2.30 - €2.65, respectively.

The public market trading price targets published by financial analysts do not necessarily reflect current market trading prices for Telefónica or Terra. Such estimates are subject to uncertainties, including the future financial performance of Telefónica and Terra and future market conditions.

(v) Analysis of Precedent Transactions

Morgan Stanley has analyzed the tender offer by Deutsche Telekom for the 26% of T-Online it didn't already own, and the subsequent merger between Deutsche Telecom and T-Online announced on October 9, 2004.

For the purposes of this analysis, Morgan Stanley has used the ratio of aggregate value (defined as market capitalization plus total debt less cash and cash equivalents plus other adjustments) to estimated 2005 earnings before interest, taxes, depreciation, and amortization, and has applied this multiple to Terra's 2005 earnings before interest, taxes, depreciation and amortization, based on financial forecasts prepared by Terra's management. Based on the number of shares, Morgan Stanley has estimated the implied value per share as of February 21, 2005 as follows:

Financial Statistic	Financial Statistic Amount	Multiple Applied Based on Precedent Transactions	Implied Value per Share
Terra's aggregate business value to 2005 earnings before interest, taxes, depreciation and amortization	€52 MM	17.7x	€2.96

No company or transaction utilized in the precedent transaction analyses is identical to Terra or the merger. In evaluating the comparable companies, Morgan Stanley has made judgments and assumptions with regards to industry performance and business, economic, market and financial conditions and other

matters, many of which are beyond the control of Terra, such as the impact of competition on the business of Terra networks or the industry generally, industry growth and the absence of any adverse material change in the financial condition or forecasts for Terra or the industry of the financial markets in general, which could affect public trading values or the aggregate value of the transactions to which the merger in question is being compared.

(vi) Exchange Ratio Analysis

Morgan Stanley has analyzed the ratio of the closing prices of Terra’s stock divided by the corresponding closing prices of Telefónica’s stock over various periods ending February 21, 2005. Morgan Stanley has examined the premiums arising from a comparison of the announced exchange ratio of 0.2222, as set forth in the Merger Plan, and the benchmarks set forth in the following table, observing the following:

	Telefónica (€/share)	Terra (€/share)	Implied Exchange Ratio	Implied Premium (1)
Last 90 Days Avg.	€12.18 - € 13.76	€2.20 - €2.70	0.181 - 0.196	23% - 13%
Last Six Months Avg.	€10.66 - €13.76	€2.17 - €2.70	0.196 - 0.204	9% - 13%
Last Twelve Months Avg.	€10.40 - €13.76	€2.17 - €2.70	0.196 - 0.209	6% - 13%

(1) Implied premium defined as announced exchange ratio of 0.2222 divided by the resulting exchange ratio for each trading average

(vii) Comparison with Criteria for De-Listing Offers

Telefónica’s directors, being advised by Morgan Stanley, have determined that that the value of Terra used to calculate the exchange ratio meets the requirements set forth in Section 7(3) of Royal Decree 1197/1991 for the determination of the de-listing offering price. The amounts that they arrived at, adjusted for the €0.60 per share dividend that Terra is to pay to its shareholders prior to registration of the merger, are as follows:

- (a) Book value: €2.28 per share.
- (b) Last 6 months average listing price (prior to 02/21/05): €2.31 per share.
- (c) Last twelve months tender offer price: although it would not be applicable because no offer has been made during the last year, it is appropriate to indicate that the offer for Telefónica in May 2003 was made at a price of €2.65 per share (discounting the €2 extraordinary dividend distributed in

2004 and the €0.60 extraordinary dividend pending distribution prior to the merger).

- (d) Liquidation value: Although the specific calculations have not been made, Telefónica's directors and financial advisors believe that the liquidation value would never be more than the above-mentioned book value (€2.28 per share).

All of the foregoing leads to the deduction that the valuation of Terra taken into account in formulating the exchange ratio (€2.98) is considerably greater than the highest of the indicated criteria.

(viii) Reference to Tax Credit arising from the sale of Lycos Inc. during fiscal year 2004.

As set forth in Terra's report corresponding to its annual financial statements for fiscal year 2004, Terra has recognized a tax credit in the amount of €272 million, which is the result of multiplying the applicable tax rate by the difference between the sale price of Lycos Inc. shares and the value with which the capital increase used to acquire this company was accounted for, less corrections that were already deductible for tax purposes prior to the sale.

Such report also notes that the possibility of showing a greater negative tax basis for fiscal year 2004, in the amount of up to 7.418 billion Euros, as a result of applying the tax acquisition value resulting from taking the market value of Lycos shares that were received, instead of the book value with which they were recorded in application of the provisions of Section 159 of the Corporations Act. Notwithstanding the foregoing, given the contrary position stated by the Spanish Revenue Service in response to tax questions in similar cases, and current uncertainties regarding the final decision that it might adopt, as of the date of preparation of the annual financial statements, no accounting effect whatsoever was taken into account with respect thereto for purposes of the valuation. Despite the fact that the above-mentioned legal difficulties put the effectiveness of such tax credits into question, and that in the best of cases under the current situation, there will probably be a long time before recovery thereof, a value of approximately €230 million has been attributed thereto, which equals €0.40 per share of Terra.

4.4. Net Book Value of Terra's Assets to be Received by Telefónica

Pursuant to the individual balance sheets of Terra as of December 31, 2004, the value of Terra's equity that will be received by Telefónica on such date is the amount of 1,633,964 thousand Euros.

4.5. Total Number of Telefónica Shares Needed to Satisfy the Exchange

Given the type of exchange established in the Merger Plan, taking into account the prohibition on participating in the exchange set forth in Section 249 of the Corporations Act, and assuming, as is envisaged:

- (a) that Terra's capital stock, currently represented by 574,941,513 shares, with a par value of 2 Euros each, will not change through the registration of the merger with the Commercial Registry;
- (b) that Telefónica will not change its shareholdings in Terra (436,205,419 shares, representing 75.87% of the capital stock) as of the date of the Plan, except for the acquisition on the Stock Exchange of 7 additional shares of Terra (with Telefónica becoming the holder of 436,205,426 Terra shares); and
- (c) that on the date of the exchange, Terra will not have more than the 7,000,000 of its own shares mentioned in Section 5 of the Merger Plan held in treasury, and such treasury stock will not change through the date of registration of the merger with the Commercial Registry;

the maximum number of Terra shares that would participate in the exchange would be 131,736,087, for which reason the maximum number of Telefónica shares to deliver to the shareholders of Terra in the exchange would be 29,274,686

As noted in Section 3.2.4 above, Telefónica has a sufficient number of shares in treasury to satisfy the merger exchange with old shares. The Board of Directors of Telefónica therefore expects to fully perform the exchange with old Telefónica shares, which will simplify the procedure.

4.6. Report of Terra's Directors

Sections 2.4 and 2.5 of the report recently issued by Terra's directors on the Merger Plan contain a detailed description of the criteria used by its financial advisors (Citigroup Global Markets Limited and Lehman Brothers Europe Limited) in order to value Terra and Telefónica and to assist Terra in the determination of and rationale for the exchange ratio proposed for the merger. The report of Terra's directors concludes by stating that the exchange ratio is considered to be fair for Terra's shareholders other than Telefónica.

Terra retained the financial advisory services of Citigroup Global Markets Limited and Lehman Brothers Europe Limited with respect to the merger and the process of valuation of Terra and Telefónica, as well as the determination of and rationale for the exchange ratio proposed for the merger. As already indicated, on February 23, 2005, both entities issued fairness opinions to Terra's Board of Directors regarding the merger transaction in which, based on and subject to the provisions of such documents, the merger exchange rate and the extraordinary dividend of 0.60 Euros per share (initially not contemplated in Telefónica's merger plan) that Terra is to distribute to its shareholders in accordance with the Merger Plan, are fair from a financial point of view for Terra's shareholders other than Telefónica. The report of Terra's directors on the Merger Plan (which, as already indicated, can be viewed on the websites of Telefónica and Terra as from the date of call to the respective Ordinary General Shareholders' Meetings) contains a summary of the various valuation analyses of the companies performed

by Citigroup Global Markets Limited and Lehman Brothers Europe Limited with respect to the preparation of their fairness opinion.

5. CONCLUSION

For the foregoing reasons, the director's of Telefónica state their conviction that:

- (a) the Merger Plan which is the subject of this Report is highly appropriate for both entities and the shareholders thereof, given that the merger will allow for the integration of the Telephony and Internet businesses and thereby ensure success in facing the challenges raised by the development of the industry, technological change and new customer needs; and
- (b) the exchange ratio proposed in the Plan is justified, and is fair for the shareholders of both entities, as confirmed by the reports of the financial advisors and the independent expert appointed by the Commercial Registry.

* * * * *

This report has been prepared and approved in Madrid, on April 13, 2005, by the directors of Telefónica, who sign below. It is hereby noted that the Directors Antonio Viana-Baptista and Enrique Usued Aznar have abstained from participating in the drafting and signing of this Report, as they understand that they are affected by a potential conflict of interest. For this reason, their signatures do not appear in this document. Likewise, it is stated that the signature of the Director Mr. José Fonollosa García is missing, since he did not attend the meeting of the Board of Directors held on the aforesaid date.

BOARD OF DIRECTORS OF TELEFÓNICA

César Alierta Izuel

Isidro Fainé Casas

Fernando de Almansa Moreno-Barreda

Jesús María Cadenato Matía

Maximino Carpio García

Carlos Colomer Casellas

Alfonso Ferrari Herreo

Gonzalo Hinojosa Fernández de Angulo

Miguel Horta e Costa

Luis Lada Díaz

Antonio Massanell Lavilla

Mario E. Vázquez

Antonio Alonso Ureba

Pablo Isla Álvarez de Tejera

Gregorio Villalabeitia Galárraga

J. Antonio Fernández Rivero

José Fonollosa García

NOTE: In connection with Section 3.3.4 of the Report of the Directors of Telefónica, S.A. regarding the proposed merger, please be informed that the Ordinary General Shareholders' Meeting of Telefónica, S.A. has been finally called for May 30, 2005, on first call, and on May 31, 2005, on second call, and that the Ordinary General Shareholders' Meeting of Terra Networks, S.A. has been finally called for June 2, 2005, on only call.