REPORT OF THE DIRECTORS OF TERRA NETWORKS, S.A. ON THE PLAN FOR THE MERGER BY ABSORPTION OF TERRA NETWORKS, S.A. INTO TELEFÓNICA, S.A.

Madrid, April 12, 2005

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This report was prepared by the Directors of Terra Networks, S.A. pursuant to Article 237 of the Revised Spanish Corporations Law approved by Legislative Royal Decree 1564/1989, of December 22 (the **"Corporations Law"**), with a view to explaining and supporting in detail, in compliance with the legislation in force, the merger plan (the "**Plan**" or the "**Merger Plan**") of Terra Networks, S.A. (the absorbed company, hereinafter **"Terra"**) and Telefónica, S.A. (the absorbing company, hereinafter **"Telefónica"**), deposited at the Madrid and Barcelona Mercantile Registries on March 2 and 3, 2005, respectively.

1. LEGAL ASPECTS OF THE MERGER

1.1 General characteristics

In accordance with the provisions of the Plan, the terms of which are deemed to be reproduced here as necessary, the projected merger will consist of the absorption of Terra into Telefónica with the extinguishment of the former, by dissolution without liquidation, and the transfer en bloc of its assets and liabilities to the absorbing company, which acquires, by universal succession, the right and obligations of the absorbed company.

This universal transfer means that all the assets and liabilities making up the absorbed company's net worth are acquired in a single act. Accordingly, all the assets, right and obligations and, in general, all the legal relationships of the absorbed company are transferred, which relationships will remain in force despite the change in party, save in those cases in which, at the wish of the parties or by statutory provision, a change in party under the specific legal relationship gives rise to the termination of such relationship.

The merger also means that the shareholders of the absorbed company are simultaneously incorporated into the absorbing company through the allotment to those shareholders of shares representing a part of the absorbing company's capital stock in proportion to their respective holdings in the capital stock of the absorbed company.

1.2 Applicable legislation

The basic corporate legislation on mergers is found in Articles 233 through 251 of the Corporations Law and in Articles 226 through 234 of the Mercantile Registry Regulations.

1.3 Selection of Telefónica as absorbing company

Telefónica was selected as absorbing company due to its larger size and stock market capitalization, its greater presence on the telecommunications market and the fact that Telefónica owns 75.87% of the capital stock of Terra.

1.4 Legal procedure for the merger

1.4.1 Merger Plan and exchange ratio

For a merger to be carried out, the Corporations Law requires the Directors of the merging companies to prepare a merger plan.

In this connection, on February 23, 2005, all the Directors of Terra and Telefónica (with the exceptions recorded in the Merger Plan itself) approved and signed the Merger Plan.

The Merger Plan sets an exchange ratio, without any additional cash payment, of two (2) Telefónica shares, each with a par value of one euro (€1), for every nine (9) Terra shares, each with a par value of two euros (€2).

1.4.2 Deposit of the Merger Plan

Pursuant to Article 226 of the Mercantile Registry Regulations, a copy of the said Merger Plan was deposited at the Madrid and Barcelona Mercantile Registries on March 2 and 3, 2005, respectively.

The fact that the Merger Plan was deposited at the Madrid Mercantile Registry was published in the Official Mercantile Registry Gazette on March 14, 2005 and at the Barcelona Mercantile Registry in the Official Mercantile Registry Gazette on March 29, 2005.

1.4.3 Report of an Independent expert

Likewise, pursuant to Article 236 of the Corporations Law, on February 24, 2005 the Directors of each merging company asked the Registrar of the Madrid Mercantile Registry, as the Registrar of the registered office of the absorbing company, to appoint a single independent expert on behalf of both companies to issue a report on the Merger Plan.

On March 3, 2005, the Madrid Mercantile Registry appointed KPMG Auditores, S.L. as independent expert to issue a single report on the Merger Plan and the net worh contributed by the company which is to be extinguished.

The aforesaid independent expert issued its report by the statutory deadline, with the following conclusion:

"In accordance with the work performed, for the sole purpose of complying with the provisions of Article 236 of the Revised Corporations Law and having regard to section 4 above, we deem that:

- *The valuation methodologies used by the Board of Directors to determine the actual value of the Companies are appropriate in the context and the circumstances of the proposed transaction, and justify the share exchange ratio proposed in the Merger Plan.*

- *The net equity transferred by the company that will be dissolved is at least equal to the maximum increase in capital of the acquiring company as foreseen in the Merger Plan".*

1.4.4 Report of the directors

The Directors of Terra also approved and signed this Report on the date hereof, with a view to explaining and supporting the legal and economic aspects of Merger Plan in detail, with special reference to the exchange ratio, all in compliance with Article 237 of the Corporations Law.

1.4.5 Call of Shareholders' Meetings to deliberate and, if appropriate, approve the merger

Once the foregoing requirements have been met, the management bodies of the two companies will resolve to call their respective Shareholders' Meetings with a view to deliberating and, should be the case, approving the projected merger. It is foreseen that the Shareholders' Meeting of Terra will be held on May 31, 2005, on first and only call, and that the Shareholders' Meeting of Telefónica, will be held on May 24, 2005, on first call, and on May 25, 2005, on second call.

Pursuant to Article 238 of the Corporations Law, when the call notice for the Shareholders' Meeting is published, the following documents will be made available to shareholders, debenture holders and holders of special rights other than shares, as well as to employee representatives, for inspection at the registered office:

(a) Merger Plan;

(b) Report of the independent expert on the Merger Plan;

(c) Report of the Directors of Terra and of Telefónica on the Merger Plan;

(d) Annual accounts and management reports for the last three fiscal years of Terra and Telefónica, with the related auditors' report;

(e) Merger balance sheets of Terra and of Telefónica, which correspond to the last annual balance sheet of each company, with the related auditors' report;

(f) Current bylaws of Terra and at Telefónica;

(g) List of first names, last names and ages, in the case of individuals, or corporate name, in the case of legal entities, and, in either case, the nationalities and addresses of the Directors of Terra and of Telefónica, as well as the date since which they have held office and, if appropriate, the same details for those who are to be proposed as Directors as a result of the merger.

Pursuant to Article 240.2 of the Corporations Law, shareholders, debenture holders and holders of special rights other than shares may, as from the date of publication of the call notice to the respective Shareholders' Meetings, ask to have the foregoing documents delivered or sent at no charge.

All of the foregoing documents will be accessible telematically as from the date of the call notice, on the Terra website (www.terranetworks.com).

1.4.6 Publication of the merger resolutions and opposition period for creditors

Pursuant to Article 242 of the Corporations Law, the merger resolution must be published three times in the Official Mercantile Registry Gazette and once in two large circulation newspapers in Madrid and Barcelona, respectively.

Following publication of these notices, which must state for the record the right of shareholders and creditors of Telefónica and Terra to obtain the full text of the merger resolutions and the merger balance sheets, a one-month period will commence in which the creditors of the merging companies may oppose the merger until they obtain sufficient guarantee for their financial claims not yet due at the time of publication, pursuant to Article 234 of the Corporations Law.

1.4.7 Deed of merger

Following adoption of the relevant merger resolutions, publication of the notices and lapsing of the statutory period without any creditor having exercised his right to oppose the merger or, if appropriate, after the financial claims of creditors who did exercise their right have been satisfied or duly guaranteed, the relevant deed of merger will be executed.

Prior to registration of the deed of merger, the Barcelona Mercantile Registrar will record an entry in the deed stating that, from the standpoint of the registry, there are no obstacles to registration at the Madrid Mercantile Registry. Afterwards, said deed of merger will be filed with the Madrid Mercantile Registry for its registration, and the Barcelona Mercantile Registry will be asked to cancel all the entries of Terra.

1.4.8 Making the exchange

After the deed of merger has been registered at the Madrid Mercantile Registry, the shares of Terra will be exchanged for shares of Telefónica on the terms stipulated in the Merger Plan and described in the following section.

1.5 Procedure for exchanging the shares

The procedure for exchanging Terra shares for Telefónica shares is described in section 5 of the Merger Plan.

Section 6 of the Merger Plan provides that, if necessary, Telefónica may increase its capital stock by the necessary amount and issue the needed number of shares to cover the exchange of Terra shares, according to the exchange ratio stipulated in the Plan and with application of Article 249 of the Corporations Law. Section 6 also provides that the amount by which capital is to be increased may be reduced by the delivery of Telefónica treasury stock to the shareholders of Terra.

In accordance with the provisions of the Merger Plan, it is foreseen that Telefónica will use only treasury stock to make the exchange of shares under the merger and, accordingly, it will not be necessary for Telefónica to issue new shares for the exchange.

In the light of the provisions of Article 249 of the Corporations Law (the Terra treasury stock or Terra shares owned by Telefónica will not be exchanged for Telefónica shares), in line with the exchange ratio included in the Merger Plan (2 Telefónica shares for every 9 Terra shares) and given that:

(i) the capital stock of Terra, currently represented by 574,941,513 shares, each with a par value of €2, will not be modified until the registration of the merger;

(ii) Telefónica currently owns 436,205,419 Terra shares (representing 75.87% of its capital stock), and this holding will not be modified, other than by the acquisition in the stock market of 7 Terra shares, so that the number of Terra shares on the market is a multiple of the exchange ratio, for the purpose of facilitating the exchange; and

(iii) Terra has no more treasury stock than the 7,000,000 shares referred to in section 5 of the Merger Plan and such treasury stock will not be modified until the registration of the merger;

the maximum number of Terra shares exchanged will be 131,736,087 which will require Telefónica to deliver up to a maximum of 29,274,686 shares of treasury stock, which will be frozen as from the date of adoption of the merger resolution.

Accordingly, after the merger has been resolved by the Annual Shareholders' Meetings of Telefónica and Terra, and the merger resolution has been registered at the Mercantile Registry, Telefónica will make the exchange by delivering treasury stock to the shareholders of Terra, according to the aforesaid exchange ratio. The exchange will take place, as mentioned, after the deed of merger has been registered at the Madrid Mercantile Registry and will be made by the financial institution and during the period indicated in the notices to be published in the Official Mercantile Registry Gazette and in two of the large circulation newspapers in Madrid and Barcelona.

Terra shares will be exchanged for Telefónica shares through the entities participating in Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A. [Securities Registration, Clearing, and Settlement Systems Management Company, Inc.] (IBERCLEAR) which are the custodians of the shares.

In accordance with section 5 (d) of the Merger Plan, shareholders of Terra who own shares representing a fraction of the number of Terra shares set in the exchange ratio may acquire or transfer shares with a view to exchanging them pursuant to the exchange ratio. The relevant decisions either to purchase or to sell Terra shares on the market in order to attain a number of Terra shares that is a multiple of nine must be made by each shareholder on an individual basis.

Notwithstanding the foregoing and under section 5 of the Merger Plan, the Boards of Directors of Terra and Telefónica deemed it appropriate, following the relevant conversations, to submit to the approval of their respective Shareholders' Meetings a mechanism aimed at facilitating the exchange in the case of shareholders of Terra who own a number of shares that is not a multiple of nine (9). The terms and conditions of this mechanism are as follows:

(i) Bearing in mind that the exchange ratio is equivalent, in singular terms, to the delivery of one share of Telefónica for every 4.5 shares of Terra, at the close of the last stock market session of Terra, each shareholder of Terra who, pursuant to said exchange ratio, expressed in singular terms, of one share of Telefónica for every 4.5 shares of Terra, is entitled to receive a whole number of shares of Telefónica and has an excess fraction or a residue of shares of Terra of less than 4.5, may transfer such fraction or residue to such share fraction/residue acquirer as may be designated for the purpose by Telefónica and Terra, all the foregoing on the understanding that for the calculation of the fraction/residue corresponding to each shareholder position it will be considered the total number of shares of Terra forming such position.

Likewise, a shareholder of Terra who has a number of shares of Terra that is less than 4.5 may transfer those shares to the share fraction/residue acquirer.

It will be deemed that each shareholder of Terra accepts the share fraction/residue acquisition system provided for herein, without needing to send instructions to the relevant entity participating in IBERCLEAR, which will inform the shareholder of the result of the transaction after completion.

(ii) Having regard to the exchange ratio resolved, it is stated for the record that, regardless of the number of shares making up each shareholder position, the only situations in which a fraction/residue can be acquired are as follows:

Number of Terra shares	**Corresponding number of shares of Telefónica by virtue of exchange**	**Fraction/residue of Terra shares subject to fraction/residue 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**

Consequently, in any shareholder position, if there is a fraction/residue, it will range from a minimum of 0.5 Terra shares to a maximum of 4 Terra shares.

(iii) The fraction/residue acquisition price will be set pursuant to the arithmetic mean of the average weighted prices of Terra shares on the Spanish Unified Computerized Trading System (Continuous Market) for Terra’s last three stock market sessions.

If the fraction/residue in question is one share of Terra, its purchase price will be the arithmetic mean of the average weighted prices of Terra shares on the Spanish Unified Computerized Trading System (Continuous Market) for the last three stock market sessions of Terra; by analogy, if the fraction/residue is not one share, its acquisition price will be calculated using the same criterion as that resolved herein, but in due proportion to the specific amount of the fraction/residue.

(iv) The entity designated as the share fraction/residue acquirer will, acting in its own name and behalf, acquire any excess share fraction or residue in the positions existing at the close of the last stock market session of Terra. The shares or fractions of shares of Terra acquired by the acquirer will be exchanged for the appropriate number of shares of Telefónica pursuant to the exchange ratio approved above.

1.6 Terra stock option plans

According to the provisions of the Merger plan, Telefónica will succeed Terra as obligor under the Terra stock option plans. Those plans are: (i) the Terra stock option plan approved at the General Shareholders' Meeting of Terra held on October 1, 1999, as amended by resolutions approved at the General Shareholders' Meetings held on June 8, 2000 and on June 7, 2001 and as implemented by the Board of Directors of Terra, and (ii) stock option plans resulting from the assumption by Terra of the Lycos Inc. stock option plans approved at the General Shareholders' Meeting of Terra held on June 8, 2000, amended by the General Shareholders' Meeting held on June 7, 2001, and implemented by the Board of Directors.

Therefore, following the registration of the merger, Telefónica will succeed Terra as obligor under those plans. Terra stock option rights will be automatically converted into Telefónica stock option rights, on the terms resulting from the exchange ratio set in the Merger Plan. All reference to Terra or, as the case may be, to Lycos Inc. or to Lycos Virginia, in the stock option plans will be deemed made to Telefónica as from the date of registration of the merger.

In order not to harm the interests of the beneficiaries of those plans, Telefónica will, if necessary, establish mechanisms that ensure due regard to the commitments given by Terra in relation to said stock option plans.

1.7 Bylaw amendments at the absorbing company

No bylaw amendments will be made at the absorbing company as a result of the merger.

It is placed on record that, nevertheless, Telefónica intends to reduce its share capital to redeem treasury stock in accordance with Program TIES.

1.8 Administrative issues

Lastly, section 15 of the Merger Plan indicates that the effectiveness of the projected merger is subject to the service of the notices and to the obtainment of the authorizations and registrations required in Spain and in the other jurisdictions in which the two companies are present.

It is not expected to be any further need to apply for or obtain authorizations or registrations in Spain, or in the other jurisdictions in which the two companies are present, for the effectiveness of the merger, except for the registration of a form named F-4 that has been submitted by Telefónica to the Securities and Exchange Commission of the United States of America. The submission of such form and its content was reported to the Spanish Securities Market Commission by means of a Relevant Fact.

1.9 Applicable tax regime

The conditions required by the Revised Corporate Income Tax Law, approved by Legislative Royal Decree 4/2004 are met and, accordingly, the projected merger qualifies for the special tax regime set forth in Title VII, Chapter VIII and in additional provision two of the Revised Corporate Income Tax Law.

In this connection, pursuant to the Merger Plan, a proposal will be submitted to the Shareholders' Meeting to adopt a resolution to submit the merger to the special tax regime indicated above.

2. ECONOMIC ASPECTS

2.1 Strategic support for the merger

As explained in the Merger Plan, the strategic support for the transaction is based on the fact that Terra, like many other Internet companies, has evolved within the context of a strategic model based on a separation between the telecommunications business and the Internet service provider (ISP) business. Notwithstanding other previous 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 service provider, and that, at the same time, a new model based on the operational integration of the telephone 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 boundary between the above-mentioned businesses.

- The explosion of broadband technology has, in fact, created a new dynamic in the supply market, with which synchronization can only be obtained based on a complete interweaving of the network functions and the provision of services, or, put another way, the integrated management 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. Therefore, they must either invest in network infrastructure (which could 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 network operators, who already have the necessary infrastructure and technical and human resources.

- Moreover, on the demand side, today's customer is not content with Internet access alone. Users' preferences are becoming increasingly oriented toward 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.

- 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, voicemail, 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 the competing groups aimed at making bandwidth the center or core of their strategy, and, consequently, at combining the telephone 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 latter of which is about to be completed.

The proposed merger of Telefónica and Terra set forth in the Merger Plan obeys the same logic.

At this respect, the Boards of Directors of both companies have considered, in fact, that this path must be taken 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 within the telecommunications market.

Therefore, the merger is viewed as a strategic imperative of the highest order, and as an outstanding opportunity for mutual advantage. The shareholders of both Terra and Telefónica will benefit from it.

Following the content of the Merger Plan, trying to summarize the most essential aspects, it can be stated that the integration of the businesses resulting from the merger will make it possible:

(a) to strengthen the <u>competitive positioning</u> of Terra and Telefónica in the above-referenced markets, which will translate into an increase in customers and an expanded market share. This is the case because of (i) the increased 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 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.;

(b) to make better <u>use of current customer bases</u>, 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) <u>to minimize costs and optimize investments</u>, 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;

(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 of promoting and creating 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.

2.2 Merger balance sheets

Pursuant to Article 239.1 of the Corporations Law, the annual balance sheets of Terra and Telefónica as of December 31 2004 will be used as the merger balance sheets. Those balance sheets were verified by the merging companies' auditors.

It is stated for the record that between the date of the Merger Plan and the date of this Report, there have been no significant changes in the net worth of Terra or in that of Telefónica.

2.3 Exchange ratio

The exchange ratio proposed in the Merger Plan, which was calculated on the basis of the actual net worth of Telefónica and Terra, will be as follows, without any additional cash payment: two (2) shares of Telefónica, each with a par value of one euro (€1), for every nine (9) Terra shares, each with a par value of two euros (€2).

The exchange ratio was calculated having regard to the following dividends that Telefónica and Terra plan to distribute, as referred to in section 8 of the Merger plan:

(i) As a result of the negotiation with Telefónica of the terms of the merger on market conditions, Terra will pay a dividend of €0.60 per share with a charge to the "Additional Paid-in Capital Reserve" account. The proposed distribution was resolved by Terra's Board of Directors at its meeting on February 23, 2005 and will be submitted for approval by the Shareholders' Meeting to be called to resolve on the merger. In any event, this dividend is to be paid prior to registration of the merger of Telefónica and Terra at the Mercantile Registry. Only Terra shareholders will benefit from this distribution.

(ii) By Telefónica:

(a) Payment on May 13, 2005, of an interim dividend for the year ended December 31, 2004. This dividend was announced by the Board of Directors at its meeting on January 26, 2005, and was establish as a fixed amount of €0.23 per share. Terra shareholders who become Telefónica shareholders as a result of the merger will not benefit from this dividend.

(b) The distribution of Telefónica treasury stock, in a ratio of one share of treasury stock for every twenty-five shares held by the shareholder, with a charge to the additional paid-in capital reserve. The proposed distribution was resolved by the Board of Directors at its meeting on November 24, 2004, and will be submitted for approval by the Annual Shareholders' Meeting of Telefónica. Because the shares are to be delivered on June 28, 2005 and, in any case, before the merger of Telefónica and Terra is registered at the Mercantile Registry, Terra shareholders who become Telefónica shareholders as a result of the merger will not benefit from this dividend.

(c) The payment of a dividend with a charge to the additional paid-in capital reserve to be made on November 11, 2005, provided that the merger deed has been registered at the Madrid Mercantile Registry before then. If the merger is registered at the Mercantile Registry after that date, the dividend will be paid on the sixth stock exchange business day after the date of registration. The proposed dividend was announced by Telefónica's Board of Directors at its meeting on November 24, 2004, and will be submitted for approval by the Annual Shareholders' Meeting of Telefónica. The fixed amount of the dividend is €0.27 per share. Unlike the provisions for dividends described above in subsections (a) and (b), this dividend will be received by both Telefónica shareholders and the Terra shareholders who become Telefónica shareholders as a result of the merger.

2.4 Actual net worth of Terra and Telefónica

2.4.1 Actual net worth of Telefónica

In the case of Telefónica, the valuation by the Board of Terra was based on the company's market price. This valuation method is justified by the high liquidity of the Telefónica share.

The application of this method results in the allocation to Telefónica of an actual value of €66,361 million, which was then used to set the exchange ratio. As mentioned, this amount was calculated having regard to the market price of Telefónica at the close of the stock market session on February 21, 2005 (€14.19 per share), discounting a total of €0.80 per share for the dividends that Telefónica plans to distribute prior to registration of the merger, which entails a value of €13.39 per share. The foregoing figure (€66,361 million) is the result of multiplying the price per share by the total number of Telefónica shares (4,956 million).

2.4.2 Actual net worth of Terra

In the initial proposal of Telefónica, the implied actual value of Terra amounted to €1,690 million, equal to €2.98 per share.

With a view to comparing the reasonableness of this implied value, the investment banks advising Terra on the transaction, Citigroup Global Markets Limited (**"Citigroup"**) and Lehman Brothers Europe Limited (**"Lehman Brothers"**) performed a valuation analysis of Telefónica and Terra, in the latter case primarily using a methodology involving a sum-of-the-parts discounted cash flow analysis for operating assets, according to section 2.5 below.

In the light of these valuations, Terra negotiated with Telefónica and Telefónica agreed to allow Terra to distribute an anticipated dividend of €0.60 per share prior to the merger, which entails a total amount of approximately €337 million.

Once this amount is discounted, the actual values of Terra considered by the Board of Directors of Terra are lower than €1,690 million, the implied premium in the exchange ratio ranging between approximately 10% and 15%.

2.5 Valuation methods

Terra contracted the services of Citigroup and of Lehman Brothers as financial advisors for the merger and to assist Terra with the valuation process of Terra and Telefónica (collectively, the "**Companies**") and Terra´s determination and justification of the exchange ratio proposed for the merger.

On February 23, 2005, the two advisors issued fairness opinions relating to the merger, addressed to the Board of Directors of Terra. In those opinions they concluded that, on the basis of and subject to the provisions of said documents, the exchange ratio of the merger, taking into account the anticipated dividend of €0.60 per share to be distributed by Terra to its shareholders pursuant to the Merger Plan, is fair from a financial point of view for the Terra shareholders other than Telefónica. It is also stated for the record that Morgan Stanley & Co. Limited, as financial advisor of Telefónica for this transaction, expressed its fairness opinion to the Board of Directors of Telefónica, stating that the exchange ratio agreed is fair for Telefónica shareholders.

Based on the advice of both advisors, Terra performed the relevant evaluation of the Companies and, on the basis thereof and after negotiating with Telefónica on market conditions, it decided on the economic terms of the merger set forth in the Merger Plan. At this regard, it is stated for the record that the anticipated dividend of €0.60 per share to be distributed by Terra to its shareholders prior to the merger was not initially included in the merger proposal of Telefónica and is the result of such negotiation.

Citigroup and Lehman Brothers performed various valuation analyses of the Companies as a basis for the preparation of their respective fairness opinions. The following sections 2.5.1 and 2.5.2 are a summary of each of the material analyses performed by each of the aforesaid advisors.

2.5.1 Citigroup

The following is a summary of the main financial analyses performed by Citigroup as a basis for the preparation of its fairness opinion.

For this purpose, Citigroup took into account, among other factors, the proposed dividend of €0.23 per Telefónica share in respect of 2004 and the proposed distribution by Telefónica of one Telefónica share for every 25 Telefónica shares, in which Terra shareholders will not participate, and the proposed dividend of €0.60 per Terra share to be paid by Terra to all Terra shareholders.

A) Past Share Price Performance

Citigroup reviewed the relationship between movements in prices of Terra shares and Telefónica shares and the implied offer price for the merger for the period between July 25, 2003 (the date on which Telefónica officially announced to the CNMV the number of Terra shares it acquired in the tender offer) and February 11, 2005 (the last trading day before Telefónica publicly announced its intention to make an offer for a merger with Terra).

The implied offer price for the merger was calculated by multiplying the adjusted Telefónica share price by the exchange ratio of 2/9 and then adding €0.60 for the effect of the anticipated dividend on Terra shares to be paid before consummation of the merger.

The adjusted Telefónica share price was calculated by subtracting the anticipated cash dividend of €0.23 from the Telefónica unadjusted share price and then adjusting the result for the anticipated stock dividend on

Telefónica shares of one share for every 25 outstanding shares, in which cash and stock dividends Terra shareholders will not participate.

Citigroup also adjusted the Terra share price for the €2.00 cash dividend per Terra ordinary share paid in July 2004 in the period prior to the payment of such dividend.

In addition, Citigroup compared the implied offer price with the trading price of a Terra share on February 11, 2005 (the last trading day prior to the public announcement of Telefónica's intention to make an offer) and the one, three and six-month trailing averages in the period prior and up to February 21, 2005, in the case of Telefónica, and up to February 11, 2005, in the case of Terra.

The following table sets forth the results of this analysis:

	Terra Networks Ordinary Share Price (€)	**Implied Offer Price (€)**	**Premium**
February 11, 2005	3.19	3.58	12%
Last Month Trailing Average.......	3.11	3.56	14%
Last 3 Month Trailing Average....	2.96	3.49	18%
Last 6 Month Trailing Average....	2.90	3.35	16%

B) Precedent Transactions Analysis

Noting that Telefónica currently controls Terra, Citigroup compared the premium that the implied offer price for the merger represented over the price on the last trading day before the announcement and the three and six month trailing averages thereof with the premium on similar last trading days and for similar trailing periods represented by:

- the cash consideration for four recent de-listing tender offers by Spanish companies;
- the consideration in three recent mergers involving significant shareholders (owning less than half of the equity) of Spanish companies acquiring the remainder of the equity of those companies; and
- the consideration for two recent offers by controlling shareholders (owning in excess of half of the equity) of European internet service providers to acquire the remainder of the equity of those companies.

The precedent transactions considered by Citigroup Global Markets Limited were the following:

Spanish De-Listing Offers

Date Announced	Company
April 22, 2002	Hidroelectrica del Cantabrico
December 9, 2003	Aceralia Corporacion Siderurgica SA
May 31, 2004	Centros Comerciales Carrefour SA
June 4, 2004	Cementos Molins SA

Spanish Significant Shareholder Mergers

Date Announced	Acquirer	Target
April 16, 2002	FCC	Portland Valderrivas
July 1, 2003	ACS	Grupo Dragados
August 1, 2003	Metrovacesa	Bami

Offers by Controlling Shareholders of European ISPs

Date Announced	Acquirer	Target
February 23, 2004	France Telecom	Wanadoo
October 9, 2004	Deutsche Telekom	T-Online

With respect to the financial information for the foregoing transactions and the companies involved therein, Citigroup relied on information available in public documents. The following table summarizes the median premium (discount) offered in these transactions over the price on the last trading day before announcement and the three- and six-month trailing averages thereof and, in the far right column, sets forth for comparative purposes the same information for the implied offer price in the proposed merger between Terra Networks and Telefónica:

Period	Median Spanish De-Listing Offer Premium (Discount)	Median Spanish Merger Consideration Premium	Median European ISP Premium	Implied Offer Price Premium For Proposed Merger
1 day	(2.2)%	9.3%	8.6%	12%
3 month	2.7%	2.4%	17.3%	18%
6 month	7.0%	7.0%	19.0%	16%

Citigroup observed that none of the foregoing transactions was identical to the proposed merger of Terra and Telefónica.

C) Terra Networks Valuation

Discounted Cash Flow Analysis

Citigroup's primary methodology for reviewing the value of Terra was a sum-of-the-parts discounted cash flow analysis for each of Terra's individual operating assets and certain non-operating assets.

Citigroup applied country-specific discount rates based on weighted average cost of capital assumptions to calculate the net present value of Terra´s management's forecasted free cash flows from its operating assets, the benefits of future tax savings relating to net operating losses and payments to be received by Terra under its strategic alliance agreement with Telefónica. Citigroup applied greater discount rates, however, to calculate the net present value of a potential additional tax credit resulting from the August 2, 2004 sale by Terra of Lycos Inc. as Terra´s ability to realize value from this contingent asset is speculative and difficult to predict.

Citigroup then adjusted the value of Terra to reflect Terra´s net cash (including amounts due from Telefónica under tax sharing arrangements) and other non-operating assets (including investments in unconsolidated and other non-wholly owned affiliates and anticipated proceeds from dispositions).

The result of this sum-of-the-parts discounted cash flow analysis was an implied value per Terra share of €2.90 to €3.71.

Comparable Companies Analysis

Using publicly available information, Citigroup reviewed the relative share price performance from July 2003 to February 2005 of Terra and the following five publicly held European internet service providers, as well as a market-weighted index comprised of such companies:

- freenet.de
- Iliad
- Telecom Italia Media
- Tiscali
- United Internet

Citigroup also compared the listed companies' multiples of firm value (equal to equity value plus straight debt, minority interest, straight preferred stock, all out-of-the-money convertibles, less investments in unconsolidated affiliates and cash) to forecasted revenues, gross profit and EBITDA for 2005 - 2007 with such multiples for Terra.

Citigroup then calculated a range of illustrative valuations for Terra´s operating assets by applying deviations of plus or minus 10% from the medians of such multiples for the comparable companies to Terra´s management's forecasts and then adding Terra´s net cash and other non-operating assets valued in a manner consistent with the methodology employed in the analysis described above under the heading "—Discounted Cash Flow Analysis".

The result of this comparable companies analysis was an implied value per Terra share of €2.73 to €3.77.

Citigroup observed that none of the selected companies was identical to Terra. In particular, Citigroup noted that Terra´s relatively lower expected 2005-2007 profitability would suggest a valuation of Terra toward the lower end of the valuation range.

Research Analyst Target Prices

Citigroup reviewed research analysts' target prices for Terra shares published between July 1, 2004 (after adjusting for the €2.00 cash dividend per Terra share paid in July 2004) and February 15, 2005.

The range of these target prices (excluding the highest and lowest values) was from €2.80 to €3.17.

D) Telefónica Valuation

Citigroup was not provided with any non-publicly available business or financial information, including financial forecasts, for Telefónica and Citigroup had no access to Telefónica's management. This limited the valuation analyses with respect to Telefónica that were available to Citigroup.

Citigroup reviewed the value of Telefónica using a sum-of-the-parts analysis that used various valuation methodologies for Telefónica's primary operating assets, including trading comparables and market value, and then adjusted for overhead costs, non-operating assets and liabilities and minority interests.

For Telefónica's principal operating assets—Telefónica Móviles, the fixed-line Spanish telecommunications business and Telefónica International—which collectively represent the substantial majority of Telefónica's firm value, Citigroup's primary valuation methodology was based on a comparable companies analysis. Citigroup compared Telefónica Móviles to Telecom Italia Mobile and Vodafone and its market value; for the Spanish fixed-line business, to British Telecom; and for Telefónica International, to Telmex, Telesp, Brasil Telecom and Tele Norte Leste.

The result of this analysis was an implied value in the range of €13.36 to €16.39 per Telefónica share, as compared to a market price of €14.19 per Telefónica share as of February 21, 2005.

Citigroup also reviewed research analysts' target prices for Telefónica shares published between June 18, 2004 and February 11, 2005. The range of these target prices (excluding the three highest and the three lowest values) was from €13.50 to €16.50.

2.5.2 Lehman Brothers

The following is a summary of the main financial analysis used by Lehman Brothers as the basis for the issue of its fairness opinion to the Board of Directors of Terra.

To this effect, Lehman Brothers took into account, among other factors, the proposed dividend of €0.23 per Telefónica share in respect of 2004 and the proposed distribution by Telefónica of one Telefónica share for every 25 Telefónica shares, in which Terra shareholders will not participate, and the proposed dividend of €0.60 per Terra share to be paid by Terra to all Terra shareholders.

A) Terra valuation

Sum-of-the-Parts Analysis

Lehman Brothers reviewed the stand-alone valuation of Terra Networks on the basis of a sum-of-the-parts approach, utilizing different valuation methodologies depending on the type of asset.

For Terra´s cash position, Lehman Brothers used book value as of December 31, 2004. For financial investments and interest in other companies, Lehman Brothers used market value, option value or net present value of future proceeds from the sale of interests subject to an offer or a commitment to buy from a third party.

For the strategic alliance contract between Terra and Telefónica and Terra's joint venture interests, operating assets and tax credits, Lehman Brothers used discounted cash flow valuation, pursuant to which forecasted free cash flows attributable to such assets were discounted to net present value by weighted cost of capital rates.

In addition to being valued on a discounted cash flow basis, as a supplemental comparison, Terra's Spanish operating assets were also valued by using a comparable companies approach, pursuant to which multiples derived from implied values from transactions involving companies in comparable businesses and from EBITDA and revenue of comparable companies were applied to Terra's Spanish access business and its other Spanish business. Multiples derived from subscriber acquisition costs and gross margins of companies in comparable businesses were also applied to Terra's Spanish access business.

The result of Lehman Brother's sum-of-the-parts analysis was an implied value per Terra Networks ordinary share of €3.18.

Other Value Sources

Lehman Brothers has also analyzed other potential sources of value or loss of value not included in the sum-of-the parts analysis like potential synergies, loss of past tax credits and the potential ability to realize value from a tax asset relating to Terra's sale of Lycos Inc.

Accordingly, Lehman Brothers calculated an adjustment to its sum-of-the-parts implied value per Terra share described above to take into account an estimate of the aggregate impact of these other potential effects on value to arrive at an adjusted merger value per Terra share of €3.57.

Comparable Companies Analysis

Lehman Brothers compared Terra as a whole against the following eight other companies:

- easynet
- freenet.de
- Iliad
- TI Media
- T-Online
- Tiscali
- United Internet
- Web.de

Lehman Brothers applied the average multiple of the listed companies' enterprise values to forecasted EBITDA for each of 2005 and 2006 to Terra's forecasted EBITDA for such years to calculate implied firm values for Terra, and then made adjustments to such firm values for other assets and liabilities.

The results of this analysis were implied equity values of €3.05 and €3.18 per Terra share based on Terra's forecasted EBITDA for 2005 and 2006, respectively.

Lehman Brothers noted that, while the review of comparable companies served as comparative information, due to the different profitability and risk profile of Terra, the comparable companies analysis should not be deemed a meaningful valuation methodology.

Broker Views

Lehman Brothers also reviewed brokers' target prices for Terra shares in reports published between April 2004 and February 8, 2005. Lehman Brothers adjusted two of the target prices published in April 2004 for the €2.00 dividend on Terra Networks ordinary shares paid in July 2004.

The average of these target prices was €3.00 and the median was €3.00.

B) Telefónica Valuation

Lehman Brothers was not provided with any non-publicly available business or financial information, including financial forecasts, for Telefónica. Therefore, Lehman Brothers analyzed Telefónica's valuation using a market-based approach. This method is supported by the share's high liquidity.

Broker Views

Lehman Brothers reviewed brokers' target prices for Telefónica in reports published between November 11, 2004 and February 21, 2005.

The average of these target prices was €14.92 and the median was €14.55.

Past Share Price Performance

Lehman Brothers reviewed the past share price performance and trading volumes of Telefónica shares from May 25, 2003 (the launch date of Telefónica's 2003 tender offer for Terra shares) through to February 14, 2005(the date that Telefónica announced its intention to make an offer for a merger with Terra).

Lehman Brothers also calculated the average market price of Telefónica shares for the one-month, six-month and one-year periods prior to February 14, 2005 and for the period from May 25, 2003 to February 14, 2005. The following table sets forth the results of this analysis:

Period	Average Share Price (€)
1 month	14.02
6 months	13.05
1 year	12.67
Since Launch of Tender Offer on May 28, 2003	11.52

C) Relative Valuation

Lehman Brothers performed a relative analysis of the past share price performance by comparing market prices of Terra shares (as adjusted for a dividend payment of €2.00 per share on July 29, 2004) to market prices of Telefónica shares during the period between May 28, 2003 and February 1, 2005. Lehman Brothers also calculated the average ratio of the market price of a Telefónica share to the adjusted price of a Terra share for the month of January 2005, the six-month period of August 2004 through January 2005, the one-year period of February 2004 through January 2005 and for the period between May 25, 2003 and January 4, 2005.

The following table sets forth the results of this analysis:

Period	Average Ratio
1 month	4.49:1
6 months	4.45:1
1 year	4.30:1
Since Launch of Tender Offer on May 28, 2003	4.02:1

Lehman Brothers Europe Limited noted that the ratios set forth in the above table were not adjusted to include the effect of the anticipated cash dividend of €0.60 to be paid to Terra shareholders prior to consummation of the merger.

D) Public Market Valuation of Consideration

Lehman Brothers Europe Limited analyzed the implied offer price for the proposed merger based on the exchange ratio of 4.5:1, the high and low market prices for Telefónica shares during the one month period prior to February 22, 2005 and the market price on such date, and adding the effect of the €0.60 anticipated dividend on Terra shares.

The results of this analysis are set forth in the table below:

	Low	High	As of February 22, 2005
Implied Terra Networks Share Price in Offer (€)	3.59	3.84	3.69

Lehman Brothers observed that the range of the implied offer price set forth in the table above is greater than the adjusted merger value of €3.57 per Terra Networks ordinary share mentioned above under the heading "—Terra Networks Valuation — Other Value Effects".

2.5.3 *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. 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, according to the advice received, a value of approximately €0.40 per share of Terra has been attributed thereto by the Board of Directors of Terra.

2.6 Comparison with the methods foreseen for de-listing offers

Merely as an indication, the Directors of Terra asked their financial advisor, Lehman Brothers, to calculate each of the Terra values that would result from applying the methods stipulated in Article 7.3 of Royal Decree 1197/1991, having regard to the dividend of €0.60 per share Terra plans to pay its shareholders prior to registration of the merger.

This analysis produced the following values:

- Underlying book value of Terra: €2.31 per share (as of December 31, 2004).
- Liquidation value of Terra: €2.28 per share.
- Average market price of Terra during the six-month period prior to February 14, 2005 (weighted average): €2.30 per share.

- Price of previously offered consideration, if any tender offer had been made in the preceding year. No tender offer had been made for Terra in the preceding year. Nonetheless, Terra was the subject of a tender offer by Telefónica in May 2003 at a price of €5.25 per share. Adjusting the price by the €2 anticipated dividend distributed by Terra to its shareholders between that date and the current time, and by the €0.60 anticipated dividend it plans to distribute before carrying out the merger, the comparable price would be €2.65 per share.

Consequently, the implied value of the Terra share in the merger (€2.98 per share) is higher than the highest price resulting from the application of the methods provided for in Article 7.3 of Royal Decree 1197/1991, adjusted by the €0.60 dividend per share to be distributed by Terra.

2.7 Conclusions

In the light of the foregoing, the Directors of Terra conclude:

- that the merger examined in this Report is highly advisable for both merging companies and their shareholders, since the merger will permit the integration of the telephone and Internet businesses and thus enable the two companies to deal successfully with the challenges posed by the development of the industry, technological change and customers' new needs; and

- that the exchange ratio was calculated on the basis of the actual values of the two merging Companies; and that the exchange ratio is deemed fair for the shareholders of Terra other than its majority shareholder, Telefónica, as confirmed by the financial advisors.

* * *

On the basis of the foregoing considerations, repeating where necessary the content of the Merger Plan, in accordance with the provisions of article 237 of the Corporations Law, the Directors of Terra Networks, with the qualifications indicated below, approve and sign this Report on the Plan for the merger by absorption of Terra Networks, S.A. into Telefónica, S.A.

* * *

Madrid, April 12, 2005.

Mr. Joaquín Faura Battle	Mr. Francisco Moreno de Alborán y de Vierna

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Mr. Alfonso Merry del Val Gracie	Mr. Carlos Fernández-Prida Méndez-Núñez

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Mr. Luis Badía Almirall

It is noted for the record that (i) all the Directors appointed as per indication of Telefónica, S.A., that is, Mr. J. Alfonso Bustamante Bustamante, Mr. Enrique Used Aznar and Mr. Fernando Labad Sasiaín have abstained from attending and participating in the deliberations of the Board of Directors of Terra Networks, S.A. on this Report and, consequently, have not signed it, because it was believed that they are subject to a potential conflict of interest; and (ii) that D. Luis Bassat Coen has also abstained from participating in the deliberations in relation to it, because it was believed that he is subject to a potential conflict of interest, and for this reason his has not signed this report either.

NOTE: In connection with Section 1.4.5 of the Report of the Directors of Terra Networks, S.A. regarding Merger plan, be informed that the General Shareholders' Meeting of Terra Networks, S.A. has been finally called for June 2, 2005, on only call, and that the 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.