

**REPORT OF THE THE NOMINATING, REMUNERATION AND CORPORATE
GOVERNANCE COMMITTEE OF TELEFÓNICA, S.A.**

IN RELATION WITH

**PROPOSED APPROVAL OF THE DIRECTORS' REMUNERATION POLICY (ARTICLE 529
NOVODECIAS OF THE SPANISH LAW ON CORPORATIONS)**

24th April 2018

1. INTRODUCTION

This report includes the proposal put forward by the Nominating, Remuneration and Corporate Governance Committee for the Directors' Remuneration Policy (hereinafter referred to as the "Remuneration Policy") of Telefónica, S.A. (hereinafter referred to as "Telefónica" or the "Company"), which shall be in force for a three-year term from 2019 to 2021 and submitted to the General Shareholders' Meeting as a separate item on the agenda.

This report is made available to shareholders on Telefónica's website, as stipulated by Article 529 novodecias, section 1, of the redrafted text of the Spanish Law on Corporations (with initials in Spanish "LSC"). This article requires that all listed companies have in place a remuneration policy approved by the General Shareholders' Meeting at least every three years and that any remuneration paid to the Directors must be consistent with such remuneration policy.

The approval for information purposes of the Annual Directors' Remuneration Report for the financial year 2014, as point eleven on the agenda of the General Shareholders' Meeting held on 12 June 2015, allowed for considering Telefónica's Remuneration Policy included in such report as the Remuneration Policy for the following three financial years, all in accordance with the provisions in section 2 a) of the Transitional Provision of Act 31/2014 on the reform of the Spanish Law on Corporations to improve corporate governance.

Bearing in mind the foregoing, the Nominating, Remuneration and Corporate Governance Committee will submit a new Remuneration Policy for approval which, if approved by the General Shareholders' Meeting, will be applicable from 1 January 2019 until 31 December 2021.

2. PRINCIPLES OF THE DIRECTORS' REMUNERATION POLICY

The general principles underpinning the Remuneration Policy are the following:

- Value creation: Alignment with the interests of the shareholders and the aim of sustainably creating value over time.
- Link between remuneration and profits: A significant portion of the remuneration for the Executive Directors and Senior Executives is variable and receiving it is subject to achieving financial, business and value creation targets that are pre-determined, specific, quantifiable and aligned with the Company's corporate interests.
- Flexibility: The variable remuneration is not guaranteed and sufficiently flexible for the possibility of not paying out this component.
- Competitiveness: In order to have the best professionals on board, both in its structure and its overall amount the remuneration package must be competitive with respect to other comparable companies at the international level.
- Good Governance: When determining the remuneration for the Directors, the Company takes into consideration any developments in the regulations, best practices and national and international recommendations and trends related to the remuneration of the Directors of companies listed on the stock market.
- Fairness: The professional merit, experience, time spent and responsibility undertaken by each Director will be appropriately remunerated.
- "Equal Pay": The remuneration policies and practices guarantee there is no discrimination on the basis of gender, age, culture, religion or race.
- Suitability: The amounts are sufficient to remunerate the qualifications, time spent and responsibility of the Directors, guaranteeing their required loyalty and allegiance to the Company, without compromising the independence of the Non-Executive Directors.
- Transparency: The level of transparency in relation with remuneration is in line with the best corporate governance practices in order to create trust among shareholders and investors.

3. SUMMARY OF THE NEW ASPECTS INTRODUCED IN THE 2019-2021 REMUNERATION POLICY WITH RESPECT TO THE 2015-2018 POLICY

Telefónica has carried out a process of reflection regarding the Remuneration Policy taking into account the recommendations received during the shareholder involvement process it carries out on a regular basis, the best market practices and the general recommendations for corporate governance at the international level.

Based on the conclusions obtained, Telefónica has drawn up the Remuneration Policy, which maintains the basic outlines applied in the previous financial years and introduces the following changes with respect to the previous policy:

- Regarding the Annual Variable Remuneration, in the case of targets overachievement, it has been set a new maximum level of 233.10% of Fixed Remuneration (129.5% of the target annual variable remuneration) for the Executive Chairman and 194.25% of Fixed Remuneration (129.5% of the target annual variable remuneration) for the Chief Executive Officer.
- A new Long-Term Incentive Plan is introduced for the Executive Directors, among other members. This Plan features the following:
 - A maximum incentive limit for each cycle of the plan of 250% of the Annual Fixed Remuneration for the Executive Directors.
 - In addition to the economic-financial targets and targets related to creating value for shareholders, the possibility of setting targets linked to sustainability, the environment, society or good governance with a maximum overall weight of 10%.
 - At least the 25% of the shares that are awarded under the Plan will be subject to a retention period of one year.
- The Executive Directors must hold (directly or indirectly) a number of shares (including those awarded as remuneration) equivalent to two years' gross fixed remuneration for as long as they are members of the Board of Directors and perform executive duties.

4. VALIDITY

This Remuneration Policy will be submitted for the approval of Telefónica's General Shareholders' Meeting and, if approved, shall remain in force from 1st January 2019 until December 2021, notwithstanding any amendments, adaptations or replacements when appropriate agreed, which might be approved by Telefónica's General Shareholders' Meeting.

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Madrid, 24th April 2018