

3.0

Towards a Digital Telco.

Objective:

create value

for everyone_



"The Digital revolution will change the world (it has already started to): the way of interacting with one another, of studying, learning, producing, taking care of ourselves... everything will be different! In such a future, the rules are not set. It is a great opportunity for our sector and for Telefónica to design the future that begins today."

José María Álvarez-Pallete

Chief Operating Officer, Telefónica

The opportunities of a sector in transformation

Telecommunications are at the core of the digital revolution. The whole digital ecosystem revolves around them: devices, applications, content and operative systems. Without doubt, it is the telcos that make the Internet possible.

Demand for connectivity has grown fast, with a smartphone park of 17% of users worldwide, up 42% in 2012

We are going through radical changes. Mobility, broadband, and all the new digital services that become a reality thanks to them, are creating a new world, a digital world. In it, our children are digital natives. And us, digital immigrants that become dazzled with what is nowadays possible to do with just a mobile phone and a broadband connection.

The way in which we enjoy, learn, interact with others, and work keeps evolving. Thus, faster and ubiquitous accesses will be increasingly necessary in order to serve the strong connectivity demand that all forecasts point to; these are already visible through the service growth rates on land line and mobile data offered by the operators. A proof of this trend and potential is seen in the number of smartphones, showing a 42% increase in 2012, but which still only accounts for 17% of the users worldwide. There are already 1.1 billion

smartphones and 2.4 billion internauts, and mobile Internet traffic exceeds that of PCs in countries like India. Nevertheless, beyond connectivity and data, a new way of thinking will be necessary, specially for the so-called digital emigrants, i.e. those people that still haven't made the most of all possibilities provided by the digital world.

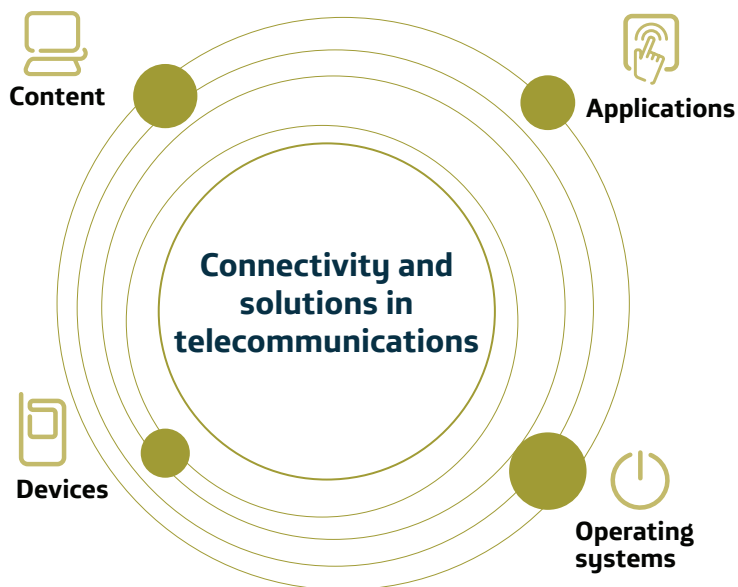
In order to give way to this new trend, new network capacities and intelligence are being developed, requiring a new technological framework for the infrastructures: the new generation networks. Some of the many opportunities that are already in place are fixed fiber accesses, fourth generation mobile networks, cloud computing, treatment of mass volumes of real-time data or machine-machine connections. Their impact is much greater than the simple renewal of the industry's services portfolio.

1.1 billion
smartphones
worldwide

2.4 billion
internauts
worldwide

In **2012**
the number of smartphones and tablets
sold outnumbered PCs

Distribution of value created by Telefónica



And in this new world, what is the role of telecommunications? In simple terms, this industry makes the Internet possible. The telecommunications industry constitutes the backbone of the new digital ecosystem, which in turn is pushing forward industrial reinvention in all types of sectors. This is nowadays clear regarding distribution and contents, but other economic activities - such as financial services, health, education and public administration - are also progressing in their digitalization processes. Those mentioned alone represent 35% of the world's GDP. Beyond services, digital revolutions are also expected in primary and secondary sectors because of the impact of robotics, georeference, new materials or 3D printing.

Taking part as an ICT enabler in the new value chains represents an important opportunity for telecommunications, whose industry will have a determining role thanks to its networks, customer relations and third party platforms, recurrent direct revenues and multi-local presence. All these give the telecoms industry a distinct advantage over the other Internet agents, who are limited due to indirect business models based on advertisement, with a limited local adaptation and depending on the temporary tolerance of the users regarding their weaknesses on integration, stability, security, transparency or privacy.

We can speak of a new industrial revolution, a digital one, in which the operators are best placed in terms of the opportunities which they are opening up. In this sense, the intense internal competition among them has served as a stimulus for the industry in the development of characteristics such as anticipation and ability to adapt in timely fashion regarding technological changes, variations in consumer preferences or the economic, political and social reality; as well as regarding the urgency to increase the efficiency in operations, the accuracy in the deployment of infrastructure, the release of non-strategic assets and the efficiency regarding project development and execution. Those operators most advanced in their own transformation will be able to enjoy preferential access to the growth potential arising from the digital world and the digitalization of other sectors.

This is why Telefónica is evolving towards becoming a Digital Telco, to lead the new digital ecosystem and contribute in the redesign of the rules.

Towards a new positioning

Telefónica is participating in a transformation process in order to become a digital operator. The Group has played, and continues to play, a leading role within the telecommunications world and must hold that role in the new digital ecosystem, with an active participation in the development of, and debates over, the Internet.

The Company wants its customers to enjoy all possibilities provided by the digital world. Operators' telecommunications networks make the existence of the Internet possible, but Telefónica also aspires to a safe Internet, a trustworthy Internet, and an open Internet.

Concepts such as portability in digital life, interoperability of ecosystems, respectful and non-intrusive advertising, respect for the privacy policies, or security in communications are key issues in Internet.

All of them are related to the concepts of trust and freedom of choice for our users. Telefónica wants to help people understand, access and enjoy the best that the digital world has to offer. For this to be possible, trust is a key aspect, not only for the role that Telefónica wants to have in the digital world, but also for this world's sustainable development.

In this line, Telefónica wants users always to have options, and to be allowed to choose in this digital world. Under no circumstance should this new ecosystem be more closed off and provide less options to users than the ones they have been enjoying in the more traditional Web ecosystem.

Telefónica is already adopting a stand in all of them that aims to and must remain close to the concerns of Company customers.

A MODEL FOR CREATING VALUE

A structure for implementing the strategy

Faced with a changing market, Telefónica believes in an integrated vision of its businesses, R&D and the digital world, with the customer always at the heart of its strategy.

Telefónica is an integrated and diversified telecommunications group that offers a wide range of features, principally in Europe and Latin America. The Company's activity is centered around services of fixed and mobile telephony, broadband, Internet, data traffic and pay TV, among others.

The presence of the Company in 24 countries, managed through regional structures, allows it to make use of the advantages of both its local positioning and its international scale. This robustness is reinforced by the opportunities presented by the agreements and participations entered into with China Unicom and Telecom Italia.

As a multinational telecommunications company which operates in regulated markets, Telefónica is subject to different laws and regulations in each of the jurisdictions in which it provides services. In this regard, it is expected that in Europe, the legal environment will continue to change as the common framework in force in the European Union is revised. Besides, in some countries, Telefónica could be faced with the pressure of regulatory initiatives in respect of rates and the reform

of rights of use and allocation of spectrum. These questions are related to the quality of service and the regulatory treatment given to the deployment of the new broadband infrastructure.

In highly competitive markets, the Company starts out from a strong position, which will allow it to profit from emerging growth opportunities. In this way, Telefónica will be able to give impetus to broadband services, both mobile and fixed, or develop other additional ones based on connectivity, IT applications and systems, and adjacent businesses. The motive is clear: the Company wants to lead the telecoms sector and be ahead of the game, whatever trends may arise.

Business model

In order to establish itself as a telecoms operator of the digital world and grasp the opportunities that its structure and its industrial and strategic alliances present, in September 2011 Telefónica defined a new organizational structure. Its objective: to fortify its business model to make it more efficient and make the most of the synergies that arise from an integrated perspective on the businesses, processes and technologies, to direct itself even more towards the customer.

The Company model, which became fully operational in 2012, rests on four pillars:

- Digital
- Global Resources
- Latin America
- Europe

Telefónica's strong competitive position will allow it to profit from emerging growth opportunities

Digital



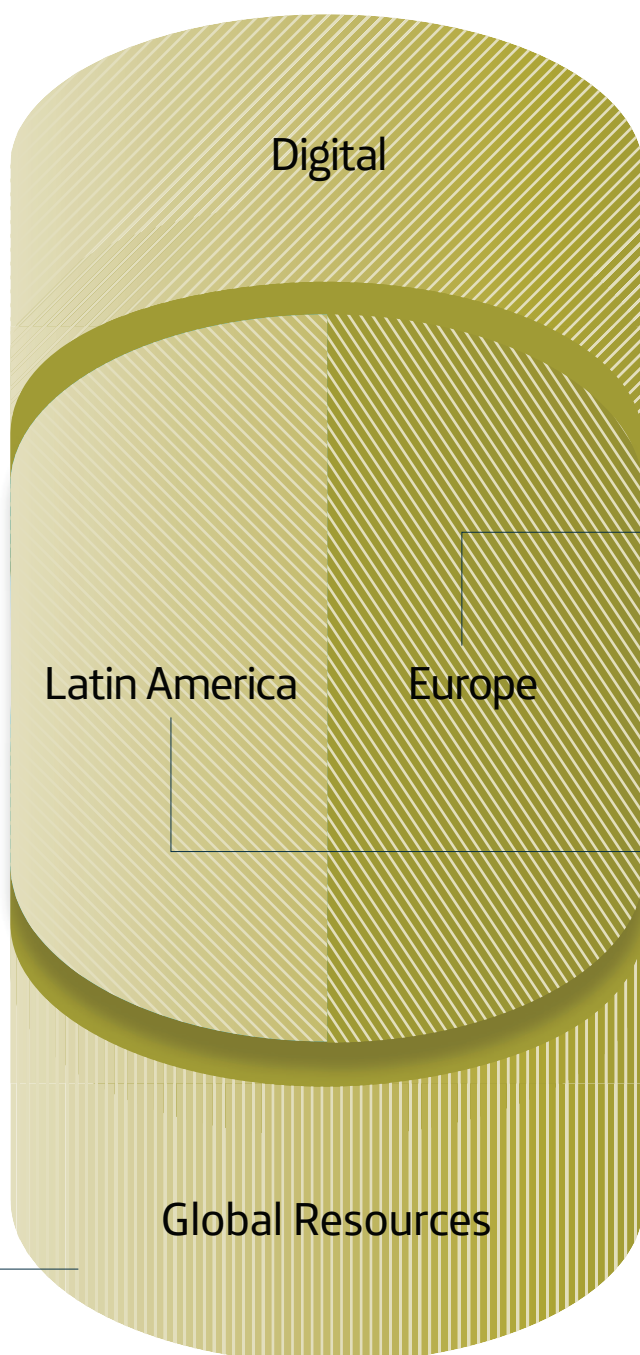
- To take advantage of all the growth opportunities of this environment.
- To accelerate innovation, broaden and strengthen the range of products and services.
- To maximize the advantages of Telefónica's customer base in a world which is ever more connected.

Global Resources



- The creation of the operating unit of Global Resources guarantees the profitability and sustainability of the businesses, taking advantage of the scale of the Company as well as accelerating the transformation towards a fully global model.
- The improvement of operational efficiency will be one of Telefónica's objectives. To achieve this, different local and regional initiatives will be implemented, such as network sharing agreements.

Organizational structure adapted to the business



Europe



→ European customers will continue to occupy center stage in Company strategy and management priorities will focus on maintaining satisfaction. To this end, mobile broadband will be fomented strongly, complementing existing services with new products.

→ **In Spain**, in the second half of 2011, a strategy improving Company positioning and increasing efficiency was launched. Key changes have been made in the commercial and operational model, such as improvement in the value proposition and quality of service, elimination of subsidies for new clients and the launch of Movistar Fusión (a package including all domestic communications needs).

Latin America



→ The strategy on the American continent is based on a model which leverages its growth and the economies of scale without losing sight of dealing with the customer locally. The mobile business will continue to play a fundamental part as a driver of growth. With this in mind, Telefónica will continue increasing the capacity and coverage of its networks, and tuning its distribution channel to increase the quality on offer. As for the fixed-line business, the availability of higher broadband speeds will be boosted and the range of packaged services will be extended. The intention is also to improve operational and commercial efficiency and seek new synergies to implement global, regional and local projects.

VALUE FOR SHAREHOLDERS

A company of nearly a million-and-a-half shareholders

At 2012 year end, Telefonica was the seventh largest telecommunications company in the world in terms of stock market capitalization, the top integrated European operator and 18th in the Eurostoxx 50 ranking, which covers the largest companies of the Eurozone.

Telefónica is a company fully quoted on the Stock Exchange which has a total of 4,551,024,586 ordinary shares with nominal value of 1 euro, held by around one and a half million shareholders. The Company shares are quoted on the Spanish continuous market (within the select Ibex 35 index) and the four Spanish stock exchanges (Madrid, Barcelona, Bilbao and Valencia), as well as those of London (United Kingdom), New York (United States), Buenos Aires (Argentina) and Lima (Peru).

At the time of the call of the 2013 General Shareholders' Meeting, the Company had 1,463,746 shareholders distributed around the world. The most significant shareholders include BBVA (5.753%) and Caixa (5.596%).

2012 achievements

In 2012, Telefónica distributed 4,046 million euros in remuneration to its shareholders, an amount representing 58% of the cash flow generated in the reporting period and around 8% of the stock market capitalization of the Company at the end of that period. It should be noted that in mid-2012, due to the extremely harsh financial and economic context and external factors that aggravated possible financial risks, Telefónica decided to take definitive measures to mitigate these possible risks. In this regard, the Board of Directors decided at its meeting in July 2012, in accordance with the principle of prudent management and in the best interests of all of the stakeholders of Telefónica, as an exceptional and specific measure, to cancel the dividend and repurchase of shares for

€4,046m

used to remunerate the shareholders during 2012

1,463,746

shareholders at the time of the call of the General Meeting

70,286

calls dealt with by the Shareholders' Office



In 2012, Telefónica spent 4,046 million euros in remunerating its shareholders, a sum that exceeded the 2012 cash flow by 58%

2012 (including payments in cash and the scrip dividend of November 2012 and May 2013, respectively). In 2013, the Company has declared its intention to repay the dividend (0.75 Euros per share) in two parts: a first instalment (0.35 euros per share) in November 2013 and a final payment in the second half of 2014.

Shareholders' Office

Through the Shareholders' Office, Telefónica ensures transparent and smooth communications with its individual shareholders, facilitating the same information in time and form as the institutional shareholders. At the close of 2012, over 200,000 shareholders were registered at the Shareholders' Service Center who receive the Shareholder Card that identify them as such. The Company distributes among them the quarterly magazine, *Acción Telefónica*, a publication with financial references and news reports as well as information about exclusive campaigns that can be accessed. During 2012, we sent 593,798 copies directly to shareholders' homes.

The Telefónica Shareholders' Office has a free telephone number (900 111 004), through which it dealt with a total of 70,286 calls during 2012, with a monthly average of 5,857. For the period coinciding with the Annual General Meeting, the number of monthly calls went up to 20,690. Apart from these telephone consultations, the Shareholders' Office also answered more than 5,348 queries by email (accion.telefonica@telefonica.es) and by post.

VALUE FOR CUSTOMERS

The year the commercial offer was simplified

In 2012, we transformed the commercial model from one centered on subsidies to another more sustainable, based on quality and differentiated from the competition.

Transparent communications and tariff simplification are essential, so that customers can see the competitiveness of products and services

Lines of progress

The basis of the Group's business is to offer value to its customers. This is why Telefónica is totally committed to the continual improvement of customer experience and the emotional link with the Company's brands. That is, to transform the Company into a global communications leader of the digital world.

To achieve this, Telefónica is fomenting a cultural shift which puts the customer at the heart of daily work, a fundamental maxim for all those who form part of the Company. This process is the fruit of the conviction that only by means of customer satisfaction and the building of solid relations of trust will it be possible to achieve the growth objectives which the Company has set itself.

Achievements 2012







At the close of 2012, total accesses had grown by 3% year-on-year to reach 315.7 million, with significant rises in the numbers of contract customers and for fixed and mobile broadband. Especially notable is the evolution of Telefónica accesses in Latin America (now 67% of the total), with an increase of 6% over December 2011.

Mobile accesses reached 247.3 million at the end of the last quarter, 4% more than in 2011. This is founded on sustained growth in the contract segment of the market (+7% year-on-year) now representing 33% of all mobile accesses. The net mobile gain in 2012 totals 12.1 million accesses (excluding the disconnection of 3.6 million inactive mobile accesses in Spain and Brazil) with the contract segment being 52%.

Mobile broadband accesses attained 52.8 million at December 2012; they increased by 38% year-on-year and make up 21% of all mobile accesses (up by more than 5pp with respect to the previous year). Also noteworthy was the strong commercial activity in smartphones during the year, with a net gain of 15.4 million in 2012 (over 20% year-on-year) and a penetration of 19% of the base of mobile accesses (over 6 percentage points up over the previous year). The fourth quarter is especially worth highlighting, with a net gain of 5.4 million, the largest in 2012 and 73% greater than in the third quarter. It is also important to point out the significant acceleration in the quarterly net gain of intelligent phones in Europe, fundamentally due to the commercial impulse recorded in Telefónica Spain.

Fixed accesses reached 40 million at the end of the fourth quarter in 2012, recording a net gain in the quarter of 181,000 accesses (-217,000 in Q3) and a smaller fall in interannual terms compared to September (-0,3% at Dec 2012 compared to -1,5% at September 2012).

Retail fixed broadband accesses were 18.6 million at the end of 2012, representing growth of 3% over December 2011, recording a net gain in the year of 530,000 accesses (+72,000 in the quarter). In the fourth quarter, it is notable that Telefónica Europe had a quarterly net gain for the first time since March 2011. This increase is due to the commercial impetus in fixed broadband recorded at Telefónica Spain. Retail fixed broadband accesses attained a penetration of 46% of all fixed-line accesses (+1.5 percentage points year-on-year).

Country	Main achievements		Challenges 2013
	Qualitative	Quantitative	
Spain 	<ul style="list-style-type: none"> • Introduction of a new commercial model for terminals based on fidelity and eliminating subsidies • Launch of Movistar Fusión, the best convergent product on the market • Growth in customer satisfaction index • Reduction in complaints and <i>churn</i> 	1.1 million Fusión customers	<ul style="list-style-type: none"> • Acceleration of the quality transformation process and simplification aimed at lower cost and investment
United Kingdom 	<ul style="list-style-type: none"> • Improvement in behavior of market in On&On tariffs for smartphones and for pre-pay in the Pay&Go rates • Preparation for the commercial launch of 4G services in 2013 with an infrastructure-sharing agreement with Vodafone • The Company was the one with the fewest complaints about its network 	Net gain in contracts 961,000 (+118% over the preceding year)	<ul style="list-style-type: none"> • To maintain the commercial impetus with proposals that lead the market while we offer real 4G network experience
Germany 	<ul style="list-style-type: none"> • Strong commercial push • Success in monetizing mobile data • Investment focused on mobile LTE networks to face future growth and secure access to the VDSL platform 	The penetration of smartphones rose by 6pp with respect to the preceding year, to reach 26%	<ul style="list-style-type: none"> • To increase our mobile market share through use of our multibrand portfolio and to maintain a competitive network with the delivery of LTE to urban areas
Czech Republic and Slovakia  	<ul style="list-style-type: none"> • Commercial drive in focussed areas despite the continual fierce competition • Growth in number of customers 	Total accesses: 9.3 million (+4% compared to the previous year)	<ul style="list-style-type: none"> • Continued spotlight on efficiency to protect profitability
Ireland 	<ul style="list-style-type: none"> • Growth in number of contract customers 	782,000 customers with contract (+4% compared to the previous year)	<ul style="list-style-type: none"> • Move towards business stabilization






315.7
million
total accesses

247.3
million
mobile accesses

52.8
million mobile
broadband accesses

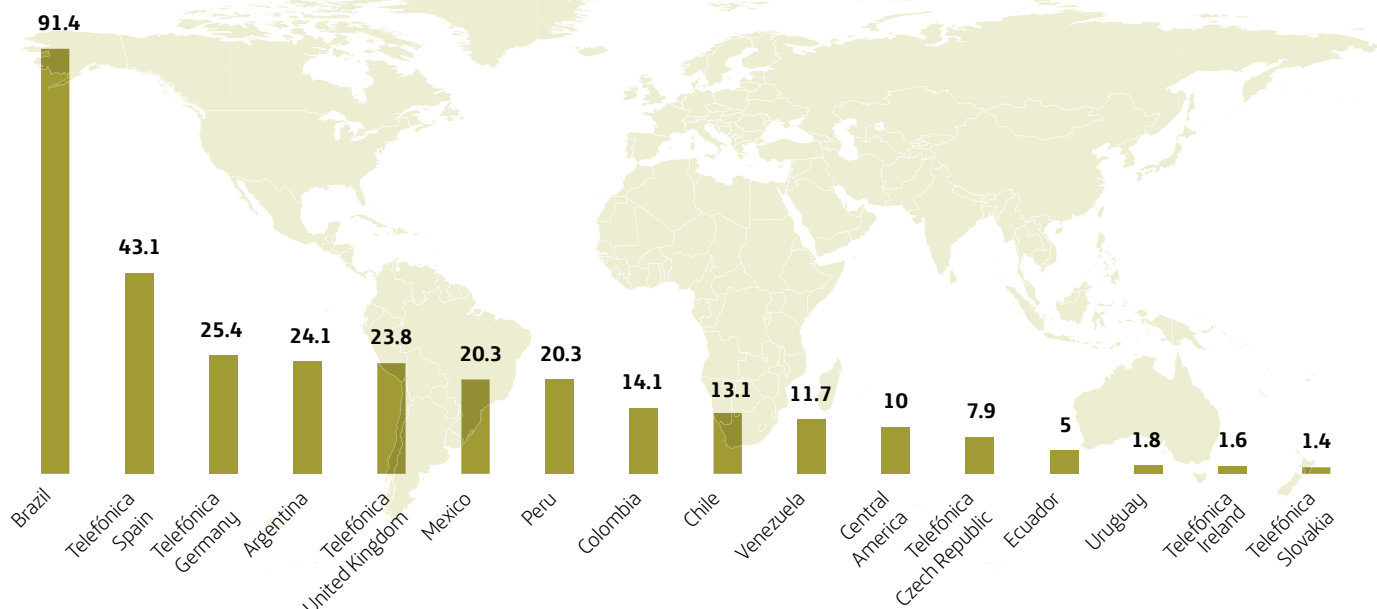
33%
of mobile accesses
are now contracts

Country	Main achievements		Challenges 2013
	Qualitative	Quantitative	
Argentina 	<ul style="list-style-type: none"> The network of specialized channels has been increased, with more than 50 new Relationship Points A new portfolio of digital products was launched (SONORA, mobile, Wanda, Cloud services, etc.) A daily data rate was launched to attract mass use of mobile broadband, with an offer segmented towards a younger public 	<ul style="list-style-type: none"> 24.1 million accesses, with year-on-year growth of 5% More than 85% of fixed accesses are as part of DUO or TRI packages There was an increase of over 20pp in the Service Level of Technical Customer Service 	<ul style="list-style-type: none"> Improve the quality of the mobile network
Brazil 	<ul style="list-style-type: none"> The brand has been unified, boosting the Company's differential attributes and increasing the possibilities of connection Convergence of customer service channels The best rated operator in the AIF (service performance index) of Anatel (the country's regulator) in mobile telephony Launch of the IPTV platform and acceleration of the use of fiber 	<ul style="list-style-type: none"> Integration of accounting systems for accesses of fixed line (10.6 million), mobile (76.1 million) and television (601,000 accesses) Workforce growth of 4.9%: there are 91.4 million accesses and 80 million contracts per month received by all service channels 100,000 customers were attended 	<ul style="list-style-type: none"> Focus on the change underway in the fixed business while keeping up the good performance of the mobile business, profiting from the quality of our offer
Central America 	<ul style="list-style-type: none"> Telefónica established itself as the mobile operator with the greatest customer growth in Central America In all the operators of the region, the Company is leader in ISC (Index of Customer Satisfaction), outstanding even in Nicaragua and El Salvador, the best performance in Latin America 	<ul style="list-style-type: none"> The figure of 10 million customers was reached, attaining year-on-year growth of 23% Total coverage was increased by 24% and the 3G footprint rose by 46% 	<ul style="list-style-type: none"> Focus on getting to know the customer, and maintaining leadership in the ISC
Chile 	<ul style="list-style-type: none"> Development of the high-speed mobile and fixed broadband offer, both in VDSL technology and in optical fibre, and continuous improvement through service bundling Launch of the new TV platform over IPTV Change of the call center model with better prepared managers to improve resolution and satisfaction indicators 	<ul style="list-style-type: none"> The year closed with over 13 million accesses, a year-on-year growth of 4% Noteworthy are the growth of the mobile operator by more than 5% boosted by the increase in the pre-pay market and smartphones and the rise of 6% in broadband and 8% in television recorded by the fixed operator The growth in the number of high-speed broadband customers is another highlight. At year's end, there were over 70,000 customers 	<ul style="list-style-type: none"> Improvement in satisfaction and transformation into online company

Country	Main achievements		Challenges 2013
	Qualitative	Quantitative	
Colombia 	<ul style="list-style-type: none"> Consolidation as the leading telecoms operator in the country with a convergent portfolio, commercialized under the single brand Movistar and capture of synergies produced by the fusion 	<ul style="list-style-type: none"> Handling of 14.1 million accesses, with year-on-year growth of 3% Growth in the customer bases for broadband (+15%), television (+12%) and post-pay (+10%) 	<ul style="list-style-type: none"> To capture the growth in the data market
Ecuador 	<ul style="list-style-type: none"> Substantial growth in the penetration of Small Screen (customers with data packages contracted). The proportion with a contract has gone from 31% to 37%, and the penetration of the pre-pay market doubled (from 3% to 6%) Launch of the Mobile Sales Point channel to permit growth in pre-pay capture in areas like the coast, where participation in the market is low 	<ul style="list-style-type: none"> The year closed with over 5 million accesses, a year-on-year growth of 11% over 2011 Percentage of new contracts of "Planes Smart" (bundled voice + data), which went from 31% in 2011 to 56% in 2012 The number of contracts grew 12% during 2012 	<ul style="list-style-type: none"> Maintenance of growth in the traditional business
Mexico 	<ul style="list-style-type: none"> Launch of the campaign "Prepago cero" (pre-pay zero), a landmark in the strategy of rate reduction within the "Todo Destino" (all destinations) plans Launch of new data plans to develop the mobile broadband business, with the launch of LTE being a highlight Operator with best network quality and fewest complaints Highest customer satisfaction index in the industry 	<ul style="list-style-type: none"> Total accesses reached 20.3 million 	<ul style="list-style-type: none"> Consolidation of the sales channel for the value segment Simplification of processes
Peru 	<ul style="list-style-type: none"> Renewal of three mobile concessions for 18 years and 10 months Consolidation of the integrated fixed-mobile organization, achieving management convergence with good results for the Company Continuous improvement in data plans to foment the adoption of <i>smartphones</i> 	<ul style="list-style-type: none"> Handling of 20.3 million accesses with year-on-year growth of 8% 	<ul style="list-style-type: none"> Leadership in the data market
Venezuela 	<ul style="list-style-type: none"> Focus on commercial campaigns to foment the adoption of mobile broadband and boost the penetration of smartphones Boost digital services focused on television (DTH) 	<ul style="list-style-type: none"> Handling of 11.7 million accesses, with year-on-year growth of 12% Attainment of 3.2 million smartphones, or a total of 33% of the customer base The number of television customers (DTH) doubled, to reach 215,000 	<ul style="list-style-type: none"> Maintain leadership in smartphones

Accesses by country

Millions



KPIs, mobile business

2011 2012



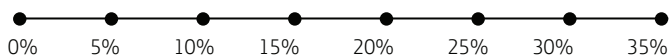
% mobile **contract** customers of the total



% penetration of **Telefónica mobile broadband**



% penetration of **smartphones** of total Telefónica customer base



A look at the future

The optimal evolution of the fourth quarter of 2012 compared with the earlier ones offers certain grounds for optimism about the changes implemented in Telefónica's commercial model, which have transformed its offer from subsidy-centered to a more sustainable model based on quality and the development of differential offers that increase customer fidelity.

Telefónica is making progress in policies of Customer Intelligence, which lets it maintain distinct but fair prices and lets it focus on providing digital services that use its assets. Similarly, the Company is resolutely in favor of quality in its services, which makes it pay special attention to network quality, consumer experience, and makes it offer multi-channel communication to all its customers.

In the future, the levers of growth in revenues coming from customers will be in Latin America and the data market.

67%

of total customer base in Telefónica Latin America

4%

growth in mobile accesses with respect to 2011

40

million fixed accesses in 2012

78%

of all customers are mobile access (millions)



Challenges

Telefónica Group knows that fundamental for the customer are transparent communication and simplification of rates. To wit, that its users can assess the competitiveness of its products and services and their security and flexibility to be adapted to users' needs.

Telefónica has consolidated a collaborative and sharing work culture which has allowed it, in recent years, to swap best commercial practices and customer experiences, bringing them to all the countries where it is present.

For instance, the launch of Movistar Fusión at the end of 2012 has meant for Telefónica Spain an extremely important step on the path of centering its activity on the customer that it has taken. To achieve this, customer requirements and wishes were collected through a multitude of surveys and interviews. Movistar Fusión's USPs (unique selling points) are saving, transparency and simplicity. This is the first truly integrated offer on the Spanish market, with a single bill that includes fixed line, mobile, fixed and mobile

broadband, and even television all in a single product. And for the first time, with line rental included in the price.

It is important to emphasize that products like Movistar Fusión, which the Company is backing strongly, contribute to a more sustainable customer relationship model. The motive is easy: they imply significant reductions both in the total cost to the customer and in churn, meaning that operational costs are reduced for the Company and its market share goes up.

On the other hand, the rates of economic growth and penetration in Latin America make clear that one of the critical factors in Telefónica's success will be its ability to lead the evolution of the mobile contract sector and of smartphones in the region.

Customers by type of access



78%
mobile
accesses



13%
fixed-line
accesses



6%
data and
Internet
accesses



2%
distributor
accesses



1%
pay TV

3%
year-on-year
growth in
total accesses

12.1
million net
gain in
mobile accesses

13%
of customers
have fixed line

2%
of customers
are distributors



THE VALUE OF INNOVATION

Innovation as a lever for changing to the digital world

The challenge of a changing and digital world requires unequivocal support for innovation in all divisions and as a way of doing business.

Telefónica's R&D&I activities impregnate all areas of the Company, so representing one of the biggest ICT innovation networks in the world

Fundamental plans

Telefónica is aware that technological innovation turns out to be key to achieving sustainable competitive advantages which permit the differentiation of the products it develops. So, R&D pervades all areas of the Company, both the transversal units (Telefónica Digital and Telefónica Global Resources), and the local operators. As for how it should be done, the Company considers that the way to ensure a differential advantage in its technological innovation activities is via R&D. This, combined with the acquisition of technology, represents an efficient manner of incorporating leading-edge products.

R&D activities take place by means of the work of Telefónica R&D and of a large variety of companies. Thus, we get one of the world's

largest networks of innovation in the ICT sector. This model has permitted the opening of Telefónica's platforms to collaboration with third parties, backing new technology-based companies through venture capital initiatives and entering companies of technological interest.

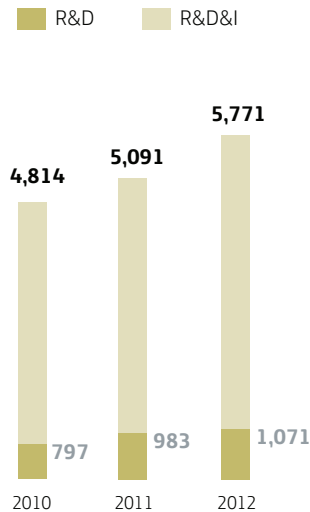
2012 achievements

The Company celebrated this year the 25th anniversary of the founding of Telefónica R&D. And if this division was news in its day for being one of Europe's first private R&D centers, today it is news again for reaching a quarter of a century. During these years, Telefónica R&D has carried on adapting to the needs of the business and has joined the select band of companies investing more than one billion euros in R&D.

Performance evolution

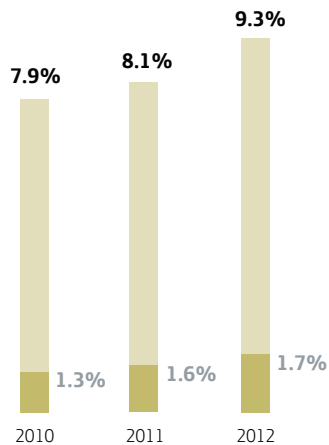
R&D&I investment

Million euros

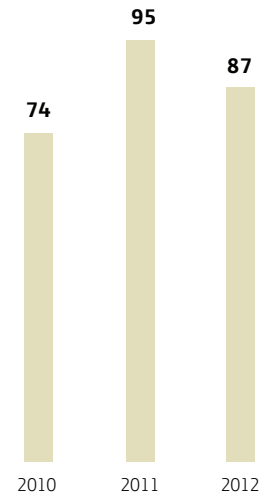


Percentage of revenue

% R&D over revenue % R&D&I over revenue



No. of patents



Currently, Telefónica has research centers in the United States, Israel, the United Kingdom, Brazil and Spain, where scientists and technologists of over 20 nationalities work.

For 2012, the following achievements should be highlighted:

- **TU Go.** This converts telephone service into an app which can be installed on whatever device is considered most appropriate.
- **Firefox OS.** Created with the intention of making intelligent telephones which use open web standards and where all functionality can be developed with HTML5 applications. It already has more than 2,500 developers.

'Wayra' is today one of the most important innovation projects in Telefónica. This is the link which connects startups to the Company. This initiative opens up great potential for distributing their ideas and projects in the markets where the Company is present (with over 300 million customers) and access to its vast network of partners and businesses all over the world. For Telefónica, this company accelerator is the perfect environment to identify talent and make it competitive as quickly as possible.

A large number of the projects that 'Wayra' advances are oriented towards strategic areas, from OTT applications or financial services to cloud computing. In 2012, Telefónica has

fomented the work of 180 startups out of a total of 13,748 projects received.

A look at the future

Success in innovation should be founded on a global model which covers, as well as the execution of projects, tools which assist with talent management, encouragement of creativity, the generation of ecosystems based on business acceleration, the development of actions that bet on innovation, the protection and evaluation of the results, and the assessment and quantification of the return, among other values.

Telefónica has known how to adapt its Research, Development and Innovation model to take advantage of opportunities and respond to the needs of the business during the last 30 years. But in addition, the Company has not only moulded itself to this context but, by means of its developments, has helped to build the future.

When Telefónica R&D was created 25 years ago, the Group centered its activity on Spain and innovations were for mobiles and the Internet. Now, this division is at the technological vanguard and, with it, the Company is in a position to continue playing a central role in the development of new technologies for the future.

Telefónica Digital has worked with Mozilla to develop the Firefox mobile operating system, based on HTML5



With 'Wayra',
Telefónica
offers startups
access to its
customers,
partners and
businesses

But, in this leading-edge work, Telefónica will not be playing alone - the Company enjoys the privilege of having one of the world's largest innovation ecosystems.

Another bet on the future is Telefónica Digital, created to lead and promote the opportunities that this new world offers. Its next objective: to reach 5,000 million euros in 2015, a sum which would represent annual growth of around 20%. Within its areas of activity, the highlights include the development of the open mobile operating system Firefox based on HTML5 with Mozilla, the push for machine-to-machine (M2M) solutions in different sectors, putting the emphasis on efficiency (fleet management, insurance, control of electricity consumption, smart cities), the design of alternative mobile payment methods for the population of Latin America without access to banking, digital health solutions (eHealth) and the creation of Telefónica Dynamic Insights, a new global unit aimed at opening up new value creation opportunities in the area of Big Data.

Challenges

Although, like the majority of companies, Telefónica measures innovation through its R&D&I effort, the real key is to determine the return that this effort yields, as reflected in the development of new products, platforms, patents and other intangible technological assets. To correctly identify and generate this,

the Company created the Telefónica Patent Office four years ago, a division which works closely with the inventors at Telefónica R&D.

As the basis of its business, Telefónica continues to believe that the customer is one of its principal sources of inspiration when defining new technological solutions and platforms. For this, the Company works by different routes. If we consider the early stages of the innovation process, one of the most critical units of Telefónica R&D is that of User Experience. Through this, the most innovative services are defined jointly with the customer. In parallel, initiatives are also undertaken in other business units of the Group which have direct interaction with end users. The idea is to use all this information as feedback for the creation cycle.

Beyond that innovation, at Telefónica the transversal activities with technological potential should increase the efficiency of the network and of its operations. Indeed, they have to support the transformation of telecommunications infrastructure so that it is lighter, more flexible and more configurable. So, by means of innovation in technology and network architecture, the capacity for adaptation of Telefónica to the ever-changing requirements of customers and digital services is boosted. In other words, innovation is put to work to build a much more digital company, a Digital Telco of the 21st century.

Research centers in **5** countries

180

startups fomented by 'Wayra'

25 years of Telefónica R&D

+5,771

million euros dedicated to R&D&I

Action lines	2012 successes	Targets	Challenges
Global R&D effort	1,071 million euros dedicated to R&D&I. Despite global economic difficulties, the figure reflects the upward trend of the Company in this area	<ul style="list-style-type: none"> Keep up the effort in research and development to ensure products are differentiated and that the efficiency of processes increases due to own technologies 	<ul style="list-style-type: none"> Progress in identifying results obtained from R&D, justifying its profitability Maintain or increase the weight of R&D as a percentage of the Company's investment effort
No. of new patents in the intangible assets portfolio	87 new patents generated by Telefónica R&D (of these, 54 have been registered by Telefónica Digital, 30 by Telefónica Global Resources and three by Telefónica España)	<ul style="list-style-type: none"> Continue generating patents within Telefónica Group, with a greater emphasis on quality rather than quantity Emphasize the protection of products and technologies that, as new assets, cause Group value to increase 	<ul style="list-style-type: none"> Early identification of new ideas for patenting throughout the Group and management of other intangible technological assets beyond own patents
Acceleration of startups through 'Wayra'	8.6 million euros of outside financing for companies promoted by the 'Wayra' project	<ul style="list-style-type: none"> Ensure that startups incubated in 'Wayra' can in future raise more financing outside Telefónica as their acceleration periods come to an end 	<ul style="list-style-type: none"> Increase the influence of 'Wayra' in selecting startups in countries in which it operates Foment development of risk capital and business angels in countries where Telefónica operates Facilitate access to financing for 'Wayra' companies

THE VALUE OF BEING DIGITAL

Towards the digital economy

Telefónica's digital products and services accelerate market growth through investment, collaborations and joint ventures.

Telefónica offers key digital solutions for the new financial services society, M2M communications, eHealth, advertising, video and media, security and cloud computing

Key pillars

Our goal is to transform Telefónica into a Digital Telco by creating new digital solutions to solve society's needs. In order to achieve this goal, Telefónica is committed to bringing to market new products and services. We cannot do this alone so we will partner with, invest in or potentially acquire other companies. These products and services are brought to market across seven key segments – financial services, M2M, eHealth, advertising, video and media, security and cloud computing.

2012 achievements

Telefónica's digital solutions, which have provided revenues of approximately €2.4bn to Telefónica, have been brought to market across seven key segments:

Financial services

The mobile phone is becoming more central to people's lives and has the potential to transform the way people carry money and pay for things. Telefónica believes that the mobile will become a gateway for a range of services ranging from credit & debit cards, money transfers, loyalty cards and that ultimately the mobile will replace the physical wallet. Telefónica aims to be a world leader in the provision of digital financial services through the mobile wallet.

It is also committed to working with a wide range of financial partners to grow the overall m-commerce ecosystem. An example of a financial service is MFS: a joint venture between Telefónica and MasterCard that will develop payment solutions using mobile telephony in Brazil. MFS's first product, set to launch in May 2013, will be a pre-paid account accessed via mobile phones alongside a MasterCard card, which will let consumers transfer cash to other people, make in-store purchases, top up their phones and carry out other financial transactions. The product will primarily focus on the payment requirements of Telefónica Vivo customers who do not have bank accounts, offering them financial inclusion. However, users who already have current accounts can also sign up for the service. Cash can be transferred onto pre-paid accounts at mobile phone refill stations, supermarkets and newspaper stands. Another example of a financial service is Direct-to-bill: Telefónica has signed global agreements with Facebook, Google, Microsoft and RIM to offer a simple and convenient way for customers to purchase goods, particularly virtual goods, via their mobile phones. Whether they are buying an app, mobile game or making an in-app purchase, Direct-to-bill enables the customer to simply charge the payment to their phone bill or prepaid credit, avoiding the need to use a credit card. Recent research from MACH found that over a third of European smartphone users have paid for applications via operator billing.



M2M

Machine-to-machine (M2M) communications are transforming all manner of industries across the world. After more than 100 years innovating in the way people communicate, Telefónica's bet for the forthcoming years is developing communications between things.

M2M communications are transforming industries, from utilities to transportation, providing more efficient, cheaper and more sustainable supply chains and operational processes, and enabling the creation of new business models.

Telefónica, as a leader in the telecommunications industry, wants to provide its customers with the best M2M solutions backed by its solid assets: global scale, wide portfolio of M2M value-added services and the best communications network. An example of a M2M service is "Pago como conduzco". Generali and Telefónica have partnered to create "Pago como conduzco" in Spain, a pioneering motor insurance policy that calculates the premium according to driving habits. It is aimed at customers of all kinds, although it especially benefits younger drivers with good driving habits. "Pago como conduzco" also has the potential to improve road safety. It provides suggestions based on the driving habits of the insured which could prove useful towards improving their driving.

eHealth

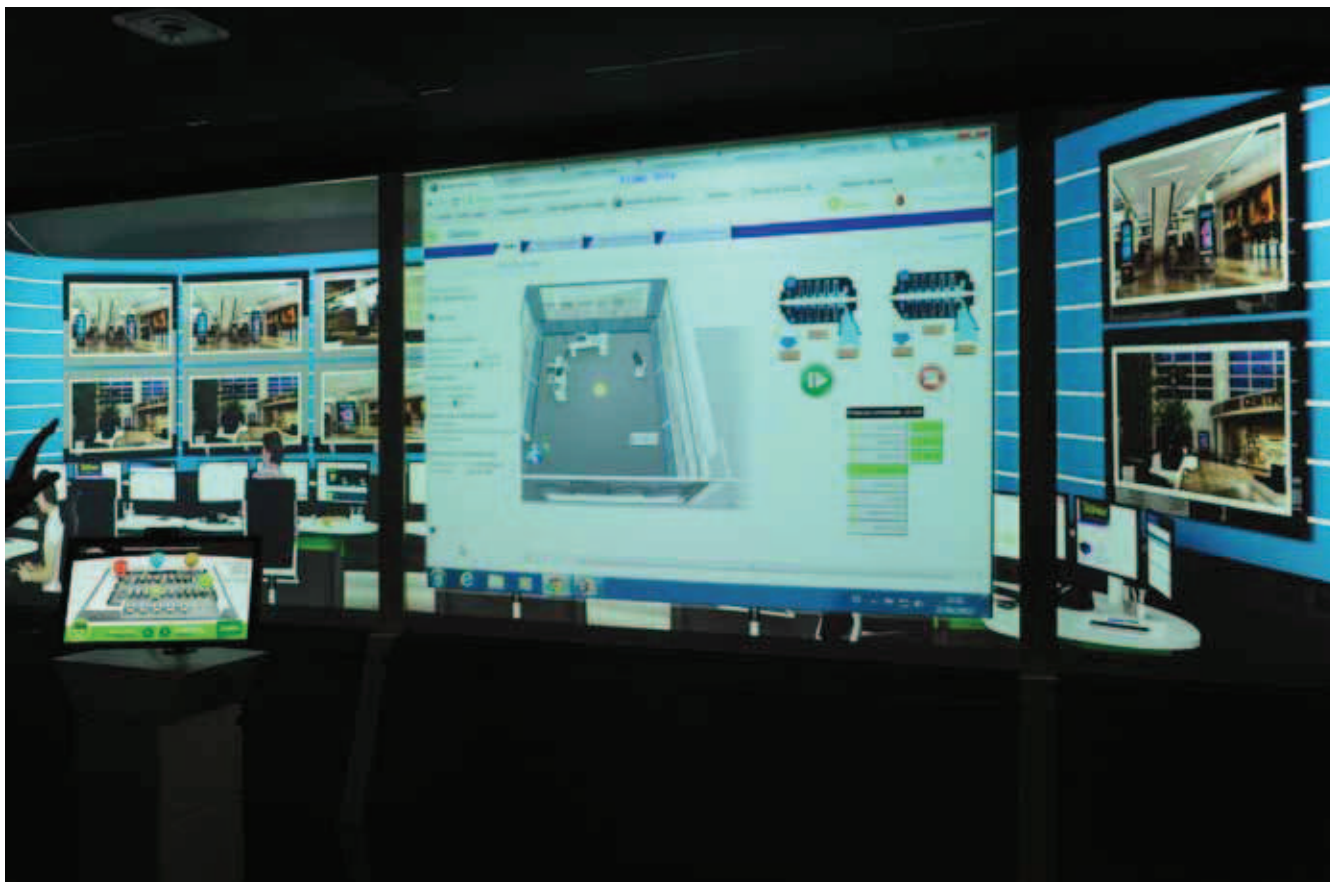
Governments around the world are grappling with growing healthcare costs, driven by ageing populations. Telefónica believes information and communications technologies have the potential to radically transform healthcare, providing both greater quality of care for patients and driving greater efficiencies for healthcare providers. From demand and access management through to remote patient management, mobile telecare and tele-consultation, Telefónica is able to provide innovative products and services to both healthcare providers and directly to end users.

An example of an eHealth service is Axismed. Telefónica has acquired a controlling stake in Axismed, Brazil's largest chronic care management company. The deal, which was concluded at the end of last year, will enable Telefónica Group to accelerate the development of a complete end-to-end service proposition in the fast growing Brazilian e-health market, targeting private healthcare providers, corporate customers as well as the 90 million Vivo customers in Brazil.

Advertising

The mobile advertising market is growing rapidly as brands increasingly realize the potential of mobile to deliver highly targeted and relevant marketing communications to customers. Through its advertising team,

Telefónica health services can improve the quality of patient care while offering increased efficiency



Telefónica's portfolio of cloud services covers all segments, from large enterprises and the public sector to SMEs and SOHO

Telefónica is able to leverage its strengths in this area, including global customer base, unparalleled customer knowledge and innovations in new advertising models.

Video & media

Telefónica is a leading provider of Pay TV and IPTV services across a number of countries in Latin America and Europe. In addition, its Content Delivery Network provides content owners with the ability to offer their customers the best viewing experience anywhere, anytime and on any device. An example of the video & media service is TokBox. Telefónica has acquired TokBox, the leading video communications platform. The acquisition of TokBox, based in San Francisco, builds on Telefónica's strategy of driving innovation in its core business of communications, with capabilities that will now extend beyond voice and messaging to live video. TokBox's OpenTok Video Platform enables the rapid development of live video-based communications services through the simple addition of video calling into websites and mobile applications. Telefónica will leverage TokBox's Platform to enhance the communication services it offers business and consumer customers, adding cross-platform Web-based video communications to its existing voice and messaging capabilities.

Security

Telefónica offers a range of managed security services for large corporations to ensure the integrity of traffic on their networks. This includes clean email and web security, and protection against denial-of-service attacks. For consumer customers, Telefónica is developing a number of products to protect mobile devices and PCs against viruses and malware, and to offer content filtering and child protection services.

Cloud computing

Telefónica has a portfolio of best-in-class cloud services covering all segments from Large Enterprise & Public Sector to SME & SOHO and the consumer market, and addressing different areas such as infrastructure services for supporting mission-critical business workloads, marketplaces for software as a service, personal cloud services and a totally innovative set of cloud services intended for smart devices. An example of a cloud service is Instant Servers: an Infrastructure-as-a-Service offering that delivers on-demand, high-performance cloud computing for developers, digital businesses and large enterprises. Customers benefit from the reassurance of a market-leading service-level agreement (SLA) of 99.996% per year backed by a financial

Product/business area	Update
Big Data/Telefónica Dynamic Insights	Smart Steps currently being trialed by customers in the UK
Financial services	<ul style="list-style-type: none"> • Wallet services live in UK (m-commerce, money messages), Germany (NFC, money messages) and Czech (NFC) • Wanda launched in Argentina and Peru/new CEO announced Providing Telefónica wallet for GSMA NFC showcase
Advertising	<ul style="list-style-type: none"> • Weve JV operational in the UK • Sprint global partnership • Taking O2 Media model to Brazil
eHealth	<ul style="list-style-type: none"> • Remote Patient Management trials in UK, Spain • Axismed acquisition in Brazil
Video	Global Video Platform launched in partnership with Microsoft. First deployments in Brazil, Spain and Chile
Carrier billing	<ul style="list-style-type: none"> • Global partnerships with Facebook, Google, RIM and Microsoft. Google Play integration live in Spain and Germany • BlueVia focusing on payments APIs – also combining Telenor payments APIs
TU Me	Approx 1m registered users
Cloud	<ul style="list-style-type: none"> • Instant Servers available globally (IaaS product) • Partnership with Feed Henry to provide one-stop shop for enterprises to create, manage and host their apps
M2M	<ul style="list-style-type: none"> • Pay-as-you-drive car insurance launched in Spain with Generali • Smart M2M management platform available in Spain and Brazil and soon to launch in Chile, Argentina and Czech Republic • Smart Metering Platform launched • Providing M2M services to General Motors' OnStar outside of US • Part of global M2M Alliance alongside KPN, DoCoMo, Rogers, Singtel, Telstra, Vimplecom and Etisalat

compensation in the event of non-compliance. Instant Servers also achieves lower operational costs allowing customers to serve more workloads per virtual machine when compared to other public cloud services. Customers are able to acquire, manage, monitor and control their virtual servers quickly and simply via the website at all times, and they only pay for the type of cloud services they require and the time they use them for. Instant Servers' cloud computing infrastructure is built on Joyent's cloud infrastructure, a high-performance cloud infrastructure that is the only solution specifically built to power real-time web, enterprise and mobile applications.

A look at the future

The world is going digital. Whether it is consumers looking for entertainment or to communicate, or companies trying to reach customers in different ways or make their businesses more effective, everyone and everything is going digital. Telefónica Digital's

goal is to go beyond connectivity, transforming Telefónica into a Digital Telco by creating new digital solutions to solve society needs.

The digital revolution is being shaped by three trends:

- A surge in demand for digital services. Wherever they are, people want to be connected.
- Smartphones going mass market and increased availability of high-speed data networks.
- Companies in every industry using digital technology to transform how they do business (radically changing customer experience; operational processes; and business models).

This new reality presents great opportunities for industry, but also big challenges.

THE VALUE OF OUR PROFESSIONALS

A team for a future company

The telecommunications market demands being agile, global, digital and leaders. This is why Telefónica has incorporated these qualities into all the systems for assessing the performance of its professionals.

Through the 'Talentum' program, Telefónica has incorporated over 1,500 young professionals in its project

Lines of progress

Telefónica works on various fronts to guarantee improvement of its workforce's productivity ratios. It does so in a complex macroeconomic context in a sector which is redefining the rules of the game in all areas (technological, structure of the competition, regulation, etc.)

This shifting reality necessitates that another of its priorities is the identification and development of its key capacities to continue being one of the leading telecoms operators of the sector. So, the employee talent management policies must ensure that the best professionals, the leaders of the future, are recruited and retained.

Internally, Telefónica promotes the idea that all its employees participate actively in transforming radically the way of working in the Company. To wit, building an organization more customer-centered, more agile, more global and more digital and therefore more leading.

Achievements 2012

Telefónica Europe launched the program 'Talentum' with the objective of incorporating young professionals in all regions. More than 1,500 workers joined the project in the year 2012.

As a key lever to strengthen the transformation of Telefónica, the new global performance model was launched, which in 2012 was applied to all the Company's managers. This scheme takes into consideration both the results obtained (the what), and the way they were achieved (the how, measured in terms of the Company's transforming behaviors: customer-centered, agile, global, digital and leader).

Telefónica's policies and plans in the area of human resources management continue to be aimed at improving the level of satisfaction and commitment of its employees. In 2012, it was 79% (2.5 percentage points more than the year before). Further, Telefónica was listed as one of the best multinationals in the ranking *Best Place to Work* 2012; the Company obtained 13th position.

1,500

incorporations thanks
to the 'Talentum'
program

+2.5

percentage points
in satisfaction
of employees



A look at the future

For better results, people management systems at Telefónica consider the sociodemographic trends in each region in which it operates. So, the Company takes into account relevant aspects such as the presence of different generations at the same time (baby boomer, generation X and generation Y), the scarcity of talent, the globalized management of knowledge in the network, the impact of new technologies in the workplace (bring your own device, flexibility, permanent connectivity), etc.

To ensure leadership in the new digital environment it will be key to have business capacities in the future. So, the Company is going to broaden the program 'Talentum', a project born

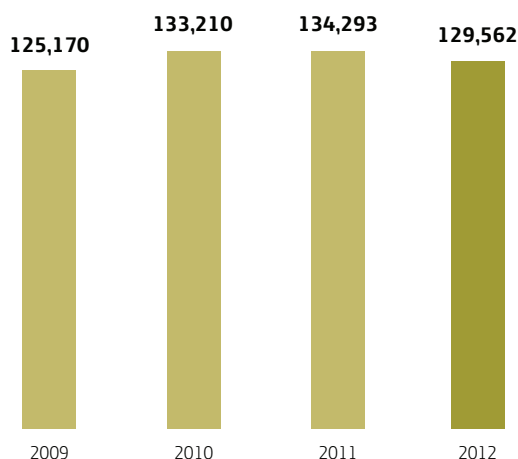
in Telefónica Europe, to the rest of the Group. This initiative aims to attract professionals with ability, aptitudes, innovative spirit and new ideas (fresh thinking).

Likewise, the new conditions of the business and its environment demand faster adaptation, a more agile organization and simpler processes. This transformation has to be taken to heart by the employees of Telefónica Group. That implies new ways of working, cultural change, and managing to function with a simpler organization.

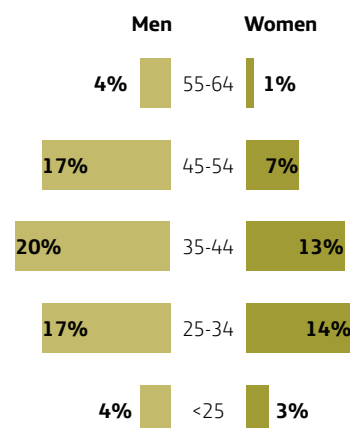
Moreover, the Company will drive forward internal mobility for its professionals to ensure diversity and satisfy the needs of new businesses and opportunities worldwide.

Evolution of the workforce without Atento

Number of employees



Age pyramid



Telefónica was listed as one of the best multinationals to work for in the *Best Place to Work* ranking

The development programs, especially those of Universitas Telefónica, will be at the service of the Company's transformation and the evolution of the leadership style of its executives.

Challenges

The speed of change forces the Company to adapt itself to it faster, at a pace which cannot be allowed to jeopardize quality or doing things right.

Only a committed team, aligned with the aspirations and values of the Company will allow it to adapt itself to the required transformations.

Another key factor for Telefónica in the next few years will be the management of critical capacities, and to know how to respond to an environment of uncertainty. Thus, the focus

and the areas in which it will be necessary to be prepared in the near future will be mainly:

- Marketing
- Technology
- New businesses
- Digital profiles.

It will be fundamental in this task to find the right balance between internal development of capacities and their acquisition.

To obtain these abilities and know-how, Telefónica must be established as an employer of reference in the area of telecoms and digital businesses.

It will be vital to have as well-informed a workforce as possible to improve decision-taking more rapidly and effectively.

133,263
employees in total, fewer
than in 2011 because of
divestment of Atento

2,546
participants
in 40 Universitas
programs

Area of activity	Achievements 2012		Targets	Challenges
Boost productivity among the team of professionals	A workforce better adjusted to the business	+2.7% improvement in the hierarchical index	<ul style="list-style-type: none"> • Towards strategic planning of resources • Flatter organisations with empowered employees • To ensure management of change in the process of simplification of the Company 	Manage different generations and cultures
Construction of capacities for the future	Launch in Europe of the program 'Talentum'	+1,500 incorporations	<ul style="list-style-type: none"> • Management of capacities critical for the business • Extend the initiative 'Talentum' to the whole of Telefónica Group • Boost the internal mobility of talent 	The scarcity of talent is becoming more intense in certain sectors and profiles
Acceleration of the transformation of the Company	New global performance model	79% level of satisfaction and commitment of employees • Telefónica, nº 13 in the ranking <i>Best Place to Work</i>	<ul style="list-style-type: none"> • Extend the model to the whole workforce of Telefónica • Evolution of the style of leadership, supported by Universitas Telefónica • The capacity for rapid adaptation to change, key for the process 	Business environment very changeable and uncertain

Agenda

Transformation in HR

Support for the business



19.4%
increase in ratio
of women
managers

over 3,000,000
hours
of training

13th
company in the ranking
of multinationals,
Best Place to Work



THE VALUE OF BEING GLOBAL

A competitive scale

Global Resources has played a vital role in the operational transformation of Telefónica. Its emphasis has been on homogenization, simplification of applications and the catalogue of devices, together with growing revenues in multinational businesses. All this has represented efficiency savings of over 1,000 million euros.

Seven big operational efficiency projects: Operations & Network, IT, Devices, Purchasing, Global Solutions, Global Services and Human Resource

Lines of progress

The model of Global Resources is based on optimization of the economies of scale of the Company, the quest for greater efficiency in its operational model and advancing its capacities in its global areas. To this end it is structured into seven main areas: Operations and Network, IT, Devices, Purchasing, Telefónica Global Solutions (TGS), Global Services and Human Resources.

In the area of Operations and Network, the focus is on increasing efficiency in digital transformation tools, developing capacities to allow turning Telefónica's networks into a differential element with respect to the competition.

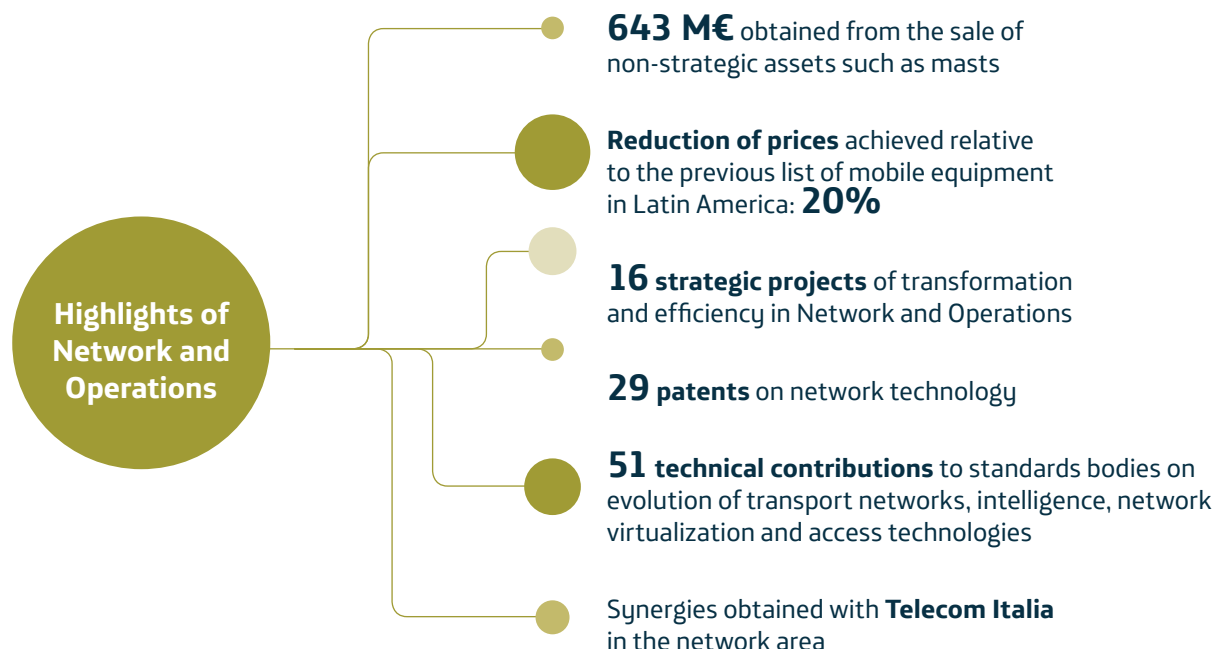
The objective of the Information Technology (IT) area is to drive the Company to convert itself into a Digital Telco through the simplification of

applications, excellence in production and the construction of three new data centers. All this is with the support of Telefónica Global Technology (TGT), an internal IT services company.

In the Purchasing area, the advantages of Telefónica's size are strengthened by global and strategic management, based on a matrix organizational structure. This system is administered according to a single set of rules, processes and systems, and strict guiding principles.

Telefónica Global Solutions, which is in charge of multinational businesses, distributors and roaming, manages relations with large multinational customers and carriers to improve their experience and consolidate the operational and commercial processes.

Area of activity	Achievements 2012	Targets	Challenges
<p>Global network management and operations, which have made possible:</p> <ul style="list-style-type: none"> • Maintenance of common requirements for purchasing new generation network technology • Sharing networks • Homogenized solutions and processes 	<p>Over 20% TCO savings from network shares in the United Kingdom (Beacon)</p>	<ul style="list-style-type: none"> • Evolution towards all-IP networks • Strengthening network intelligence and boosting its virtualization • Pragmatism in network sharing 	<ul style="list-style-type: none"> • Improvement in the efficiency of networks and operations • Transformation of the infrastructure of Telefónica in search of an entity more agile, flexible and configurable • Capacity to adapt the network to the rapidly changing needs of customers and digital services
<p>Information technologies which drive Telefónica towards becoming a Digital Telco</p>	<p>3 new data centers (ES, BR and MX), worldwide references for consolidation and cloud services</p> <p>15% reduction in applications and transformation in all operations</p>	<ul style="list-style-type: none"> • Opportunity to explore the potential of Big Data, digital products and cloud services 	<ul style="list-style-type: none"> • Simplification of the business in all its dimensions: products, policies and processes, while at the same time evolving the IT talent and culture, which will be key for attaining success in the digital world
<p>To take advantage of the benefits of the Company's scale in mobile devices</p>	<p>>80% of the total spending on devices was negotiated globally</p> <p>95% of the value in <100 references</p>	<ul style="list-style-type: none"> • Continuous improvement in management capacities for the customer's life cycle • More balanced market, both in manufacturers and operating systems 	<ul style="list-style-type: none"> • Promotion of a more user-friendly environment, which improves relations with customers • Concentration of relevant agents in the distinct market segments (tendency to duopoly) • Difficulty for new devices and operating systems to create a niche in the market
<p>Global purchasing management</p>	<p>42% of the aggregate purchasing volume</p> <p>Over 80% of all contracts awarded are to local suppliers</p>	<p>Purchasing as generator of e2e sustainable value:</p> <ul style="list-style-type: none"> • From specification to invoicing • Complete the end-to-end integration of purchasing systems 	<ul style="list-style-type: none"> • Continue boosting collaboration with local suppliers • Telefónica as a key development driver in the countries where it is present
<p>Exploitation of international businesses making use of the global power of Telefónica Global Solutions</p>	<p>Growth in businesses in double figures</p>	<p>Objective: increase business managed by 2015</p>	<ul style="list-style-type: none"> • Optimism about our global position in contexts of rapid growth, such as Latin America
<p>Generate efficiency for the support activities with services of excellent quality</p>	<p>9.11/10 Customer Satisfaction Level</p>	<ul style="list-style-type: none"> • Consolidation of the global model • Advances in efficiency through optimization of costs, extension of best practices and homogenization of processes 	<ul style="list-style-type: none"> • Market of increasing activity due to the trend of externalization of non-core activities • Resistance to change • Internalization of activities • Adverse economic environment



In 2012
over 80% of
awards were
to global
suppliers

The Global Services division, for its part, has pursued the acceleration of the worldwide shared services model. The challenges are consistency, control of the processes and increasing efficiency, while at the same time reducing costs and new technologies are 100% exploited.

2012 achievements

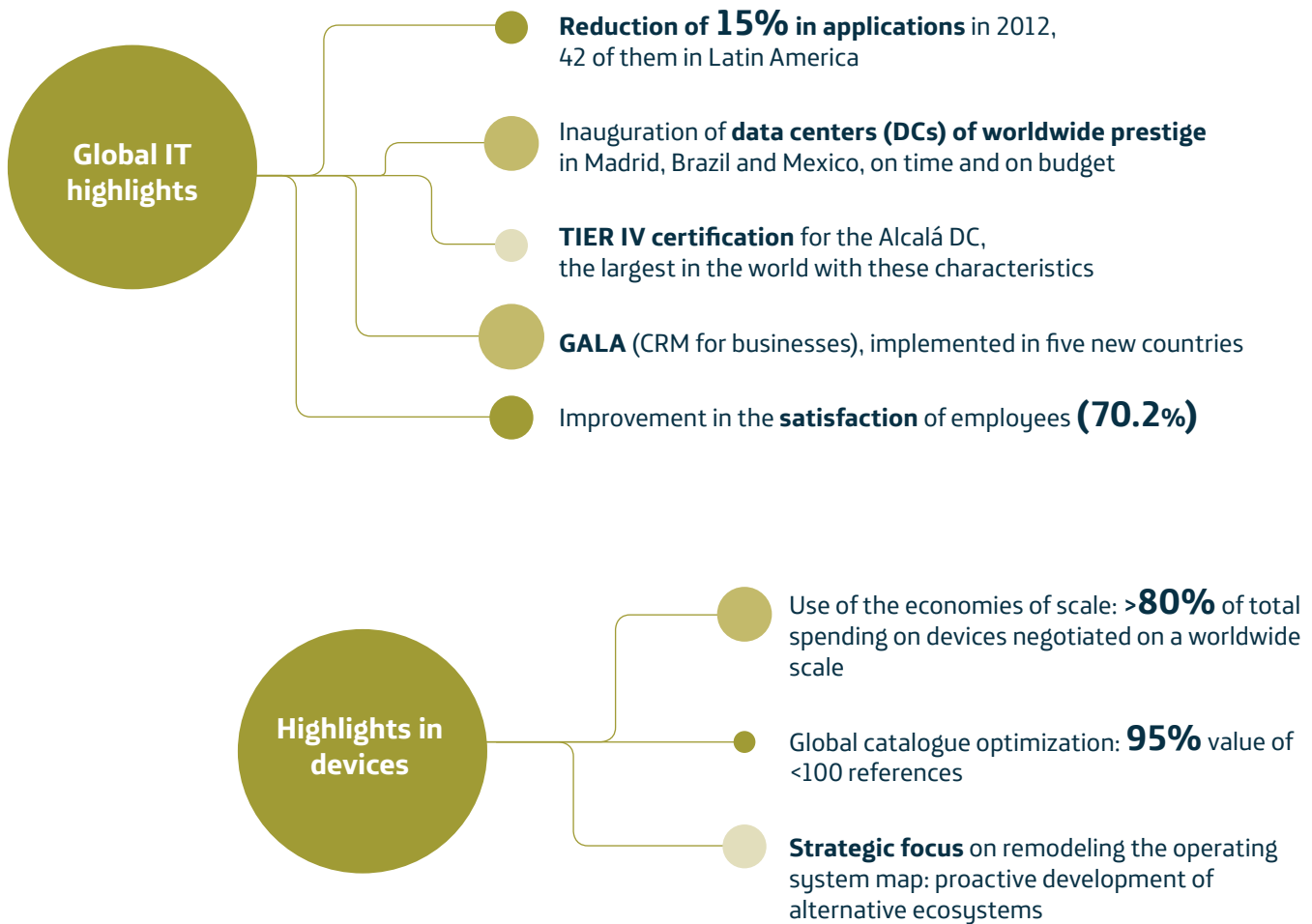
Telefónica Global Resources consolidated its operative model to help the Group to optimize the benefits of its global scale and obtain greater efficiencies and improvements in the time to market.

Initiatives in the area of Network and Operations have led to significant efficiencies. Some of these are:

- Consolidation of a global technical map for the deployment of new generation networks.
- Evolution of the transport network from a global perspective.
- Global definition of specifications for equipment in the customer's home.

- Network sharing In the UK, a joint proposal with Vodafone for sharing and deployment of the 2G, 3G and 4G mobile networks was made, as well as for the transmission network.
- Network operations efficiencies have been obtained through global homogenization of solutions and processes, the construction of mobile emplacements and the standardization of contracts of support, logistics, maintenance and repair of spare parts, as well as in reduced energy consumption.
- Common network intelligence solutions around the exposure (via APIs) of network capabilities and harmonization of service platforms.
- As regards innovation in this field, Telefónica R&D has been promoting the network virtualization ecosystem.

In 2012 the global IT area accelerated its transformation through simplification of applications (15% fewer), specifying a common systems architecture, and excellence in the production both of global services (SAP and email) and local ones. Especially noteworthy were the actions carried out



during certain special events such as the London Olympics or the Christmas campaign. In addition, the production management model was changed to two clusters (Europe and Latin America). Furthermore, three new data centers were built, in Mexico, Brazil and Spain.

Another highlight was the formalization of TGT (Telefónica Global Technology) as an internal company of the Group for IT services: it has more than 1,000 employees and operates in four countries. Finally, it remains to underline the effort in redefining the team of the area, to which new talent was incorporated, while simultaneously reinforcing the existing capacities.

With respect to mobile devices, the value negotiated globally, concentrated in 100 references, rose by up to 80%. In this way, efficiency improved in every quarter. Moreover, joint work with all business units is being carried out so that Telefónica has a more balanced map of suppliers and operating systems.

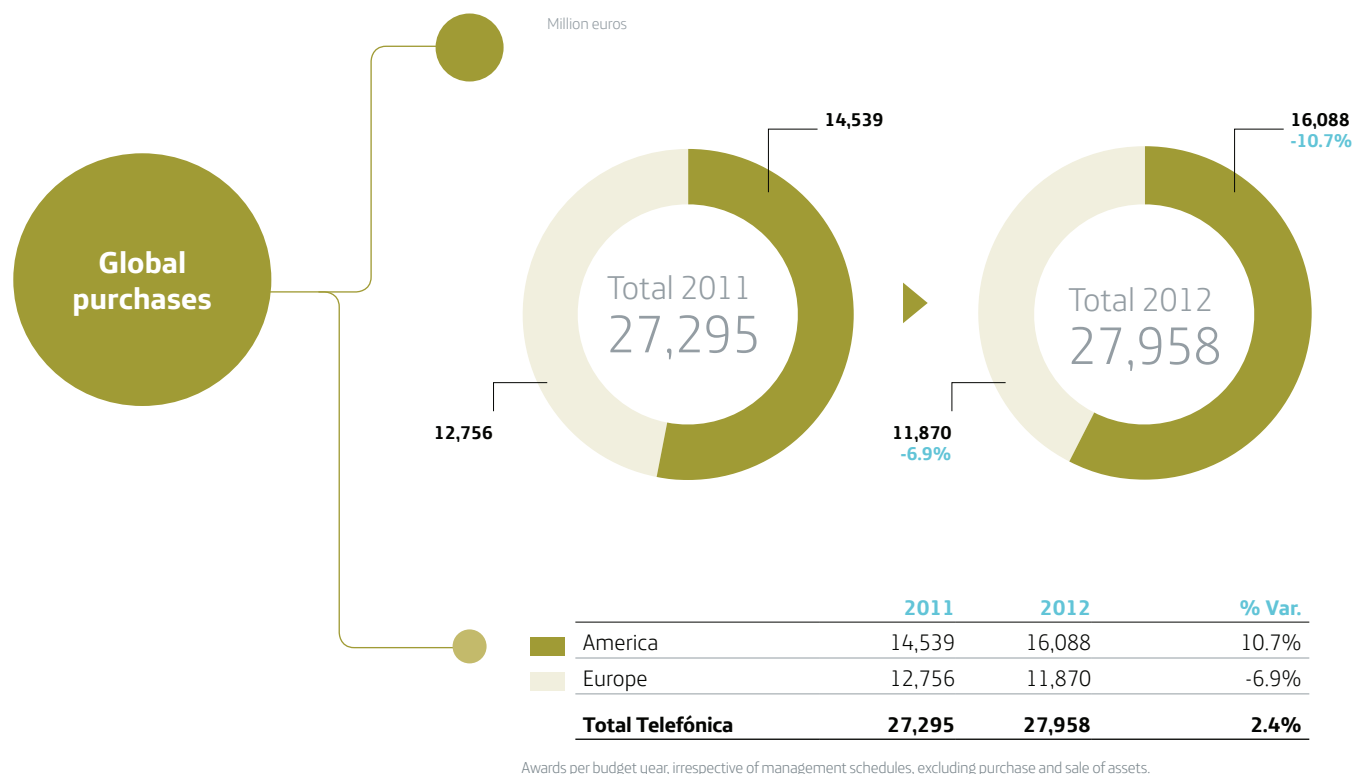
The global Purchasing area, transversal to the whole Company, was centered on the 150 main negotiations (more than 50% of the purchasing

volume) and on advancing cooperation with the distinct lines of business. So, TGS has been consolidated as the organization responsible for global negotiation processes, and new revenues have been generated for the Group through specialized services of efficient management of procurement. Indeed, a basis for developing an end-to-end purchasing model has been established, with special focus on global categories.

Telefónica Global Solutions increased annual sales by over 20% in the MNC sector, thanks to the large contracts obtained. Moreover, it has reinforced strategic alliances through agreements with Singtel, Softbank and Bouygues. In 2012, it also began to manage the CDN and roaming in Latin America, and offered the first standardized service of Global Managed Mobility and Global Managed WAN.

For the first time, the global satisfaction of Telefónica's multinational customers has been measured, permitting the design of more than 50 improvement plans. Telefónica Global Solutions is one of the major players at a global level in the IP and capacity business, and is already in Tier 1. Furthermore, in 2012 it increased the capacity of

Satisfaction studies among Telefónica's multinational customers have led to the design of more than 50 improvement plans



All Global Resources areas are seeking to collaborate in the transformation of the Company into a Digital Telco

the Panamerican submarine cable and reinforced the Central America zone with the laying of a new cable, the PCCS.

During the year, the area of Global Services, which includes Atento and tgestion, advanced towards a global shared services model. It also made progress on initiatives to improve the supply and logistics chains. At the end of the year, Atento was sold for more than 1,000 million euros, a fact which contributed to the reduction of debt.

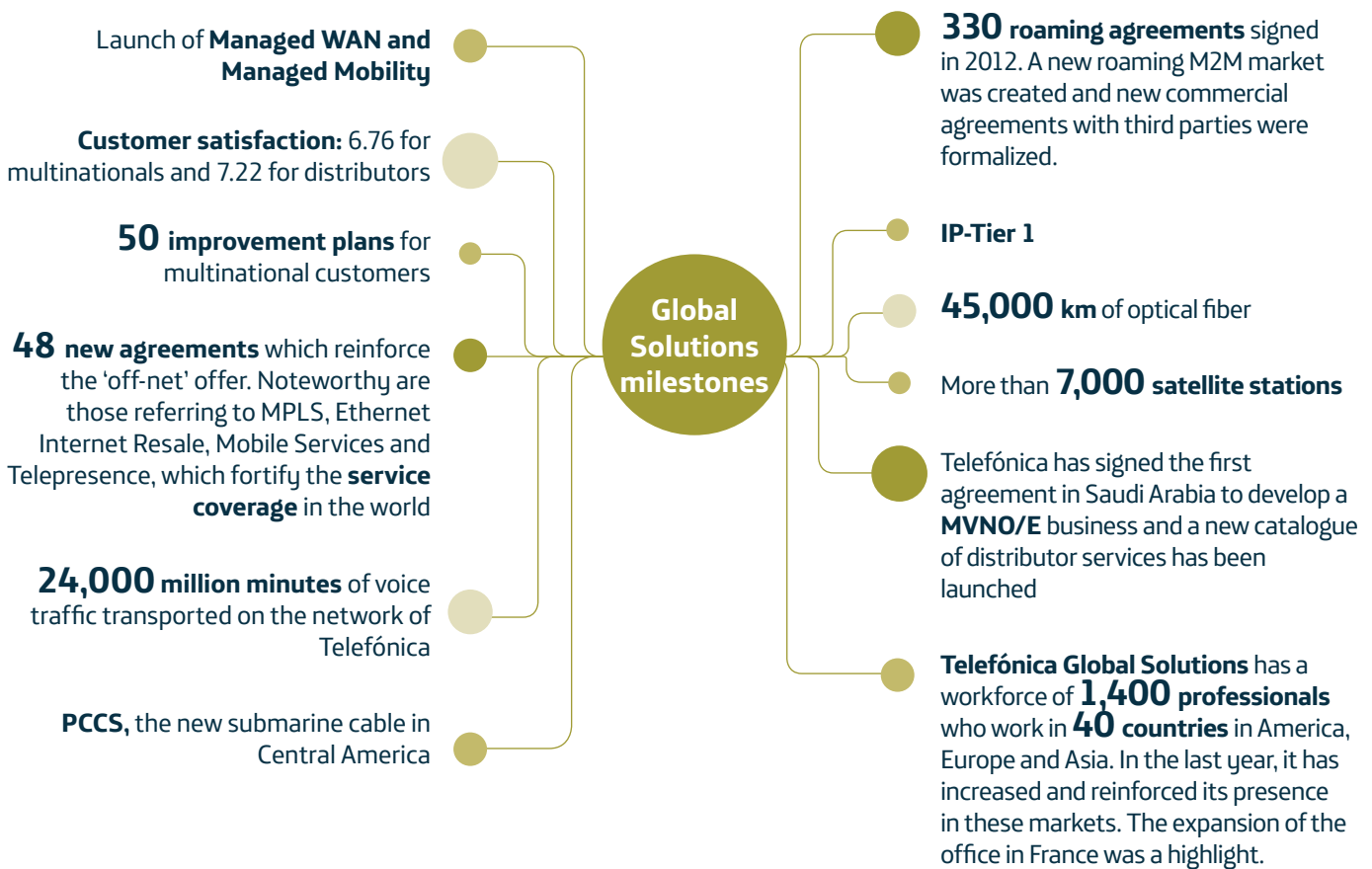
A look at the future

The current market situation conditions to a certain extent the way the Company will handle its businesses in the next few years. To the economic uncertainty, we should add the influence that legal and regulatory decisions have. For this, the focus of the distinct areas of Global Resources is oriented to help transform Telefónica into a Digital Telco.

From the perspective of Networks and Operations, of global scope, the trends indicate

a progressive evolution towards infrastructure that is more agile, flexible and adaptable. So, as a Group, it is key to advance in the consolidation of technologies and network intelligence solutions and common network evolution models to use the advantages of the global scale, as well as design network sharing strategies. Besides, Telefónica should continue working on the determination of common models and processes which achieve economies of scale. It will also be highly pertinent to be able to carry out pilots of network virtualization technology in the operations of the Group.

To be transformed successfully into a Digital Telco, a critical feature is to have excellent IT services. In addition, to maintain a healthy IT costs/revenue ratio, the Global IT area deems it necessary to achieve an appropriate trade-off among the resources dedicated to production, growth and IT transformation. For all these reasons, Telefónica should persevere in the process of simplification, under a management model that concentrates production in hubs, reduces physical infrastructure and installations and has the best IT talent available.



The world of mobile devices is today dominated by a small number of firms who work both on terminals and operating systems. Thus, the Company stresses measures that lead to wider choice for its customers while promoting the incorporation of its applications into devices that should support its technologies (2G/3G/LTE). All this is done to tailor initiatives to Telefónica's commercial offering. The ultimate objective: contribute to the creation of a sustainable (and monetizable) business model around the proliferation of tablets and phablets (phone + tablet).

Regarding the business of large multinational customers, the challenge to the Company is to combine growth and efficiency while the global model of Telefónica Global Solutions is consolidated.

Telefónica operates in a global market of multinational customers and carriers which offers great opportunities for growth. So, it is possible to increase market share, firm up the presence of Telefónica in Europe and America and reinforce its capacities in Asia, and offer

innovative solutions which have a positive effect on the experience and satisfaction of its customers. But, moreover, the Company wants to do this by leading the deployment of international infrastructure and the development of global platforms.

Finally, in regard to Global Services, Telefónica is looking at various initiatives for the transformation of its back office activities. The main challenges it faces are related to the consolidation of the model in practice. This area should extend the reach of its services to all geographies and types of business, coordinate the different lines of work to ensure their coherence with a medium-term vision and increase their profitability and efficiency. In other words, it should help the business to comply with its operational and financial commitments, maintaining the current levels of excellence in the quality of service.

While the global TGS model is being consolidated, the challenge is to combine growth and efficiency

THE VALUE OF THE BRANDS

A brand portfolio that creates value

Telefónica combines efforts to build brands that are recognized, reliable and differential and can successfully compete in the modern, complex, digital environment.

Movistar, Vivo and O2 are considered among the world's biggest brands

Lines of progress

For Telefónica, brands are high value intangible assets for the business, because they associate the Company rationally and emotionally with its customers. For this reason, its strategy, resources and investment are focused on building strong and competitive firms.

The model that Telefónica follows endows an institutional role for the Telefónica masterbrand, which is responsible for leading the relations with employees, shareholders and investors, large clients and multinationals and institutional public suppliers in the general sense. In turn, Movistar, O2 and Vivo are the commercial brands and therefore, those that are related to the customers, each one in a different geography.

Movistar and O2 are considered to be among the 100 most important brands in the world. In addition, Telefónica has other independent brands for businesses or specific initiatives in the digital world (Tuenti, Terra, TU, etc.), for low-cost mobile phone operators (48,

Fonic, Tuenti mobile, etc.) and innovation or accelerators of startups (*Wayra*).

2012 achievements

Telefónica has, under a fixed/mobile brand, integrated operations in Brazil, under the name of Vivo, and Colombia, under that of Movistar, consistently integrating the vision of the consumer.

In an increasingly global and digital world, to meet the needs of the clients - who are seeking to build relationships with global companies - Telefónica defined and approved the strategy of associating the Telefónica masterbrand with the commercial brands under a branded house structure so as to give them the attributes of solidity, leadership and innovation of a global company. Thus, Telefónica, with its logotype, supports all of the commercial communications of Movistar, O2 and Vivo. In this way, it helps the clients understand that they are interrelated: the products of a brand that has its own identity with one of the sector's most



Nuevo

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Telefónica

The Telefónica logotype supports the communications of its commercial brands



vivo

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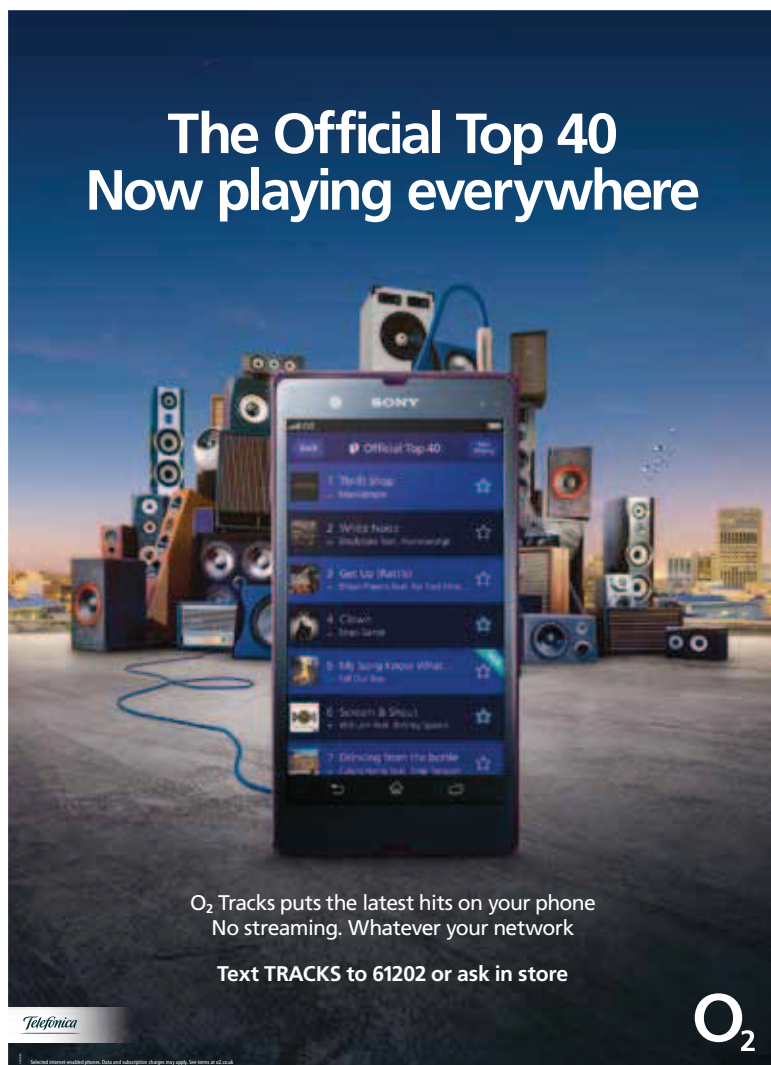
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Telefónica

vivo Conectados vivemos melhor



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Now playing everywhere

O₂ Tracks puts the latest hits on your phone
 No streaming. Whatever your network

Text TRACKS to 61202 or ask in store

Telefónica

O₂

Selected internet enabled phones. Data and subscription charges may apply. See terms at o2.co.uk

Current map of Brand Architecture

Institutional brand

Telefónica

Commercial brands

Core business

 **movistar**

O₂

vivo

Social commitment and innovation

Telefónica
FUNDACIÓN

ESP/ACIO
FUNDACIÓN TELEFÓNICA

think big
proniño

Atam
talentum

wayra

Amérigo

BlueVia

Other brands

Communications

Contents

Vertical

Services

acens
en colaboración con

FONIC

TU

terra

wanda
Tu nuevo móvil

Pleyade

Antares

tuenti

giffgaff

giffgaff

sonora

@onthespot

fonditel

tgestiona

Elasticity of the Company's brands has enabled it to enter and compete in the digital world

important and soundest corporations. On the other hand, Telefónica thus obtains greater visibility and reinforces its image among investors, analysts and multinationals, which facilitates the launch of global offers, especially in the digital world.

The elasticity of the Telefónica brands and their innovation attributes have enabled the Group to enter and compete in the digital world with significant launches in financial services (Wallet), telemedicine and M2M, among others.

In addition, two independent low cost brands have been created to compete in the European youth segment: 48 and Tuenti mobile.

Brand perception

Movistar, O2 and Vivo are among the brands held in highest esteem by the clients. They have a good reputation: they are in first and second place amongst the highest valued in all of the markets where they are present.

O2 led the Digital Brand Champion ranking made by the WIWO (Wirtschaftswoche) from among the 60 most recognized firms in Germany. It assessed the digital relationship of the brand with its audiences and identity codes, as well as its innovation and digital leadership.

Telefónica has been recognized as the most admired non-American Telco by Fortune Most Admired Companies.

77,000

items reviewed in 2012 under Brand Guardian

1,480

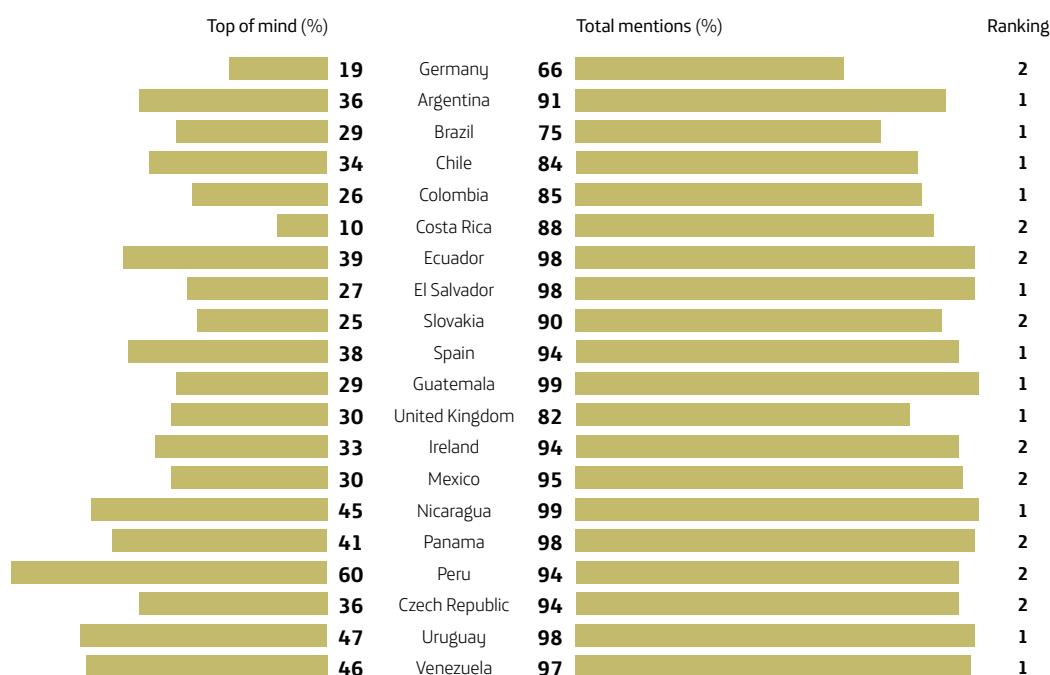
items reviewed weekly to meet the brand requirements

93%

of marketing and advertising output carried the "on-brand" issue code

Spontaneous brand recognition

Total accumulated data, 2012



Data obtained from TPSM of Milward Brown, accumulated from the total for 2012. Mobile phone category.

Telefónica has taken up the challenge of offering its clients brands consistent with the Company's positioning

Brand management

Telefónica has consolidated the global process of Brand Guardian, which seeks the coherence and consistency of its brands. It is a question of achieving maximum recognition and relevance in its global, regional and local audiences. In 2012, this system has reviewed over 77,000 communication and marketing items, which has represented a weekly volume of 1,480. In other words, over 93% of the work that went through the system had an on-brand issue code.

maintaining a two-way dialogue with all of its clients.

Challenges

- Achieve a greater bond between the commercial brands and the institutional support of Telefónica at the global level.
- Build brands closer to consumers.
- Design the brand management tools, Brand Guardian, Brand Room and training to facilitate knowledge of all of the brands.
- Extend the brands so as to offer digital services beyond connectivity.

Looking to the future

In an increasingly digital environment, with no geographical barriers and new competitors and clients who demand greater quality, service, simplicity and responsibility from the brands, Telefónica is facing the challenge of offering its users a brand experience consistent with the Company's positioning and values. To do this, it can count upon the latest technologies and full digitalization of its brands. Thanks to this, it is seen as communicating with the environment, selling its services, offering support and, finally,

VALUE FOR EVERYONE

Commitment to society

Telefónica is committed to helping the development of the communities in which it operates.

Telefónica's investment in social projects reached 158 million euros, more than the year before

Telefónica is committed to improving people's lives and the economic and social development of the communities where it is present. To this end, the Company foment and develops values and projects capable of transforming ideas into responses to social needs. The idea is that the expected economic return also manifests itself in benefits for the whole community. This commitment is developed in three basic ways: through disability, social and cultural action, and supporting the young and entrepreneurs.

The Company is working for a digital society for everybody and seeks technological inclusion for the disabled, and to help young people by means of encouraging ideas. What stands out among Telefónica's activities is: fomenting ideas through the programs 'Wayra' and 'Campus Party'; helping youth through 'Talentum' and 'Think Big'; and from the perspective of integrating the disabled, the Ability Awards and the work of ATAM.

Commitment to disability

Within Telefónica's initiatives to support people with disability, the Ability Awards are especially noteworthy. The Awards seek to recognise those companies and institutions which develop sustainable business models and which include those with disabilities in their value creation chains, whether as employee,

supplier and/or customer. Apart from this, we should underline the important efforts of ATAM, to which Telefónica contributed 14 million euros in 2012, and from which over 10,000 people benefited.

Social and cultural action

This year Telefónica contributed 158 million euros for projects directed at the young, childhood, education, social development and cultural activities related to the use of digital technologies. The role played by Fundación Telefónica in projects of education and commitment to childhood should also be highlighted.

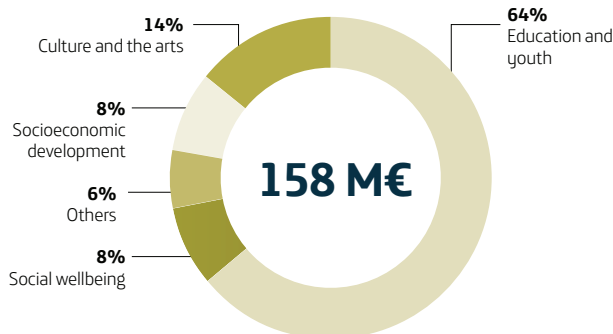
But in addition, Telefónica puts its human resources at the disposal of various social challenges and at the same time, offers its employees the chance to participate in this commitment with voluntary action. Along these lines, the Company promotes the development of the Telefónica Volunteers Program managed by Fundación Telefónica in collaboration with the areas of Corporate Responsibility, Human Resources and Communication. The objective: to promote social action and the collaboration of Telefónica's employees, forming an international network of professionals who carry out solidarity actions with social impact. During 2012, more than 24,000 staff members from 24 countries participated in some activity or campaign in the world. They dedicated 188,951 hours to 1,458 initiatives on three continents.

Over 337,000
children and adolescents attended by
the program 'Proniño'

Over 188,951
hours of volunteer work by
Company employees

Social action

Investment 2012



Source: investment in social projects according to the LBG criteria.

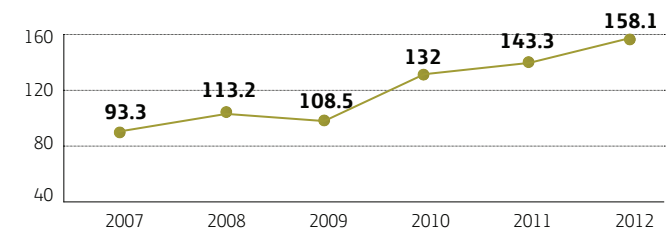
Investment by regions

42% Total Europe

58% Total Latin America

Evolution of investment

Millions of euros



With enterprise and the young

'Wayra' is the link between startups and Telefónica, offering entrepreneurs the potential of the markets in which Telefónica is present, with close to 316 million customers. It also provides them with access to its vast network of partners and businesses all over the world. Many of the projects which 'Wayra' accelerates fit with strategic areas key for Telefónica's business, such as OTT applications, financial services and cloud computing. In 2012, this initiative has given impetus to over 180 companies in which Telefónica has invested, so stimulating their capacity to create employment and undertake commercial activity.

'Campus Party', of which Telefónica is a key global member, is the world's largest technology festival, which combines innovation, creativity, science and digital entertainment. For seven days, thousands of campuseros live on-site in a unique environment where lectures, workshops, competitions and hackathons take place simultaneously. Editions of 'Campus Party' have been held in Spain and Latin America and it is planned to hold them soon in the United States and Europe.

'Talentum' is the project with which Telefónica seeks to drive young university talent and open doors for the coming generations to give them the tools and support necessary. Its principal objective is to encourage them to participate

in the creation of a new European digital world. 'Talentum' *Universities* is a program of long-term grants which brings young graduates closer to the reality of business, by fomenting their integration into the labour market. For its part, 'Talentum Startups' is aimed at students in the later years of degree courses who want to improve society with technology. Telefónica supports them by means of grants. Through the distinct modes of 'Talentum' over 1,500 young professionals have been incorporated into one of the companies of Telefónica Europe.

'Think Big' is the Company's bet on young people between 13 and 25. This is an innovation and social enterprise program that operates in all countries where the Group is present. It has a double objective: on the one hand, it offers participants the chance to implement an idea which benefits their community, and on the other, it publicises the ideas and stories of these entrepreneurs to encourage others to take the reins of their future. More than 2,700 projects have already been financed. Participants receive face-to-face and online training, the support of a mentor, and a small sum of money. To put it another way: 'Think Big' seeks to facilitate things for those who present original initiatives aimed at modifying their daily context so as to become active agents of the so necessary social change.

The 'Proniño' program catered for over 337,000 children and teenagers in 2012

Over €14m

allocated to the social integration of people with disability

Over 2,700

young people's ideas financed through 'Think Big'

Over 180

new companies boosted by 'Wayra'

VALUE FOR EVERYONE

Sustainability, a tool for creating value

Telefónica's Business Principles permit the generation of trust and make the Company more competitive. Corporate Sustainability is a business approach which aims to create long-term value through the efficient risk and opportunities management of issues related to economic, environmental and social development.

Telefónica builds its reputation by its Business Principles, gaining the confidence of its stakeholders and maximizing long term shareholder value and to society in general

Lines of progress

The creation of value by taking opportunities and the effective management of the risks inherent to economic, environmental and social development, is the focus of sustainability as a motor of responsible management and a lever of progress. For Telefónica, business transparency and managing integrity, as covered by its Business Principles, permit the generation of trust in the markets and between stakeholders and the Company. Sustainability can be taken as a synonym for competitiveness because it helps to reduce the risk premium, augments the value of the brand and differentiation for customers, improves the loyalty of employees, guarantees a stable Company project, and from society's point of view, cements its legitimacy to operate and permits sustainable development of the communities where the Company is present.

At Telefónica, projects are analysed from a triple perspective: growth in activity, increase in profitability and reduction of risk and impact for society.

2012 achievements

Within the 14 projects identified with impact in sustainability, it is worth noting the advances made in methodologies for identification and quantification of reputational risks stand out. In the area of the Group's Business Principles, their ratification at Telefónica Brazil should be mentioned.

As regards data protection and privacy, in 2012 a Privacy Task Force was formed, where all areas of the Company related directly or indirectly to this subject have a voice. Its objective: to devise a global privacy policy and strengthen Telefónica's positioning in this area.

In 2012, Telefónica carried out an evaluation of the impact of the Group in the area of human rights. Similarly, the Company signed the Guiding Principles of Privacy and Freedom of Expression of the ICT Sector and developed the *Methodological Guide to Identify and Evaluate Child Labour Risks*.

In the environmental field, in 2012 Telefónica positioned itself among the five leading

73,700

employees trained in the ethics code

19.4%

increased proportion of women managers in the Company

47%

more internal audits in the area of data protection

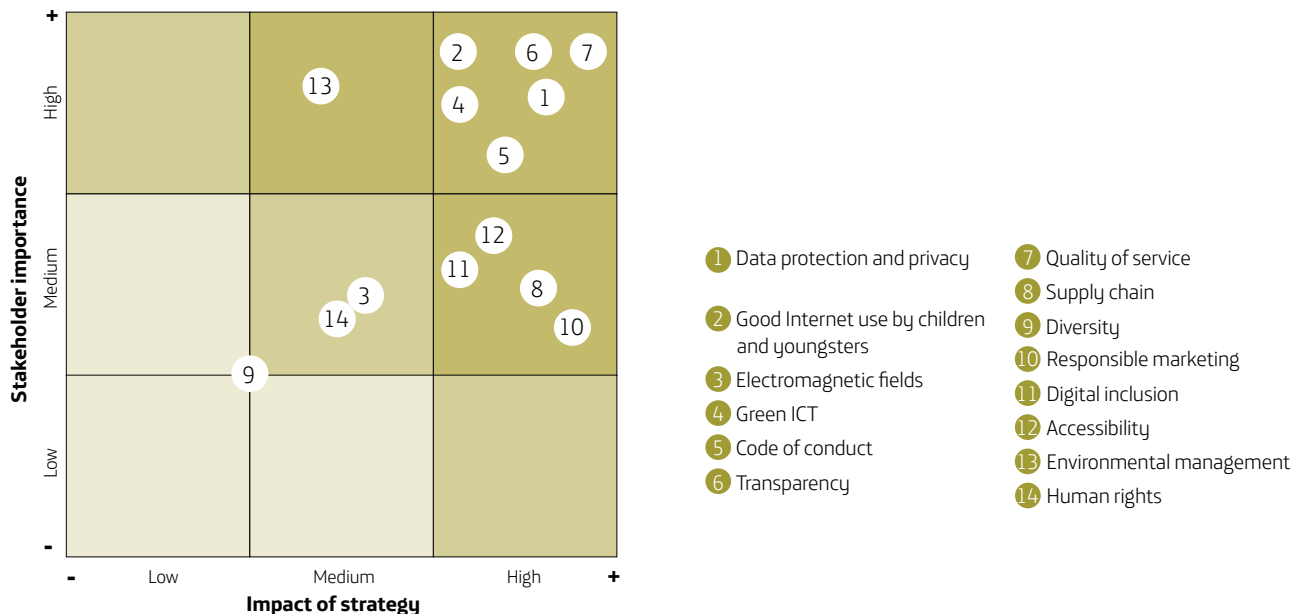
1,244

'in situ' audits of providers carried out

In top 5

leading telecoms companies in the CDP

Materiality matrix



telecom companies in the world in the Carbon Disclosure Project (CDP). The Company also made important contributions to the work of the International Telecommunication Union (ITU) in the development of methodologies to measure the environmental impact of Green ICT services and ICT in cities. The advances we made in the energy efficiency field stood out, with over 35 projects introduced in 2012 and direct savings of 5 million euros, with 75% of the energy reduction target achieved. Telefónica also established a new objective in 2012 for reducing CO₂ emissions per customer by 30% a year by 2020.

In the social area, there were some important digital inclusion projects. The holding in Peru of the second edition of 'ConectaRSE para crecer', a competition to identify the best ICT initiatives in rural areas of the country, and the launch of Wanda, the Company created jointly with MasterCard to develop mobile payments in Latin America, illustrate the work of the Company in these areas. In a different area, the M-Inclusion project was launched, co-financed by the European Commission, to set up the first platform of social inclusion by means of mobile solutions in Europe and Latin America.

A look at the future

The European Commission published in April a proposal to amend the legislation on business reporting which would establish that companies of over 500 employees will be required to include relevant and material environmental, social, staff, corruption, diversity and human rights information in their annual reports. Apropos of this, Telefónica is convinced that companies that are transparent in their financial and non-financial communication are more efficient and generate greater competitiveness and more jobs.

Challenges

The objective of Telefónica's sustainability policy is its integration into the DNA of all its businesses, and to so keep a watch over all the reputational risks that might affect the Company. For this, the Company should advance in the implementation of the risk management methodology in all business units. Likewise, given the fundamental nature of the issues of privacy and data protection, communication and implementation of policies related to these questions are important. The Company should also continue working to position ICT at the heart of the solution to climate change and as a motor of eco-efficiency in the world. Its role is to contribute to actions of mitigation of and adaptation to climate change, and to support initiatives which foment competitiveness in cities and in strategic sectors of the economy using efficient communication networks and Green ICT solutions.

The Company wants to use Green ICT services to promote a low-carbon economy and encourage competitiveness



Access the full Corporate Sustainability Report via the QR code.



THE VALUE OF RISK MANAGEMENT

Security in the face of uncertainty

Telefónica has a consistent, common methodology throughout the whole Group for how to deal with risks. This is an effective weapon with which it strengthens its commitment to suppliers and shareholders.

All risks are classified and subjected to a single management model

Risks are inherent to all businesses and business activities. The effective management of risks, as well as constituting a key component of internal control systems, contributes to meeting business objectives and the commitment of the organization to shareholders and customers.

For this, Telefónica has implemented a risk management system uniformly throughout the Group's main operations. It is designed so that those in charge in the Company, each in their area of responsibility, can carry out a timely identification, evaluation, response and follow-up of the risks.

The Company's model for dealing with risks is inspired by best market practice in this area and defines 60 types.

Classification of risks

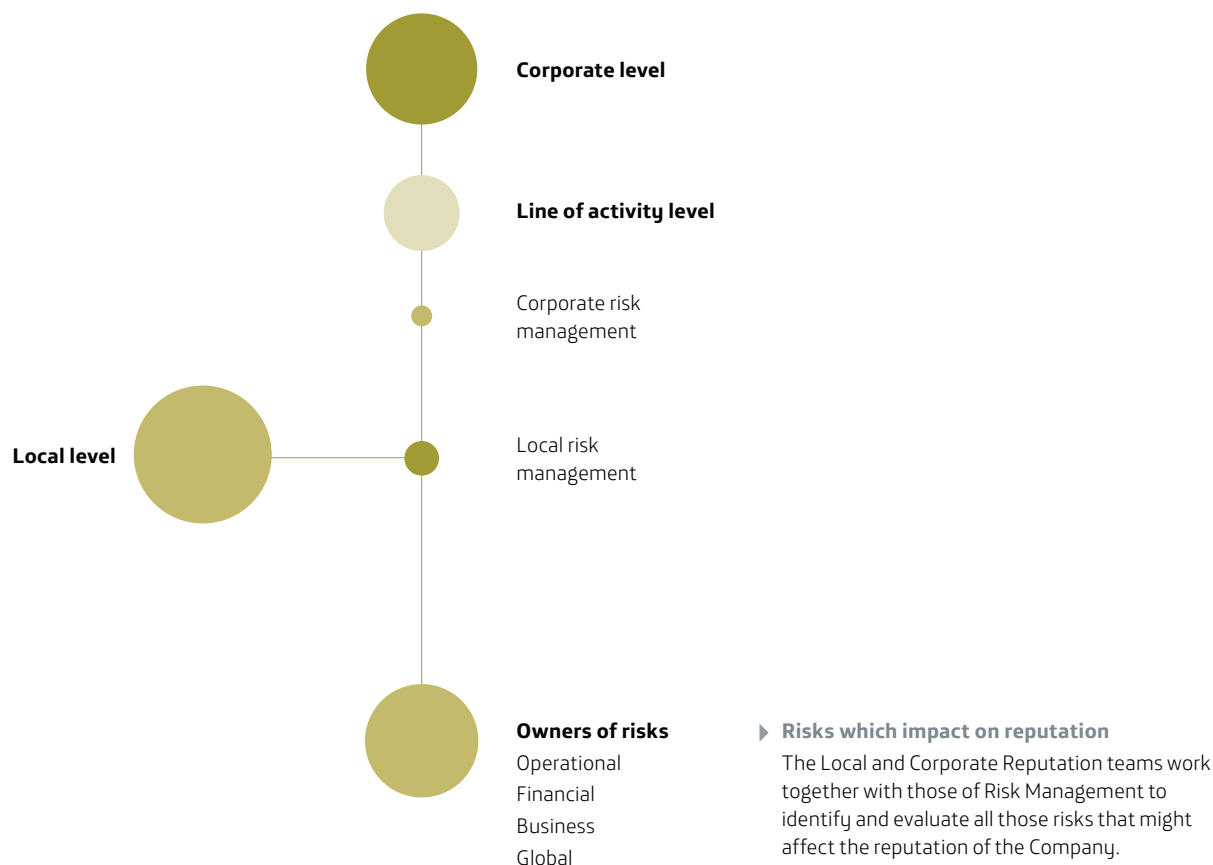
Telefónica Group's business is conditioned both by factors exclusive to it and by those common to any company in the telecoms sector. Therefore, it is considered that the business, the financial situation and the results of the Company may be affected by certain significant risks and uncertainties which fall into four main categories:

- Business
- Operational
- Financial
- Global

Process of risk management



Reporting workflow in risk management



Principal risks identified

Business

- Country risk (investments in Latin America)
- Risk arising from the current world economic situation
- Strongly regulated markets
- Highly competitive markets subject to continuous technological evolution
- Limitations of spectrum

Operational

- Shortage of supplies from providers
- Risks associated with unforeseen network interruptions
- Risks related to the Internet

Financial

- Risk with interest and exchange rates
- Risk arising from dependence on sources of external finance
- Risks related to possible asset impairment

Global

- Radio frequency emissions and potential health risks

60 types
of risks catalogued

4 categories:
business, financial, operational and global