

REPORT OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A. REGARDING THE PROPOSED REDUCTION IN SHARE CAPITAL THROUGH THE CANCELLATION OF SHARES OF THE COMPANY'S OWN STOCK, EXCLUDING THE RIGHT OF CREDITORS TO OBJECT, AND AMENDMENT OF ARTICLE 5 OF THE BY-LAWS RELATING TO THE SHARE CAPITAL, WHICH IS TO BE SUBMITTED TO THE SHAREHOLDERS FOR APPROVAL AT THE ORDINARY GENERAL SHAREHOLDERS' MEETING (ITEM VII ON THE AGENDA).

1. PURPOSE OF THE REPORT

Item VII on the Agenda for the Ordinary General Shareholders' Meeting of Telefónica, S.A., called for May 13 and May 14, 2012, includes a proposal – which is submitted to the shareholders for approval at the General Shareholders' Meeting – regarding a reduction in share capital by an amount equal to the par value of certain shares of the Company's own stock that are to be cancelled, and the amendment of Article 5 of the By-Laws relating to the share capital.

In order for the Board to be able to submit the above-mentioned proposal for a reduction in share capital and the amendment of the By-Laws for approval at the General Shareholders' Meeting, it is mandatory, pursuant to the provisions of Sections 286 and 318 of the Companies Act (*Ley de Sociedades de Capital*), that the Board of Directors prepare a report providing the rationale for the proposal, inasmuch as the approval of such proposal and the implementation thereof necessarily entail an amendment of Article 5 of the By-Laws regarding the amount of share capital and the number of shares into which it is divided.

2. RATIONALE FOR THE PROPOSAL

Within the framework of the shareholder compensation policy established by the Company and in order to contribute thereto, the Board of

Directors believes it advisable to proceed to cancel certain shares held as treasury stock, with the ensuing reduction of the share capital by an amount equal to the par value of such shares. The Company can thus reduce its treasury stock and continue with the policy of acquiring its own shares and, therefore, of increasing the earnings per share of the Company, thereby benefiting its shareholders.

If the resolution providing for a reduction in share capital contemplated in this report is adopted, Article 5 of the By-Laws of the Company would be amended to set forth the new amount of share capital and the new number of outstanding shares into which such amount is divided (after deducting the shares of treasury stock acquired by the Company and the cancellation of which is proposed).

In order to expedite the implementation of this resolution, it is further proposed that the shareholders at the General Shareholders' Meeting authorize the Board of Directors to implement such resolution (with the power to delegate, in turn, to the Executive Commission, to the Executive Chairman of the Board of Directors, or to any other person expressly authorized by the Board of Directors for such purpose) within a time limit of one year from the date of adoption of such resolution, without needing to first consult with the shareholders at a General Shareholders' Meeting.

In addition, it is deemed appropriate, in order to provide for greater ease of implementation and as permitted by Section 335 c) of the Companies Act, not to apply the right of creditors to object provided for in Section 334 of the Companies Act, and to allocate the amount of the par value of the cancelled shares to a reserve for repurchases of share capital, which may only be used by complying with the same requirements as those established for a reduction in share capital.

Based on these premises, it is proposed to the shareholders at the General Shareholders' Meeting to reduce the share capital by the amount of 84,209,363 euros by cancelling 84,209,363 shares of the Company's treasury

stock (representing 1.85% of the current share capital of the Company) and to authorize the Board of Directors to implement such resolution within a period of one year.

3. PROPOSED RESOLUTION SUBMITTED TO THE SHAREHOLDERS FOR APPROVAL AT THE ORDINARY GENERAL SHAREHOLDERS' MEETING

The resolutions that the Board of Directors proposes to the shareholders for approval at the Ordinary General Shareholders' Meeting in connection with this matter are the following:

- A) *To reduce the share capital of the Company by the amount of 84,209,363 euros, by means of the cancellation of 84,209,363 shares of the Company's treasury stock, number of shares of the Company's treasury stock at 31st December 2011, which were previously acquired in reliance on the authorization previously granted by the shareholders at the General Shareholders' Meeting, within the limits established in Sections 146 and 509 of the Companies Act. Accordingly, Article 5 of the By-Laws regarding the amount of share capital is hereby amended and shall henceforth read as follows:*

"Article 5.- Share Capital

- 1. The share capital is 4,479,787,122 euros, represented by 4,479,787,122 ordinary shares in a single series and with a nominal value of one euro each, which have been fully paid up.*
- 2. The shareholders acting at the General Shareholders' Meeting may, subject to the requirements and within the limits established by law for such purpose, delegate to the Board of Directors the power to increase the share capital."*

The reduction of the share capital is made with a charge to discretionary reserves, cancelling the corresponding amount of the restricted reserve mentioned in Section 148 c) of the Companies Act, and funding a reserve due to capital reduction in the amount of 84,209,363 euros (an amount equal to the par value of the cancelled shares) which may only be used by complying with the same requirements as those established for the reduction of the share capital, pursuant to the provisions of

Section 335 c) of the Companies Act. Accordingly, as provided therein, the creditors of the Company shall not have the right to object mentioned in Section 334 of the Companies Act in connection with the capital reduction resolved to be made.

The reduction does not involve a return of contributions, since the Company itself is the owner of the cancelled shares. The purpose of the reduction will thus be to cancel the shares of treasury stock.

It is hereby stated for the record, for purposes of the provisions of Section 411.1 of the Companies Act, that the consent of the Bondholders' Syndicates under the issuances of outstanding debentures and bonds is not required inasmuch as the approved capital reduction does not reduce the original proportion between the sum of capital plus reserves and the amount of the debentures pending repayment.

- B) To authorize the Board of Directors to determine, within one year from the date of adoption of this resolution, any other matters that have not been expressly established in this resolution or that are a result hereof, and to adopt the resolutions, take the actions and execute the public or private documents that may be necessary or appropriate for the full implementation of this resolution, including, without limitation, the publication of the legally required notices, the making of the appropriate applications and the giving of the appropriate notices required to delist the cancelled shares; such powers may be delegated by the Board of Directors to the Executive Commission, to the Executive Chairman of the Board of Directors, or to any other person expressly authorized by the Board of Directors for such purpose.*

Madrid, April 10, 2012