

REPORT OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A. REGARDING THE PROPOSED AUTHORIZATION TO THE BOARD OF DIRECTORS TO INCREASE THE SHARE CAPITAL AND EXCLUDE PRE-EMPTIVE RIGHTS, WHICH WILL BE SUBMITTED FOR APPROVAL BY THE SHAREHOLDERS AT THE ANNUAL GENERAL SHAREHOLDERS' MEETING (ITEM VI ON THE AGENDA).

1. PURPOSE OF THIS REPORT

The Agenda for the Annual General Shareholders' Meeting of Telefónica, S.A., called for May 17 and 18, 2011, on first and second call, respectively, includes in item VI thereof a proposal regarding authorizing the Board of Directors to increase the Company's share capital up to the maximum limit established by Law, with the resulting amendment of Article 5 of the By-Laws regarding the amount of share capital and the number of shares into which it is divided, and also delegating the power to exclude pre-emptive rights with respect to the issuances of shares under such authorization when the interests of the Company so require.

This Report is prepared in compliance with the provisions of Sections 286, 297.1.b) and 506 of the Companies Act (*Ley de Sociedades de Capital*) (the "**Companies Act**") approved by Royal Legislative Decree 1/2010, of July 2, in order to provide a rationale for such proposed authorization to the Board of Directors to increase the share capital, including the delegation of the power to exclude pre-emptive rights, and which is submitted for approval of the shareholders acting at the General Shareholders' Meeting.

2. RATIONALE FOR THE PROPOSAL

Section 297.1.b) of the Companies Act gives authority to the shareholders at a General Shareholders' Meeting to delegate to the Board of Directors the power to approve an increase in share capital on one or more occasions up to a particular amount, at the times and in the amounts that it

decides, without previous authorization of the shareholders, and while meeting the requirements provided for amending the By-Laws. The law provides that such increases may not in any event exceed one-half of the capital of the Company at the time of the authorization and must be made by means of cash contributions within a maximum period of five years from the date of the shareholders' resolution.

The Board of Directors believes that the proposed amendment submitted for approval of the shareholders at the General Shareholders' Meeting is justified by the appropriateness of the mechanism provided for by current corporate law allowing for the approval of one or more increases in share capital without a subsequent call to and holding of a new General Shareholders' Meeting, but within the limits, terms and conditions approved by the shareholders. This is intended to give the Company's management decision-making body quick responsiveness to act within an environment in which the success of a strategic initiative frequently depends on the ability to rapidly implement it, without the costs and delays involved in the holding of a General Shareholders' Meeting.

Market requirements demand that commercial companies, and especially listed companies, cause their governance and management bodies to be in a position to make use of the abilities provided by the regulatory framework to provide a quick and efficient response to the needs arising within the business environment in which large companies are currently operating.

Pursuant to Section 297.1 b) of the Companies Act, the proposal contemplates that payment of the shares issued be made in the form of cash contributions, and expressly provides for the possibility of an incomplete subscription for shares issued, pursuant to the provisions of Section 311 of such Act. In addition, the proposed resolution submitted at the General Shareholders' Meeting includes an authorization to the Board of Directors to take all steps required for the new shares covered by the capital increase to be admitted to trading on the Stock Exchanges on which the Company's shares are listed.

The proposal is completed with an authorization to the Board of Directors such that it may in turn delegate such delegable powers as have been received from the shareholders acting at the General Shareholders' Meeting.

Furthermore, pursuant to the provisions of Section 506 of the current Companies Act, the delegation to the Board of Directors to increase share capital contained in the proposal to which this Report refers includes the grant to the Directors of the power to exclude pre-emptive rights, subject to the provisions of the above-mentioned Section 506 of the Act as to the requirements, conditions and formalities established therein and in related provisions of the Act.

The Board of Directors believes that this power to exclude pre-emptive rights as a supplement to the power to increase capital is justified for various reasons. First, the exclusion of pre-emptive rights tends to reduce the costs associated with the transaction (especially the fees of the financial institutions participating in the issuance) as compared to an issuance with pre-emptive rights. Second, with the power to exclude pre-emptive rights, the Directors are able to considerably speed the actions and responses required by current financial markets, allowing the Company to take advantage of those times at which market conditions are most favorable. In addition, the exclusion of pre-emptive rights causes lesser distortion of trading in the Company's shares during the time of issuance, which tends to be shorter than an issuance with rights.

In any event, the total or partial exclusion of pre-emptive rights is a power granted to the Board of Directors by the shareholders acting at the General Shareholders' Meeting, and therefore, such power will be exercised within the discretion of the Board of Directors itself, with due regard to the circumstances and in compliance with all legal requirements.

In the event that the Board of Directors decides to make use of the power to exclude pre-emptive rights with respect to a specific increase in capital

that it approves in the use of the authorization granted by the shareholders at the General Shareholders' Meeting, the Directors' report and Auditor's report required by Section 308 of the Companies Act must be prepared. Both reports must be made available to the shareholders and notice thereof given to them at the next General Meeting held after the resolution providing for the increase, as required by the provisions of Section 506 of the Companies Act.

3. **PROPOSED RESOLUTION SUBMITTED FOR APPROVAL BY THE SHAREHOLDERS AT THE ANNUAL GENERAL SHAREHOLDERS' MEETING ITEM VI ON THE AGENDA**

The resolution that the Board of Directors submits for approval by the shareholders acting at the General Shareholders' Meeting in connection with this item on the Agenda reads as follows:

“VI. Authorization granted to the Board of Directors to increase the share capital pursuant to the terms and conditions of Section 297.1.b) of the Companies Act, over a maximum period of five years, delegating the power to exclude pre-emptive rights pursuant to Section 506 of the Companies Act.

To authorize the Board of Directors, as broadly as necessary under the law, in order that, under Section 297.1.b) of the Companies Act, it may increase the share capital on one or more occasions and at any time, within the term of five years as from the date of this General Shareholders' Meeting, by up to the maximum amount of 2,281,998,242.50 euros, equal to one-half of the Company's current capital. Capital increases pursuant to this authorization shall be made through the issuance and placement into circulation of new shares – with or without a premium – the consideration for which shall consist of cash contributions. For each increase, the Board of Directors shall determine whether the new shares to be issued are common, preferred, redeemable, non-voting or any other type permitted by Law. The Board of Directors may also determine, to the extent not otherwise provided, the terms and conditions applicable to the

capital increases and the characteristics of the shares, expressly providing for the possibility of an incomplete subscription, as well as freely offer new unsubscribed shares during the period or periods for exercise of pre-emptive rights. The Board of Directors may also establish that, in the event of incomplete subscription, the capital shall only be increased by the amount of the subscriptions made and may amend the article of the By-Laws relating to capital and number of shares.

Likewise, with respect to capital increases made pursuant to this authorization, the Board of Directors is authorized to totally or partially exclude pre-emptive rights as permitted by Section 506 of the Companies Act.

Whenever appropriate, the Company shall make application for listing on Spanish or foreign, official or unofficial, organized or other secondary markets of the shares issued by the Company pursuant to this delegation of powers, and the Board of Directors is authorized to conduct all formalities and take all actions that may be necessary for admission to listing with the appropriate authorities of the various Spanish or foreign securities markets on which the shares of the Company are listed.

Under the provisions of Section 249.2 of the Companies Act, the Board of Directors is expressly authorized, in turn, to delegate the powers granted in this resolution.”

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Madrid, April 8, 2011