TELEFONICA S A
Form 20-F
April 12, 2006

**As filed with the Securities and Exchange Commission on April 12, 2006**

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 20-F

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF**
**THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2005

**Commission file number: 1-9531**

# TELEFÓNICA, S.A.

(Exact name of Registrant as specified in its charter)

**KINGDOM OF SPAIN**
(Jurisdiction of incorporation or organization)

**Gran Vía, 28, 28013 Madrid, Spain**
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Ordinary Shares, nominal value €1.00 per share*** | **New York Stock Exchange** |
| **American Depositary Shares, each representing three Ordinary Shares** | **New York Stock Exchange** |

* Not for trading, but only in connection with the listing of American Depositary Shares, pursuant to the requirements of the New York Stock Exchange.

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

The number of outstanding shares of each class of capital stock of Telefónica, S.A. at December 31, 2005 was:

**Ordinary Shares, nominal value €1.00 per share: 4,921,130,397**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

**Yes x** **No o**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

**Yes x** **No o**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

**Large accelerated filer x** **Accelerated filer o** **Non-accelerated filer o**

Indicate by check mark which financial statement item the registrant has elected to follow.

**Item 17 o** **Item 18 x**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

**Yes o** **No x**

**TABLE OF CONTENTS**

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the U.S. Securities Exchange Act of 1934, as amended, and the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The forward-looking statements in this Annual Report can be identified, in some instances, by the use of words such as "expect", "aim", "hope", "anticipate", "intend", "believe" and similar language or the negative thereof or by the forward-looking nature of discussions of strategy, plans or intentions. These statements appear in a number of places in this Annual Report including, without limitation, certain statements made in "Item 3—Key Information—Risk Factors", "Item 4—Information on the Company" and "Item 5—Operating and Financial Review and Prospects" and include statements regarding our intent, belief or current expectations with respect to, among other things:

- the effect on our results of operations of competition in the Spanish telecommunications market and our other principal markets;
- trends affecting our financial condition or results of operations;
- acquisitions or investments which we may make in the future;
- our capital expenditures plan;
- our estimated availability of funds;
- our ability to repay debt with estimated future cash flows;
- our shareholder remuneration policies;
- supervision and regulation of the Spanish telecommunications sector and of the telecommunications sectors in other countries where we have significant operations;
- our strategic partnerships; and
- the potential for growth and competition in current and anticipated areas of our business.

Such forward-looking statements are not guarantees of future performance and involve numerous risks and uncertainties, and actual results may differ materially from those anticipated in the forward-looking statements as a result of various factors. The risks and uncertainties involved in our businesses that could affect the matters referred to in such forward-looking statements include but are not limited to:

- changes in general economic, business or political conditions in the domestic or international markets in which we operate or have material investments that may affect demand for our services;
- changes in currency exchange rates and interest rates;
- the impact of current, pending or future legislation and regulation in Spain, the European Union and other countries where we operate;
- the actions of existing and potential competitors in each of our markets;
- the outcome of pending litigation; and
- the potential effects of technological changes.

Some of these and other important factors that could cause such differences are discussed in more detail under "Item 3—Key Information—Risk Factors", "Item 4—Information on the Company", "Item 5—Operating and Financial Review and Prospects" and "Item 11—Quantitative and Qualitative Disclosures About Market Risk".

3

Readers are cautioned not to place undue reliance on those forward-looking statements, which speak only as of the date of this Annual Report. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date of this Annual Report including, without limitation, changes in our business or acquisition strategy or planned capital expenditures, or to reflect the occurrence of unanticipated events.

## CERTAIN TERMS AND CONVENTIONS

Our ordinary shares, nominal value one euro each, are currently listed on each of the Madrid, Barcelona, Bilbao and Valencia stock exchanges under the symbol “TEF”. They are also listed on various foreign exchanges such as the London, Frankfurt, Paris, Buenos Aires and Tokyo stock exchanges and are quoted through the Automated Quotation System of the Spanish stock exchanges and through the SEAQ International System of the London Stock Exchange. American Depositary Shares (“ADSs”), each representing the right to receive three ordinary shares, are listed on the New York Stock Exchange under the symbol “TEF” and on the Lima Stock Exchange. ADSs are evidenced by American Depositary Receipts (“ADRs”) issued under a Deposit Agreement with Citibank, N.A., as Depositary. Brazilian Depositary Shares (“BDSs”), each representing the right to receive one ordinary share, are listed on the São Paulo Stock Exchange. BDSs are evidenced by Brazilian Depositary Receipts (“BDRs”) issued under a Deposit Agreement with Banco Bradesco, S.A., as Depositary.

As used herein, “Telefónica”, “Telefónica Group” and terms such as “we”, “us” and “our” mean Telefónica, S.A. and it consolidated subsidiaries unless the context otherwise requires.

Following are definitions of certain technical terms used in this Annual Report:

“Access” refers to a connection to any of the telecommunications services offered by the Telefónica Group. We present our customer base using this model because the integration of telecommunications services in bundled service packages has changed the way residential and corporate customers contract for our services. Because a single customer may contract for multiple services, we believe it is more accurate to count the number of accesses, or services a customer has contracted for, as opposed to only counting our number of customers. For example, a customer that has fixed line telephony service and broadband service represents two accesses rather than a single customer: a fixed telephony access and a broadband access. The following are the main categories of accesses:

- Fixed Telephony accesses: includes PSTN lines (public switched telephone network), ISDN lines (integrated services digital network) and circuits. For purposes of calculating our number of fixed line accesses, we multiply our lines to service as follows: PSTN (x1); basic ISDN (x1); primary ISDN (x30, 20 or 10); 2/6 digital access (x30);

- Internet and data accesses: includes broadband accesses (wholesale ADSL and retail ADSL lines), narrowband accesses (internet service through the PSTN) and other accesses (unbundled local loops, circuits and other accesses including WiFi and fiber optic cable);

- Pay TV: includes cable TV and Imagenio IP TV (Internet Protocol TV); and

- Mobile accesses: includes mobile telephony.

## PRESENTATION OF CERTAIN FINANCIAL INFORMATION

In this Annual Report, references to “dollars” or “$” are to United States dollars, references to “euro” or “€” are to th single currency of the participating member states in the Third Stage of the European Economic and Monetary Union pursuant to the treaty establishing the European Community, as amended from time to time.

Since January 1, 2005, our consolidated annual and interim financial statements, including our consolidated financial statements as of and for the year ended December 31, 2005, are and will be prepared in accordance with the International Financial Reporting Standards adopted by the European Union (IFRS). IFRS, as adopted by the European Union and applied by us in our consolidated financial statements as of and for the year ended

December 31, 2005, do not differ from IFRS, as published by the International Accounting Standards Board (IASB), effective as of December 31, 2005, and therefore, comply in full with IFRS, as published by the IASB. Our consolidated financial information as of and for the year ended December 31, 2004 included in our annual consolidated financial statements was restated in accordance with IFRS. For quantitative information regarding the adjustments required to reconcile our Spanish GAAP financial information to IFRS, see note 2 to our consolidated financial statements as of and for the year ended December 31, 2005 prepared under IFRS.

**IFRS differs in certain significant respects from Spanish GAAP. As a result, our financial information presented under IFRS is not directly comparable to our financial information presented under Spanish GAAP, and readers should avoid such a comparison.**

# PART I

## ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

### A. DIRECTORS AND SENIOR MANAGEMENT

Not applicable.

### B. ADVISORS

Not applicable.

### C. AUDITORS

Not applicable.

## ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

## ITEM 3. KEY INFORMATION

### A. SELECTED FINANCIAL DATA

The following table presents selected consolidated financial data of Telefónica, S.A. You should read this table in conjunction with Item 5Operating and Financial Review and Prospects and the Consolidated Financial Statements included elsewhere in this Annual Report. The consolidated income statement data for the years ended December 31, 2004 and 2005 and the consolidated balance sheet data as of December 31, 2004 and 2005 set forth below are derived from, and are qualified in their entirety by reference to, the Consolidated Financial Statements and notes thereto included in this Annual Report. Our Consolidated Financial Statements have been prepared in accordance with IFRS, which differ in certain respects from U.S. GAAP. Please refer to note 23 to our Consolidated Financial Statements for a discussion of these differences.

The basis of presentation and principles of consolidation are described in detail in notes 2 and 4.z, respectively, to our Consolidated Financial Statements.

| | As of or for the year ended December 31, | |
|---|---|---|
| | **2004** | **2005** |
| | **(euro in millions, except per share and ADS data)** | |
| **IFRS** | | |
| **Consolidated Income Statement Data** | | |
| Net sales and rendering of services | 30,280.92 | 37,882.16 |
| Other income | 1,133.41 | 1,418.26 |
| Supplies | (7,637.33) | (10,065.05) |
| Personnel expenses | (5,095.17) | (5,656.34) |
| Other expenses | (6,459.80) | (8,302.60) |

| | | |
|---|---|---|
| Operating income before depreciation and amortization (OIBDA) | 12,222.03 | 15,276.43 |
| Depreciation and amortization | (5,666.03) | (6,717.68) |
| Operating Income | 6,556.00 | 8,558.75 |
| Share of profit (loss) of associates | (50.49) | (128.21) |
| Net financial expenses | (1,462.06) | (1,796.37) |
| Net exchange differences | (177.05) | 162.04 |
| Net financial income (expense) | (1,639.11) | (1,634.33) |
| Profit before taxes from continuing operations | 4,866.40 | 6,796.21 |
| Corporate income tax | (1,512.78) | (1,969.15) |

| | As of or for the year ended December 31, | |
|---|---|---|
| | 2004 | 2005 |
| | (euro in millions, except per share and ADS data) | |
| Profit for the year from continuing operations | 3,353.62 | 4,827.06 |
| Profit from discontinued operations after taxes | 131.97 | — |
| Profit for the year | 3,485.59 | 4,827.06 |
| Minority interests | (309.92) | (381.21) |
| Profit for the year attributable to equity holders of the parent | 3,175.67 | 4,445.85 |
| Weighted average number of shares (thousands) | 4,987,751 | 4,870,852 |
| Earnings per share attributable to equity holders of the parent (euros)(1)(2) | 0.637 | 0.913 |
| Earnings per ADS(1)(2) | 1.910 | 2.738 |
| Weighted average number of ADS (thousands) | 1,662,584 | 1,623,617 |
| **Consolidated Balance Sheet Data** | | |
| Cash and cash equivalents | 914.35 | 2,213.21 |
| Property, plant and equipment | 23,193.37 | 27,992.60 |
| Total assets | 60,078.86 | 73,173.77 |
| Non-current liabilities | 27,742.58 | 35,126.47 |
| Equity (net) | 12,342.47 | 16,158.43 |
| Book value per ordinary share (euros) | 2.475 | 3.317 |
| **Consolidated Cash Flow Data** | | |
| Net cash provided by operating activities | 10,131.13 | 11,139.14 |
| Net cash used in investing activities | (5,808.16) | (9,592.02) |
| Net cash used in financing activities | (3,936.61) | (434.67) |
| Cash dividends per ordinary share (euros) | 0.400 | 0.500 |

| | As of or for the year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 |
| | (euro in thousands) | | | | |
| **U.S. GAAP(3)** | | | | | |
| **Consolidated Income Statement Data** | | | | | |
| Total revenues | 31,577.20 | 28,912.60 | 27,708.40 | 29,854.90 | 35,993.30 |
| Income (loss) before tax | (6,693.81) | (8,669.63) | 3,866.05 | 3,947.58 | 6,056.12 |
| Corporate income tax | (481.40) | 3,383.16 | (1,125.73) | (1,400.81) | (1,911.92) |
| Net income | (7,175.21) | (5,286.47) | 2,740.32 | 2,546.77 | 4,144.20 |
| Net income per share(1) | (1.403) | (1.027) | 0.531 | 0.511 | 0.851 |
| Net income per ADS(1)(2) | (4.210) | (3.082) | 1.594 | 1.532 | 2.552 |
| **Consolidated Balance Sheet Data** | | | | | |
| Total assets | 90,741.77 | 66,905.14 | 61,264.42 | 62,455.91 | 76,647.79 |

| | | | | | |
|---|---|---|---|---|---|
| Long-term debt | 27,771.20 | 21,778.00 | 18,310.00 | 14,881.90 | 25,167.58 |
| Shareholders equity | 31,470.47 | 16,667.84 | 16,888.02 | 15,872.85 | 19,221.96 |
| Book value per ordinary share | 6.155 | 3.239 | 3.274 | 3.182 | 3.946 |
| **Consolidated Cash Flow Data** | | | | | |
| Net cash provided by operating activities | 8,995.8 | 9,019.5 | 9,558.7 | 10,042.7 | 10,891.44 |
| Net cash used in (provided by) investing activities | (9,528.5) | (5,585.4) | (5,462.8) | (8,543.1) | (9,290.75) |
| Net cash used in (received from) financing activities | (1,347.0) | (2,082.0) | (4,220.0) | (2,264.6) | (803.53) |
| Cash dividends per ordinary share (euros)(1) | — | — | 0.450 | 0.400 | 0.500 |

(1) The per share and per ADS computations for all periods presented have been presented using the weighted average number of shares outstanding for each period, and have been adjusted to reflect the stock dividends which occurred during the periods presented, as if these had occurred at the beginning of the earliest period presented.

(2) Each ADS represents the right to receive three ordinary shares. Figures do not include any charges of the Depositary.

(3) U.S. GAAP data for the years ended December 31, 2001, 2002, 2003 and 2004 has been restated retroactively to eliminate the monetary adjustment for inflation in hyperinflationary economies. For additional information, please refer to note 23 to our Consolidated Financial Statements included elsewhere in this document.

**Exchange Rate Information**

As used in this Annual Report, the term Noon Buying Rate refers to the rate of exchange for euros, expressed in U.S. dollars per euro, in the City of New York for cable transfers payable in foreign currencies as certified by the Federal Reserve Bank of New York for customs purposes. The Noon Buying Rate certified by the New York Federal Reserve Bank for the euro on April 6, 2006 was $1.2216 = 1.00.

The following tables describe, for the periods and dates indicated, information concerning the Noon Buying Rate for the euro. Amounts are expressed in U.S. dollars per 1.00.

| | Noon Buying Rate | | | |
|---|---|---|---|---|
| **Year ended December 31,** | **Period end** | **Average(1)** | **High** | **Low** |
| 2001 | 0.8901 | 0.8909 | 0.9535 | 0.8370 |
| 2002 | 1.0485 | 0.9495 | 1.0485 | 0.8594 |
| 2003 | 1.2597 | 1.1411 | 1.2597 | 1.0361 |
| 2004 | 1.3538 | 1.2478 | 1.3625 | 1.1801 |
| 2005 | 1.1842 | 1.2400 | 1.3476 | 1.1667 |

*Source: Federal Reserve Bank of New York.*
(1) The average of the Noon Buying Rates for the euro on the last day of each month during the relevant period.

| | Noon Buying Rate | |
|---|---|---|
| **Month ended** | **High** | **Low** |
| October 31, 2005 | 1.2133 | 1.1914 |
| November 30, 2005 | 1.2067 | 1.1667 |
| December 31, 2005 | 1.2041 | 1.1699 |
| January 31, 2006 | 1.2287 | 1.1980 |
| February 28, 2006 | 1.2100 | 1.1860 |
| March 31, 2006 | 1.2197 | 1.1886 |
| April 30, 2006 (to April 6) | 1.2272 | 1.2124 |

*Source: Federal Reserve Bank of New York.*

Monetary policy within the member states of the euro zone is set by the European Central Bank. The European Central Bank has set itself the objective of containing inflation and will adjust interest rates in line with this policy without taking account of other economic variables such as the rate of unemployment. It has further declared that it will not set an exchange rate target for the euro.

Our ordinary shares are quoted on the Spanish stock exchanges in euro. Currency fluctuations may affect the dollar equivalent of the euro price of our shares listed on the Spanish stock exchanges and, as a result, the market price of our ADSs, which are listed on the New York Stock Exchange. Currency fluctuations may also affect the dollar amounts received by holders of ADRs on conversion by the Depositary of any cash dividends paid in euro on the underlying shares.

Our consolidated results are affected by fluctuations between the euro and the currencies in which the revenues and expenses of some of our consolidated subsidiaries are denominated (principally the Brazilian real, the Argentine peso, the Chilean peso, the Peruvian nuevo sol, the Mexican dollar, the Venezuelan bolivar, the Czech kruna (crown) and the U.S. dollar). See Item 11Quantitative and Qualitative Disclosures About Market Risk.

**B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable.

**C. REASONS FOR THE OFFER AND USE OF PROCEEDS**

Not applicable.

**D. RISK FACTORS**

In addition to the other information contained in this Annual Report, prospective investors should carefully consider the risks described below before making any investment decisions. The risks described below are not the only ones that we face. Additional risks not currently known to us or that we currently deem immaterial may also impair our business and results of operations. Our business, financial condition and results of operations could be materially adversely affected by any of these risks, and investors could lose all or part of their investment.

**Risks Related to our Business**

***We endeavor to implement our business plans successfully, but factors beyond our control may prevent us from doing so, which could have a material adverse effect on our business.***

Our ability to increase our revenues and maintain our position as a leading European and Latin American provider of advanced telecommunications and Internet services will depend in large part on the successful, timely and cost-effective implementation of our business plans.

Factors beyond our control that could affect the implementation and completion of our business plan include:

- difficulties in developing and introducing new technologies;
- declining prices for some of our services;
- the effect of increased competition;
- the effect of adverse economic trends in our principal markets;
- the effect of foreign exchange fluctuations on our results of operations;
- difficulties in obtaining applicable government, shareholder and other approvals;
- difficulties in entering into key contracts with third parties;
- our ability to establish and maintain strategic relationships;
- difficulties in integrating our acquired businesses;
- the effect of future acquisitions on our financial condition and results of operations;
- difficulties in securing the timely performance of independent contractors hired to engineer, design and construct portions of our network;

- the potential lack of attractive investment targets;
- difficulties in attracting and retaining highly skilled and qualified personnel;

- changes in regulations or the interpretation or enforcement thereof and other possible regulatory actions; and
- the effect of unanticipated network interruptions.

***A material portion of our foreign operations and investments is located in Latin America, and we are therefore exposed to risks inherent in operating and investing in Latin America.***

At December 31, 2005, approximately 51.2% of our assets were located in Latin America. In addition, approximately 41.5% of our revenue from operations for 2005 was derived from our Latin American operations. Our foreign operations and investments in Latin America are subject to various risks, including risks related to the following:

- government regulations and administrative policies may change quickly;
- currencies may be devalued or may depreciate or currency restrictions and other restraints on transfer of funds may be imposed;
- The effects of inflation and currency depreciation may require certain of our subsidiaries to undertake a mandatory recapitalization or commence dissolution proceedings;
- governments may expropriate assets;
- governments may impose burdensome taxes or tariffs;
- political changes may lead to changes in the business environments in which we operate;
- our operations are dependent on concessions and other agreements with existing governments; and
- economic downturns, political instability and civil disturbances may negatively affect our operations.

In addition, revenues from operations of our Latin American subsidiaries, their market value and the dividends and management fees expected to be received from them are exposed to material country risk as a result of adverse economic conditions in the region that may adversely affect demand, consumption and exchange rates.

***Our financial condition and results of operations may be adversely affected if we do not effectively manage our exposure to foreign currency exchange and interest rate risk.***

We are exposed to various types of market risk in the normal course of our business, including the impact of changes in foreign currency exchange rates, as well as the impact of changes in interest rates. We employ risk management strategies to manage this exposure, in part through the use of financial derivatives such as foreign currency forwards, currency swap agreements and interest rate swap agreements. In particular, in order to limit our exposure to Latin American currency exchange rate fluctuations, we use financial derivatives and other instruments. We also use derivatives and funding in foreign currencies in order to hedge our exposure to the Czech crown and the British pound, following our acquisitions of Cesky Telecom and O2, respectively. If the financial derivatives market is not sufficiently liquid for our risk management purposes, or if we cannot enter into arrangements of the type and for the amounts necessary to limit our exposure to currency exchange rate fluctuations, such failure could adversely affect our financial condition and results of operations. Also, our other risk management strategies may not be successful, which could adversely affect our financial condition and results of operations. For a more detailed description of our financial derivatives transactions, see Item 11Quantitative and Qualitative Disclosures About Market Risk and note 15 to our Consolidated Financial Statements.

***We are exposed to increased liquidity and solvency risks following our acquisition of O2, thereby increasing our vulnerability to capital markets and business downturns, and reducing our strategic flexibility.***

We financed our entire acquisition cost of O2 with £17.9 billion (approximately €26.4 billion calculated based on a euro-pound exchange rate of €1.47 = 1.00 on October 31, 2005) of debt incurred under a credit facility. As a result, our leverage has increased, and our credit ratings have decreased following recent downgradings by the credit rating agencies. The credit facility has two tranches: one of which has a one-year maturity, which may be extended to two years and to two and a half years (with respect to 50% of the amount of such tranche); and the other which has a three-year maturity. Accordingly, we will be obligated to repay the entire principal amount of such debt within such period, unless we are able to refinance such debt with longer term debt. Although we have refinanced a portion of our outstanding borrowings under the credit facility through the issuance in January 2006 of approximately £4 billion aggregate principal amount of long-term bonds that mature in 2011, 2016, 2018 and 2026, we continue to have substantial refinancing needs. As of April 6, 2006, £14.175 billion (approximately €20.2 billion calculated based on a euro-pound exchange rate of €0.70060 = 1.00 on April 5, 2006) was outstanding under these credit facilities.

If our business performance deteriorates significantly, we may not be able to repay the debt maturing in the next three years with generated free cash flow plus other committed credit lines, or issue long-term debt in an amount sufficient to refinance our outstanding debt as it matures. Additional credit ratings downgrades by the credit ratings agencies could limit substantially our ability to borrow long term debt in the capital markets and thus make it more difficult to refinance the outstanding amount under the facility or increase significantly our cost of funding.

Our goal to reduce our leverage over the coming years may diminish our ability to face competitive threats, take advantage of attractive acquisition opportunities or follow a strategy requiring substantial cash consumption. If our leverage reduction goal is not met, our lenders could seek to reduce their loans to us and may refrain from granting further credit.

For a more detailed description of our liquidity risk, see "Item 11—Quantitative and Qualitative Disclosures About Market Risk".

***The development of our business could be hindered if we fail to maintain satisfactory working relationships with our partners.***

Some of our operations are conducted through joint ventures in which we own a significant, but less than controlling, ownership interest. For example, Brasilcel in Brazil, which is jointly controlled by Telefónica Móviles and Portugal Telecom, is conducted through a joint venture. As a result of our less than controlling interest in these joint ventures, our company does not have absolute control over the operations of the venture.

In addition, in some cases where we own a majority of the joint venture, we may be subject to provisions in shareholders' agreements restricting our ability to control the joint venture. The relevant corporate governance provisions vary from joint venture to joint venture and often depend upon the size of our investment relative to that of the other investors, our experience as a telecommunications operator in the relevant jurisdiction compared to that of the other investors and the preference or requirement of foreign governments that local owners hold an interest in licensed telecommunications operators. As a result, in these cases we must generally obtain the cooperation of our partners in order to implement and expand upon our business strategies and to finance and manage our operations.

The risk of disagreement or deadlock is inherent in jointly controlled entities, and there is the risk that decisions against our interests will be made and that we may not realize the expected benefits from our joint ventures, including economies of scale and opportunities to realize potential synergies and cost savings. In addition, our joint venture partners may choose not to continue their partnerships with us. Moreover, changes in control of our partners could affect our relationships with them and the management of the joint ventures.

***The costs and difficulties of acquiring and integrating businesses could impede our future growth, adversely affect our competitiveness and adversely affect our results of operations.***

We may enter into, and have recently consummated, acquisition transactions in order to, among other things, provide services in countries in which we do not currently have operations, take advantage of growth opportunities or enhance our product portfolio in a market where we currently have operations, as we have recently done. Such recent acquisitions include: Telefónica Móviles acquisition of BellSouths wireless operations in Latin America;

the acquisition by Telefónica of Cesky Telecom in the Czech Republic; and the acquisition of substantially all of the shares of O2 by Telefónica in January 2006 pursuant to a cash tender offer.

These and our future acquisitions may expose us to certain risks, including the following:

- the difficulty of assimilating the operations, information technology systems and personnel of the acquired entities;
- the difficulty of operating in new countries in Europe where we have not previously had operations and where, for example, business practices may exist that are different from those in Spain and Latin America;
- the potential disruption to our ongoing business caused by senior managements focus on the acquisition;
- our failure to incorporate successfully licensed or acquired technology into our network and product offerings;
- our acquisition of O2 may not be integrated successfully;
- the expected cost savings and any other synergies from an acquisition may take longer to realize than expected or may not be fully realized;
- the failure to maintain uniform standards, controls, procedures and policies; and
- the impairment of relationships with employees as a result of changes in management and ownership.

We cannot assure you that we will be successful in overcoming these risks, and our failure to overcome these risks could have a negative effect on our business, financial condition and results of operations.

***We may be adversely affected by unanticipated network interruptions.***

Unanticipated network interruptions as a result of system failures whether accidental or otherwise, including due to network, hardware or software failures, that affect the quality of, or cause an interruption in, our service could result in customer dissatisfaction, reduced revenues and traffic, and costly repairs and could harm our reputation. Although we carry business interruption insurance, our insurance policy may not provide coverage in amounts sufficient to compensate us for any losses we incur.

**Risks Relating to our Industry**

***We face intense competition in most of our markets, which could result in decreases in current and potential customers, revenues and profitability.***

We face significant competition in all of the markets in which we operate. Thus, we are subject to the effects of actions by our competitors in the markets where we have operations. Our competitors could:

- offer lower prices, more attractive discount plans or better services and features;
- develop and deploy more rapidly new or improved technologies, services and products;
- bundle offerings of one type of service with others;
- in the case of the wireless industry, subsidize handset procurement; or
- expand and enhance more rapidly their networks.

Furthermore, some of our competitors in certain markets have, and some potential competitors may enjoy, competitive advantages, including the following:

- greater name recognition;

- greater financial, technical, marketing and other resources;
- larger customer bases; and
- well-established relationships with current and potential customers.

To compete effectively with our competitors, we will need to market successfully our services and anticipate and respond to various competitive factors affecting the relevant markets, such as the introduction of new products and services by our competitors, pricing strategies adopted by our competitors, changes in consumer preferences and general economic, political and social conditions. If we are unable to compete effectively with our competitors, it could result in price reductions, lower revenues, under-utilization of our services, reduced operating margins and loss of market share.

***We operate in a highly regulated industry and could become subject to more burdensome regulation, which could adversely affect our businesses.***

As a multinational telecommunications company, we are subject to different laws and regulations in each of the jurisdictions in which we provide services. Furthermore, the licensing, construction, operation and interconnection arrangements of our communications systems are regulated to varying degrees by national, state, regional, local and supranational authorities, such as the European Union. These authorities could adopt regulations or take other actions that could adversely affect us and our companies, including revocation of any of our licenses or concessions to offer services in a particular market, failure to renew a license or concession, modification of the terms of a license or concession or the granting of new licenses or concessions to competitors, changes in the regulation of international roaming prices and mobile termination rates, introduction of virtual mobile operators and regulation of mobile data services. Increased or significant changes in the regulation of the activities of our operating companies, including the regulation of rates that may be charged to customers for services, could have a material adverse effect on our business, financial condition and results of operations.

Regulatory policies applicable in many of the countries in which we operate generally favor increased competition in most of our market segments, especially in the fixed line and wireless service industries, including by granting new licenses in existing licensed territories in order to permit the entry of new competitors. These regulatory policies are likely to have the effect, over time, of reducing our market share in the relevant markets in which we operate. In addition, because we hold leading market shares in many of the countries in which we operate, we could face regulatory actions by national or, in Europe, European Union antitrust or competition authorities if it is determined that we have prevented, restricted or distorted competition. These authorities could prohibit us from making further acquisitions or continuing to engage in particular practices or impose fines or other penalties on us, which, if significant, could harm our financial performance and future growth. For a complete description of the regulatory proceedings we currently face, please see Item 8Financial InformationLegal Proceedings.

***We operate under license and concession contracts.***

Most of our operating companies require licenses or concessions from the governmental authorities of the countries in which they operate. These licenses and concessions specify the types of services permitted to be offered by our operating companies. The continued existence and terms of our licenses and concessions are subject to review by regulatory authorities in each country and to interpretation, modification or termination by these authorities. The terms of these licenses granted to our operating companies and conditions of the license renewal vary from country to country. Although license renewal is not usually guaranteed, most licenses do address the renewal process and terms, which we believe we will be able to satisfy. As licenses approach the end of their terms, we intend to pursue their renewal as provided by each of the license agreements.

Many of these licenses and concessions are revocable for public interest reasons. The rules of some of the regulatory authorities with jurisdiction over our operating companies require us to meet specified network build-out requirements and schedules. In particular, our existing licenses and concessions typically require that we satisfy certain obligations, including minimum specified quality, service and coverage conditions and capital investment. Failure to comply with these obligations could result in the imposition of fines or revocation or forfeiture of the

13

license for the relevant area. In addition, the need to meet scheduled deadlines may require our companies to expend more resources than otherwise budgeted for a particular network build-out.

***The industry in which we operate is subject to rapid technological changes, and if we are unable to adapt to such changes our ability to provide competitive services could be materially adversely affected.***

The telecommunications industry is in a period of rapid technological change. Our future success depends, in part, on our ability to anticipate and adapt in a timely manner to technological changes. We expect that new products and technologies will emerge and that existing products and technologies will further develop. These new products and technologies may reduce the prices for our services or they may be superior to, and render obsolete, the products and services we offer and the technologies we use, and may consequently reduce the revenues generated by our products and services and require investment in new technology. Our most significant competitors in the future may be new entrants to our markets who are not burdened by an installed base of older equipment. In addition, we may be subject to competition in the future from other companies that are not subject to regulation as a result of the convergence of telecommunications technologies. As a result, it may be very expensive for us to upgrade our products and technology in order to continue to compete effectively with new or existing competitors. Such increased costs could adversely affect our business, financial condition and results of operations.

***Our business depends on the upgrading of our existing networks.***

We must continue to upgrade our existing wireless and fixed line networks in a timely and satisfactory manner in order to retain and expand our customer base in each of our markets, to enhance our financial performance and to satisfy regulatory requirements. Among other things, we could be required to:

- upgrade the functionality of our networks to permit increased customization of services;
- increase coverage in some of our markets;
- expand and maintain customer service, network management and administrative systems; and
- upgrade older systems and networks to adapt them to new technologies.

Many of these tasks are not entirely under our control and may be affected by applicable regulation. If we fail to execute them successfully, our services and products may be less attractive to new customers and we may lose existing customers to our competitors, which would adversely affect our business, financial condition and results of operations.

***Our business could be adversely affected if our suppliers fail to provide necessary equipment and services on a timely basis.***

We depend upon a small number of major suppliers for essential products and services, mainly network infrastructure. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own shortages and business requirements. If these suppliers fail to deliver products and services on a timely basis, our business and results of operations could be negatively affected. Similarly, interruptions in the supply of telecommunications equipment for our networks could impede network development and expansion, which in some cases could adversely affect our ability to satisfy our license requirements.

***The wireless industry may be harmed by reports suggesting that radio frequency emissions cause health problems.***

Media and other reports have suggested that radio frequency emissions from wireless handsets and base stations may cause health problems. If consumers harbor health-related concerns, they may be discouraged from using wireless handsets. While we are not aware that such health risks have been substantiated, there can be no assurance that these concerns could have an adverse effect on the wireless communications industry and, possibly, expose wireless providers, including us, to litigation. Even if the authorized health institutions confirm there is no scientific evidence of adverse health effects, we cannot assure you that further medical research and studies will refute a link between the radio frequency emissions of wireless handsets and base stations and these health concerns.

14

Government authorities could increase regulation of wireless handsets and base stations as a result of these health concerns and wireless companies, including Telefónica Móviles and O2, could be held liable for costs or damages associated with these concerns, which could have an adverse effect on our business, financial condition and results of operations. In Spain, for example, Telefónica Móviles was required by law to test and certify the emissions of all its base stations in or close to populated areas. For the year ended December 31, 2005, such tests have again confirmed lower emission levels than those required by Royal Decree 1066/2001, which approves the regulation and which establishes the conditions for the protection of the public spectrum domain, restrictions for radio frequency emissions and measures for protection against radio frequency emissions. If in the future Telefónica Móviles fails to comply fully with these standards, it could be subject to claims or regulatory actions.

**Other Risks**

***We face risks associated with litigation.***

We are party to lawsuits and other legal proceedings in the ordinary course of our business. An adverse outcome in, or any settlement of, these or other lawsuits (including any that may be asserted in the future) could result in significant costs to us. In addition, our senior management may be required to devote substantial time to these lawsuits which they could otherwise devote to our business. For a more detailed description of current lawsuits, see "Item 8—Financial Information—Legal Proceedings".

**ITEM 4. INFORMATION ON THE COMPANY**

**A. HISTORY AND DEVELOPMENT OF THE COMPANY**

**Overview**

Telefónica, S.A. is a corporation duly organized and existing under the laws of the Kingdom of Spain, incorporated on April 19, 1924. We are:

- a diversified telecommunications group which provides a comprehensive range of services, mainly in Spain and 13 countries in Latin America, through one of the world's largest and most modern telecommunications networks;
- mainly focused on providing fixed and mobile telephony services and using broadband as a means to develop each of these businesses; and
- expanding our presence in Europe, following our acquisition of substantially all of the shares of O2 in January 2006 and our acquisition of a majority stake in Cesky Telecom in June 2005.

The following significant events occurred in 2005:

- In January 2005, Telefónica Móviles completed the acquisition of 100% of BellSouth Chile and BellSouth Argentina (Movicom).
- In June 2005, we acquired a majority stake in Cesky Telecom. We have consolidated Cesky Telecom's results of operations in our Consolidated Financial Statements since July 2005. The acquisition of Cesky Telecom, the leading operator of fixed telephony and mobile telephony in the Czech Republic, will serve as a platform for us to further develop our business in Europe.
- In July 2005, Terra Networks was merged into Telefónica. This merger was intended to allow us to enhance our business model based on the integration of fixed line telephony and Internet services, following the market's evolution towards broadband services.

- In November 2005, we announced our agreement to acquire O2 plc, a U.K. mobile telephony provider with operations in the United Kingdom, Germany, Ireland and The Isle of Man. See Recent Developments.

*Business Lines*

In 2005, we reorganized the structure of our business lines to reflect the Groups new multinational scope and the integration of new businesses that we have recently acquired. The objectives of this new structure are to: (i) seek to take advantage of newly-created opportunities for synergies among our businesses; (ii) continue to transform Telefónica into a customer-service oriented company with a special focus on delivering high quality customer service and innovation; and (iii) continue developing and offering integrated telecommunications solutions to each customer segment.

In 2005, our principal business lines were:

- Telefónica de España: fixed line telephony in Spain;
- Telefónica Móviles: mobile telephony in Spain and Latin America;
- Telefónica Latinoamérica: fixed line telephony in Latin America;
- Cesky Group: integrated telecommunications services in the Czech Republic;
- Telefónica Contenidos: audio-visual media and content in Europe and Latin America;
- Directories Business: publication, development and sale of advertising for telephone directories in Europe and Latin America; and
- Atento: call centers in Europe, Latin America and North Africa.

In order to integrate O2 into the Telefónica Group, in 2006 we expect to add a new business line that will be principally comprised of O2 and will also include Cesky Telecom and Telefónica Deutschland. All other subsidiaries that are not part of our core business lines, including Telefónica Publicidad e Informacion, S.A., (see Recent Developments) Endemol Entertainment Holding N.V., Telefónica Contenidos, S.A. and Telefónica Servicios Audiovisuales will be managed by our Director of Affiliates.

In addition, on March 29, 2006, our Board of Directors approved a merger plan for the acquisition of Telefónica Móviles, S.A. by Telefónica, S.A. The Board of Directors of Telefónica Móviles also approved the merger plan. The merger is subject to approval by our shareholders and the shareholders of Telefónica Móviles.

The following chart shows the organizational structure of the principal subsidiaries of the Telefónica Group at December 31, 2005, including their jurisdictions of incorporation and our ownership interest.

Telefónica, S.A., the parent company of the Telefónica Group, also operates as a holding company with the following objectives:

- coordinate the group's activities;
- allocate resources efficiently among the group;
- provide managerial guidelines for the group;
- manage the portfolio of businesses;
- provide cohesion within the group; and
- foster synergies among the group's subsidiaries.

Our principal executive offices are located at Gran Vía, 28, 28013 Madrid, Spain, and our telephone number is (34) 91-584-03-06.

**Capital Expenditures and Divestitures**

Our principal capital expenditures during the three years ended December 31, 2005 consisted of additions to property, plant and equipment and additions to intangible assets. In 2003, 2004 and 2005, €3,705.8 million, €3,768.1 million and €5,468.6 million, respectively, was invested.

***Year Ended December 31, 2005***

In 2005, capital expenditures increased by 45.1% from 2004, principally due to expenditures relating to growth initiatives in Spain and Latin America related to our broadband business, increases in the capacity of our mobile telephony networks, the rollout of our UMTS network in Spain, technological developments in Latin America, the investment made in Distrito C (the future Telefónica Group headquarters in Madrid) and the capital expenditures of Cesky Telecom, which we consolidate as from July 2005. Our principal capital expenditures in 2005 included investments in:

- intangible assets (€1,077.32 million)
- property, plant and equipment made by Telefónica Latinoamérica (€903.6 million)
- property, plant and equipment made by Telefónica de España (€1,141.2 million)
- property, plant and equipment made by Telefónica Móviles (€1,889.9 million)
- property, plant and equipment made by Cesky Telecom (€119.7 million)

***Year Ended December 31, 2004***

In 2004, capital expenditures increased by 1.7% from 2003, principally due to expenditures by Telefónica Móviles on networks and technology for our mobile businesses in Spain, Brazil, Argentina and Mexico and investments by Telefónica Latinoamérica to further develop our broadband network for our Latin America fixed line business. Our principal capital expenditures in 2004 included:

- intangible assets (€594.1 million)
- property, plant and equipment made by Telefónica Latinoamérica (€680.6 million)

- property, plant and equipment made by Telefónica de España (€965.4 million)
- property, plant and equipment made by Telefónica Móviles (€1,352.3 million)

***Year Ended December 31, 2003***

In 2003, capital expenditure decreased by 5.6% from 2002, due to a more controlled and conservative investment policy implemented in 2003. Each of our principal business lines maintained a policy of reduced capital expenditure compared to the prior year, with the exception of our worldwide mobile business as a result of the rollout of GSM networks in Mexico and Chile. Telefónica de España and Telefónica Latinoamérica have maintained their policy of focusing capital expenditures on the development of broadband technology while maintaining the necessary capital expenditures for their traditional business. Our principal capital expenditures in 2003 included:

- intangible assets (€806.5 million)
- property, plant and equipment made by Telefónica Latinoamérica (€504.5 million)
- property, plant and equipment made by Telefónica de España (€1,804.4 million)
- property, plant and equipment made by Telefónica Móviles (€996.9 million)
- property, plant and equipment made by Telefónica Empresas (€100.3 million)

**Financial Investments and Divestitures**

Our principal financial investments in 2005 were made by Telefónica, S.A. (€3,662.5 million for the acquisition of Cesky Telecom a.s. and €1,265.8 million for the acquisition of 4.97% of O2 Plc ("O2") through open market purchases), and Telefónica Internacional (€424.5 million for the acquisition of 5.0% of China Netcom Group Corporation's outstanding shares through open market purchases). Our principal financial divestiture in 2005 was the sale of a 25% interest in Endemol Entertainment Holding, N.V.

Our principal financial investments in 2004 were made by Telefónica Móviles ($5,850 million for the acquisition of certain BellSouth companies, a portion of the acquisition price of which was paid in January 2005) and Telefónica, S.A. (€530.8 million, which included €475.1 million for additional acquisitions of Portugal Telecom shares). Our principal financial divestitures in 2004 were the sale of Lycos, Inc. and Pearson Plc by Terra Networks S.A. and Telefónica Contenidos, respectively.

Our principal financial investments in 2003 were made by Telefónica, S.A. (€1,528.5 million, which included €1,029.6 million from acceptances to our tender offer for Terra Networks shares), Telefónica Contenidos (€708.6 million) and Telefónica Móviles (€567.4 million). Our principal financial divestitures in 2003 were the overall divestiture of our interest in Antena 3 TV and the sale of our interests in Sonda, 3G Telecommunications and Inmarsat by Telefónica Internacional, Telefónica Móviles and Telefónica de España, respectively.

**Public Takeover Offers**

On March 29, 2006, the Boards of Directors of Telefónica, S.A. and Telefónica Móviles, S.A. approved a merger plan which provides for the merger of the two companies. The exchange ratio was set at four ordinary shares of Telefónica, S.A. for every five shares of Telefónica Móviles, S.A.

On October 31, 2005, we commenced a public tender offer for all of the outstanding shares of O2, a U.K. mobile services provider, for a total of approximately £17.9 billion (approximately €26.4 billion calculated based on a euro-pound exchange rate of €1.00 = £0.6767 on October 31, 2005). On January 10, 2006, we received clearance for our acquisition of O2 plc from the European Commission, subject to Telefónica Móviles' withdrawal from the European mobile operators alliance, "Freemove", and its agreement not to rejoin such alliance in the future without the European Commission's prior consent. On January 23, 2006, we made our tender offer for O2 plc unconditional in accordance with the rules of the U.K. City Code on Takeovers and Mergers. As of March 30, 2006, after the expiration of our tender offer for O2, we owned an aggregate of approximately 98.6% of O2 plcs issued share capital. We will consolidate O2 in our Consolidated Financial Statements as from January 31, 2006.

On March 29, 2005, Telefónica submitted a binding bid to purchase 51.1% of the share capital of the Czech telecommunications company, Cesky Telecom a.s., from the Czech government in an auction as part of a privatization process. The bid price submitted by Telefónica was CZK502 per share, representing a total value of 2,745.9 million for the Czech governments 51.1% of the share capital of Cesky Telecom a.s. The privatization commission formed by the Czech government for the privatization process issued a non-binding recommendation that the government of the Czech Republic accept Telefónicas bid. On April 6, 2005, the government of the Czech

Republic declared officially that Telefónicas bid was the winner of the auction through which the privatization was being conducted. On April 12, 2005, we signed an agreement with the Czech government to purchase its 51.1% stake in Cesky Telecom a.s. As a result of our acquisition of the Czech governments 51.1% stake in Cesky Telecom a.s., we were required to conduct a public tender offer for all of the remaining outstanding shares of Cesky Telecom a.s. Pursuant to the tender offer, we acquired an additional 18.3% interest in Cesky Telecom a.s. for approximately 911 million. As of December 31, 2005, we held a 69.4% interest in Cesky Telecom.

On February 23, 2005, the Boards of Directors of Telefónica and Terra Networks approved a merger plan which provides for the merger of the two companies, with the termination through dissolution without liquidation of Terra Networks and the *en bloc* transmission of all of its assets to Telefónica, which through universal succession will acquire the rights and obligations of Terra Networks. The exchange ratio was set at two ordinary shares of Telefónica for every nine ordinary Terra Networks shares. Each of Telefónicas and Terra Networks General Shareholders Meetings held on May 31, 2005 and June 1, 2005, respectively, approved the merger plan for the acquisition of Terra Networks by Telefónica, which was effected on July 16, 2005.

In August 2004, Brasilcel launched tender offers for part of the outstanding shares of Tele Sudeste Celular Participações S.A., or TSD, Tele Leste Celular Participações S.A., or TBE, Celular CRT Participações S.A., or CRT, and TCO directly and indirectly through its subsidiary TCP, which concluded in October 2004. As a result of the shares acquired in the tender offers, Brasilcels stakes in these companies share capital increased to 90.9% in TSD, 50.6% in TBE and 67.0% in CRT, and TCPs stake in TCO increased to 32.9% . The aggregate amount of consideration paid for such shares was approximately R$607 million for Brasilcel and approximately R$902 million for TCP.

On May 25, 2003, Telesp Celular Participaço s S.A., or TCP, launched a tender offer for the common shares of Centro Oeste Celular Participações S.A., or TCO, not owned by it at that date. The acceptance period finished on November 18, 2003. As a result of the shares tendered, TCP acquired 72.2% of TCOs outstanding common shares for R$16.73 per 1,000 common shares. The total purchase price for the TCO shares acquired was R$538.8 million. At December 31, 2003, TCP held 86.6% of TCOs ordinary shares, representing a 28.29% interest in TCO. TCP also announced the intention to launch an exchange offer for the remaining shares of TCO through which TCP would have become TCOs sole shareholder. This would have been followed by a merger of TCO into TCP. After the launch of the exchange offer, the *Commissão de Valores Mobiliários,* the Brazilian Securities Commission raised questions as to the exchange offers compliance with Brazilian law. Although TCP and TCO believed that the exchange offer complied with applicable law, TCP and TCO decided to terminate the exchange offer in January 2004.

On May 28, 2003, we launched a tender offer for 100% of the outstanding shares of Terra Networks that we did not own at that date. The *Comisión Nacional del Mercado de Valores*, or CNMV, approved the prospectus for the tender offer on June 19, 2003. The offer price was 5.25 per share, payable in cash. Following the tender offer, we held 71.97% of the outstanding shares of Terra Networks.

**Recent Developments**

The principal events that have occurred since December 31, 2005 are set forth below.

- On April 7, 2006, Telefónica announced that it has won the auction conducted by the Colombian government for a majority stake in Colombia Telecom (representing 50% plus one of the companys outstanding shares) for 853,577 million Colombian pesos (approximately $368 million). Telefónica expects the acquisition of such shares to occur on or about April 24, 2006. Colombia Telecom is a Colombian fixed line telecommunications company.

- On March 1, 2006, Cesky Group announced the approval of its board of directors intention to integrate its fixed line and mobile operations into a new, integrated telecommunications operator (Telefónica O2 Czech Republic, a.s.).

- At its meeting on March 29, 2006, the Board of Directors of Telefónica, S.A. decided to tentatively schedule the Annual General Shareholders Meeting for June 20, 2006, on first call, or on June 21,

20

2006, on second call. At the same meeting, the Board of Directors accepted the resignation of Mr. Miguel Horta e Costa from the Board of Directors.

- On March 29, 2006, the Board of Directors of Telefónica, S.A. and Telefónica Móviles, S.A. approved a Merger Plan for the merger of Telefónica, S.A. and Telefónica Móviles, S.A. and the *en bloc* transmission of Telefónica Móviles, S.A.’s net worth to Telefónica, S.A. Telefónica, S.A. will acquire by universal succession, all rights and obligations of Telefónica Móviles, S.A. The Merger Plan is subject to the approval of the respective general shareholders’ meetings of Telefónica, S.A. and Telefónica Móviles, S.A.

  The exchange ratio for shares of the companies participating in the merger shall be four ordinary shares of Telefónica, S.A., nominal value €1.00 each, for every five ordinary shares of Telefónica Móviles, S.A., nominal value €0.50 each, with no supplemental cash compensation. In addition, the Merger Plan sets forth the distribution by Telefónica Móviles, S.A. of an extraordinary dividend charged against the issue premium reserve and other distributable reserves for a gross amount of €0.085 per share and an interim extraordinary dividend, charged against the results obtained from January 1, 2006 to March 28, 2006, in a gross amount of €0.35 per share.

  Telefónica, S.A. plans to increase its share capital by the exact amount needed to make the exchange for Telefónica Móviles S.A. shares in accordance with the exchange ratio established in the merger plan. The maximum amount of the capital increase to be effected by Telefónica pursuant to the established exchange ratio may be reduced through the delivery to Telefónica Móviles shareholders of shares held in Telefónica’s treasury.

  In compliance with the terms of Section 226 of the Commercial Registry Regulations (*Reglamento del Registro Mercantil*), a copy of the Merger Plan was filed with the Commercial Registry of Madrid on April 3, 2006.

- On February 28, 2006, the Board of Directors of Telefónica resolved to explore strategic alternatives in relation to Telefónica’s holding in the share capital of Telefónica Publicidad e Información, S.A(“TPI”), which operates our directories business, including a possible total or partial divestiture of its holdings in that company. Telefónica intends to explore such a sale with potential buyers.

- The Board of Directors of Telefónica, S.A. at its meeting held on February 28, 2006, approved the distribution of an interim dividend from 2005 net income of €0.25 for each outstanding share with the right to receive dividends of the Company. The payment of this dividend will be effected on May 12, 2006. It is also the Board’s intention to pay a further dividend of the same amount per share in the course of 2006, in accordance with the shareholder remuneration policy approved by the Company’s Board of Directors. See “Cautionary Statement Requiring Forward-Looking Statements”.

- On February 22, 2006, at each of the Telesp Celular Participações S.A. (“TCP”), Tele Centro Oeste Celular Participações S.A. (“TCO”), Tele Sudeste Celular Participações S.A. (“TSD”), Tele Leste Celular Participações S.A. (“TLE”) and Celular CRT Participações S.A. (“CRTPart”) general shareholders’ meetings a restructuring was approved that will be effected by (i) exchanging TCO shares for TCP shares in order for TCO to consequently become a wholly owned subsidiary of TCP and (ii) the absorption of TSD, TLE and CRTPart by TCP.

- Following the expiration of our tender offer for O2, we now own substantially all of the shares of O2. O2 is a leading provider of mobile communications services in Europe, providing services in the United Kingdom, Germany, Ireland and the Isle of Man. For information on O2’s business, see “—B. Business Overview—O2”.

**B. BUSINESS OVERVIEW**

At December 31, 2005, the Telefónica Group’s total accesses increased 24.3% to 153.5 million from 123.5 million as at December 31, 2004. See “Certain Terms and Conventions”. This increase in accesses is due in part to

the acquisition of the former BellSouth mobile operators in Argentina and Chile (together, an aggregate of 3.8 million accesses) in January 2005 and the acquisition of Cesky Telecom (an aggregate of 8.3 million accesses) in June 2005. Total accesses includes 99.1 million mobile, 40.9 million fixed telephony accesses, 12.9 million Internet and data accesses and 0.7 million pay TV accesses.

The following table shows our total accesses as at the dates indicated.

| | At December 31, | | |
|---|---|---|---|
| | **2004** | **2005** | **% Change** |
| Fixed telephony accesses | 37,768.5 | 40,859.0 | 8.2 |
| Internet and Data accesses | 10,872.2 | 12,859.9 | 18.3 |
| Narrowband | 5,672.5 | 5,166.9 | (8.9) |
| Broadband | 4,736.7 | 6,902.7 | 45.7 |
| Other accesses (1) | 463.0 | 790.3 | 70.7 |
| Pay TV | 410.7 | 683.2 | 66.3 |
| Mobile accesses | 74,441.4 | 99,124.0 | 33.2 |
| Total Accesses | 123,492.8 | 153,526.0 | 24.3 |

(1) Includes broadband cable accesses in El Salvador, wireless fidelity (Wi-Fi) accesses, satellite accesses in Latin America, broadband fiber optics and leased circuits.

**Telefónica de España Spanish Fixed Line Business**

Our Spanish fixed line business is managed by Telefónica de España. The principal companies of the Telefónica de España group are:

- Telefónica de España, the parent company;
- Telefónica Data España;
- Telyco;
- Telefónica Telecomunicaciones Públicas;
- Terra Networks España;
- Telefónica Soluciones;
- Telefónica Soluciones Sectoriales; and
- Telefónica Cable.

The principal services offered by Telefónica de España are:

- Traditional fixed line telecommunication services, principally including PSTN (public switched telephone network) lines; ISDN (integrated services digital network) access; public telephone services; local, domestic and international long distance and fixed-to-mobile communications services; corporate communications services; supplementary value-added services (including call waiting, call forwarding, voice and text messaging, advanced voicemail services and conference-call facilities); video telephony; intelligent network services; leasing and sale of terminal equipment; and telephony information service.

- Internet and broadband multimedia services, principally including narrowband switched access to Internet; Internet service provider (ISP) service; portal and network services; retail and wholesale broadband access, through asymmetrical digital subscriber line (ADSL) and satellite technologies; residential-oriented value-added services (including instant messaging, concerts and video clips by streaming, e-learning, parental control, firewall, anti-virus and content delivery); IP TV service (Imagenio) and Voice over Internet protocol (VoIP) services.

- Data and business-solutions services, principally including leased lines; virtual private network (VPN) services; fiberoptics services; hosting and application service provider (ASP) service, including web hosting, managed hosting, content delivery and application, and security services; outsourcing and consultancy services, including network management (CGPs) and desktop services and system integration and professional services.
- Wholesale services for telecommunication operators, principally including domestic interconnection services; international wholesale services; leased lines for other operators network deployment; and local loop leasing under the unbundled local loop regulation framework.

***Operations***

The following table shows the development of Telefónica de Españas domestic telecommunications network and growth in usage of that network since 2003:

| | As of or for the year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2004** | **2005** |
| Fixed telephony accesses (in thousands) | 16,510.1 | 16,334.8 | 16,135.6 |
| Pre-selected lines (in thousands) | 2,279.0 | 2,379.5 | 2,284.6 |
| Shared access local loops (in thousands) | 0.004 | 37.7 | 279.0 |
| Fully unbundled local loops (in thousands) | 16.3 | 78.4 | 155.7 |
| Narrowband accesses (in thousands) | 2,722.9 | 2,263.5 | 1,614.9 |
| Broadband connections (in thousands) | 1,660.6 | 2,492.7 | 3,441.6 |
| Retail Broadband connections (in thousands)(1) | 1,070.5 | 1,614.5 | 2,719.7(1) |
| IPTV (Imagenio) connections (in thousands) | N/A | 6.0 | 206.6 |
| Average time for the provision of the PSTN service (days) | 10.9 | 18.6 | 20.4 |
| Lines in service per employee(2) | 515.4 | 566.0 | 623.5 |
| Average consumption per line (minutes/day) | 21.8 | 19.7 | 17.8 |
| Market growth of fixed line voice traffic (%) | (0.7) | (5.0) | (3.1) |
| Volume of fixed line voice traffic (in millions of minutes) | 131,897 | 123,026 | 110,207 |
| Volume of outgoing fixed line voice traffic (in millions of minutes) | 80,822 | 68,787 | 59,418 |
| Volume of incoming fixed line voice traffic (in millions of minutes) | 51,075 | 54,239 | 50,789 |
| Growth of outgoing fixed line voice traffic (%) | (12.6) | (14.9) | (13.6) |
| Growth of outgoing fixed line international traffic (%) | (1.4) | 4.0 | 13.5 |
| Growth of incoming fixed line international traffic (%) | 3.4 | 3.3 | 3.3 |
| Growth of fixed-to-mobile traffic (%) | 2.2 | (1.3) | (1.6) |
| Growth of outgoing internet traffic (%) | (18.9) | (22.5) | (27.8) |
| Growth of incoming traffic (%) | 14.8 | 6.2 | (6.4) |

(1) Includes accesses of the former Terra Networks group companies in Spain.
(2) For 2004 and 2005, this line item includes employees of Telefónica de España, S.A. (the parent company of the Telefónica de España group) and Telefónica Data España. Lines include unbundled loops.

In 2005, voice and Internet traffic decreased mainly as a result of a decrease in local calls and calls for Internet access as well as decreases in incoming traffic from other operators. The number of minutes consumed in 2005 decreased by 10.4% to 110,207 million minutes in 2005 from 123,026 million minutes in 2004. The decrease in minutes consumed in 2005 was mainly due to a 9.6% decrease in minutes per line per day to 17.8 minutes in 2005 from 19.7 minutes in 2004, mainly due to a decrease in minutes per day per line of traditional and incoming traffic.

Outgoing traffic, which includes voice and Internet calls, accounted for 53.9% of Telefónica de España's total traffic in 2005. Outgoing traffic decreased by 13.6% to 59,418 million minutes in 2005 from 68,787 million minutes in 2004. During 2005, fixed-to-mobile calls decreased 1.6% to 5,684 million minutes in 2005 from 5,777 million minutes in 2004. Calls for Internet access decreased by 27.8% to 15,486 million minutes in 2005 from 21,453 million minutes in 2004. Local calls decreased by 10.9% to 22,209 million minutes in 2005 from 24,929 million minutes in 2004. Provincial calls decreased 10.5% to 5,417 million minutes in 2005 from 6,053 million minutes in 2004. Interprovincial calls decreased 5.5% to 5,899 million minutes in 2005 from 6,242 million minutes in 2004. International outgoing calls increased 13.4% to 1,967 million minutes in 2005 from 1,734 million minutes in 2004. With respect to value added services, the number of voice mails used increased by 1.7% to 12.1 million in 2005 compared to 11.9 million in 2004. Subscribers to caller identification increased by 5.3% to 7.9 million in 2005 compared to 7.5 million in 2004. Incoming traffic, which also includes voice and Internet calls, accounted for 46.1% of Telefónica de España's total traffic in 2005. Incoming traffic decreased by 6.4% to 50,789 million minutes in 2005 from 54,239 million minutes in 2004.

During 2005, Telefónica de España continued offering different discount plans (bundled service plans and flat rate plans) targeted to different client profiles. At December 31, 2005, the total number of subscribers for such discount plans was 4,306,984. In September 2005, Telefónica de España launched a new range of bundled service packages ("Duos" and "Trios" offers). More than one million of these services packages were subscribed during the last four months of 2005, and at December 31, 2005, the total number of Duos and Trios packages was 1,180,288.

During 2005, Telefónica de España continued to expand its Internet and broadband businesses. As a result of Telefónica de España's commitment to broadband technology, at December 31, 2005 broadband customers in Spain numbered 3.4 million, representing a 36.0% increase compared to 2.5 million at December 31, 2004. Of the total number of broadband customers at December 31, 2005, 2.7 million were retail broadband clients, representing a 68.8% increase compared to 1.6 million at December 31, 2004, principally driven by the good market acceptance of the "Duos" and "Trios" bundled service packages included in the fourth quarter of 2005. Of this 68.5% increase, 9.8 percentage points of the increase is due to the consolidation of former Terra Networks entities.

IP TV (Imagenio) accesses increased to 206.6 thousand at December 31, 2005 compared to 6.0 thousand at December 31, 2004 due to intense commercial campaigns and the deployment of ADSL2+ technology.

***Regulation***

Below is a description of the current Spanish telecommunications regulatory framework. This description should be considered in light of certain developments currently underway in the regulatory and competitive environment that will have a material impact on Telefónica de España's business and operations in future years.

*Overview*

Spain is a member state of the European Union. As such, it is required to enact E.U. legislation in its domestic law and to take E.U. legislation into account in applying its domestic law. E.U. legislation can take a number of forms. "Regulations" have general application, are binding in their entirety and are directly applicable in all member states. "Directives" are also binding, but national authorities may choose the form and method of implementation. "Recommendations" are not binding, but Spanish courts are obligated to take them into consideration.

In order to strengthen free competition throughout its member states, the European Union approved a new regulatory framework in 2002. This framework is composed of a series of directives aimed at strengthening competition in the electronic communications industry within the European Union, establishing mandatory minimum service standards for all users (universal service) and users' rights, improving licensing regimes and enhancing telecommunications data protection. These directives required that member states' regulatory frameworks be modified accordingly to comply with the E.U.'s telecommunications regulatory framework within 15 months.

*The General Telecommunications Law*

In compliance with the obligation to enact this new E.U. legal framework, on November 23, 2003, the Spanish Parliament enacted Law 32/2003 (the “General Telecommunications Law”). The purpose of the General

Telecommunications Law is to advance the liberalization of the provision of telecommunications services and the installation and operation of electronic communications networks, and in this regard satisfy the principle of minimal government intervention. Accordingly, the provision of these services and the ability to operate such networks is granted as a matter of law. In this regard, the law avoids *ex ante* control by regulators as a fundamental principle, removing the current regime of authorizations and licenses and substituting them with *ex post* controls, through market analysis mechanisms necessary to determine the existence of effective competition. Furthermore, in the absence of effective competition, a series of obligations are imposed upon operators with significant market power. Within this regulatory framework, the national regulatory authority has a leading role in the implementation of the ex-post controls.

Under the General Telecommunications Law, the Spanish government issued Royal Decree 2296/2004 on December 10, 2004, containing new regulations governing the electronic communications and network access markets.

During 2005, the Spanish government approved a new regulation for the offer of electronic communication services, universal service obligations and consumer protection. This regulation, Royal Decree 424/2005, was approved on April 15, 2005. The principal aspects of the Royal Decree are as follows:

*Conditions for the Offer of Electronic Communications Services:*

- The prior regime requiring approval for the offer of electronic communications services has been superseded by this new regulation. Under the new regime, operators are only required to provide the Telecommunications Market Commission advance notice of their intention to offer electronic communications services or to operate networks; and
- Every three years, operators will be required to notify the Telecommunications Market Commission of their intention to continue with the offer of electronic communications services or the operation of networks.

*Universal Service Obligations:*

- The Telecommunications Market Commission must evaluate the net cost to operators of providing universal service. Depending on the results of such evaluations, Telefónica de España, along with other operators, may be entitled to recover certain of their respective costs incurred in providing universal servi