

Management report 2014

This Management Report has been prepared taking into consideration the 'Guidelines on the preparation of annual corporate governance reports for listed companies', published by CMNV in July 2013.

Business Model

The Telefónica Group is one of the world's leading mobile and fixed communications services providers. Its strategy is to become a leader in the new digital world and transform the possibilities it brings into reality.

Telefónica's aim is to reinforce its position as an active player in the digital world capable of seizing all the opportunities afforded by its global scale and its industrial and strategic alliances.

On February 26, 2014, the Board of Directors of Telefónica, S.A. approved the implementation of a new organizational structure focused on clients and which incorporates the digital offering as the main focus of commercial policies. The structure gives greater visibility to local operators, bringing them closer to the corporate decision-making center, simplifying the Group's global structure and strengthening cross-cutting areas to improve flexibility and agility in decision making.

From January 1 2014 on, and due to the implementation of this new organizational structure, the new organizational structure is composed of Telefónica Spain, Telefónica Brazil, Telefónica Germany, Telefónica United Kingdom and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela & Central America, Ecuador and Uruguay). These segments include all the information related to fixed, mobile, DSL, internet TV, as well as other digital services appropriate to each country. Any services not specifically included in these new segments are part of "Other companies and eliminations".

The Telefónica's Group's strategy aims to:

- Improve the customer experience in order to continue increasing accesses.
 - Lead growth:
 - Drive forward the penetration of smart phones in all markets in order to raise the growth rate of mobile data by monetizing their increasingly widespread use.
 - Defend our competitive positioning, and leverage our customer knowledge.
 - Develop the growth opportunities that have arisen in an increasingly digital context, such as media, financial services, cloud, security, advertising, M2M, e-Health, etc.
 - Capture the opportunity in the business segment.
- Continue working on the transformation of the Group's operating model:
 - Increase the modernization of networks in markets where we operate through technological advances and the acquisition of spectrum.
 - Maximize the benefits of economies of scale to increase efficiency.
 - Simplify the operative model.
 - Reduce legacy cost, especially legacy network costs.

In addition, Telefónica maintains an industrial alliance with China Unicom. Furthermore, in order to potentially unlock the value of Telefónica's scale, the "Partners" program was created in 2011, and now includes five operators (Bouygues, Etisalat, Sunrise, Megafon and O2 CZ). The Telefónica Partners Program is an initiative that makes available to selected

operators and under commercial terms a host of services that allows partners to leverage on Telefónica's scale and to cooperate on key business topics (digital services, roaming, services to multinationals, procurement, devices, etc.).

Elsewhere, in 2014 Telefónica's portfolio was restructured through the acquisition of E-Plus by Telefónica Deutschland to form the leading operator in the European. Also we are in process of acquire GVT by Telefónica Brazil, once regulatory approval has been obtained.

Additional information

Telefónica, S.A. have adapted their internal processes and payment schedules to the provisions of Law 15/2010 (amended by the Law 31/2014) and of Royal Decree-Law 4/2013, amending the Law 3/2004, which establishes measures against late payment in commercial transactions. Engagement conditions with commercial suppliers in 2014 included payment periods of up to 60 days, according to the terms agreed between the parties. For efficiency purposes, the Company has defined payment schedules with suppliers, whereby payments are made on set days. Payments to Spanish suppliers in 2014 and 2013 surpassing the established legal limit were the result of circumstances or incidents beyond the payment policies, mainly the delay in the billing process (a legal obligation for the supplier), closing of agreements with suppliers over the delivery of goods or the rendering of services, or occasional processing issues. According to the criteria previously commented, the average payment period to suppliers of the Telefónica, S.A. in Spain at December 31, 2014, according to the best estimations, amounts to 35 days.

The Company has a governance system, which applies to Telefónica's entire structure. Pursuant to the Company's commitment to its shareholders, the Board of Directors, supported by its Committees, manages the Company's business in accordance with the corporate governance rules laid down primarily in the Corporate By-laws, in the Regulation of the General Shareholders' Meeting, and in the Regulation of the Board of Directors.

Telefónica's Board of Directors consists of 18 directors and is responsible for overseeing and controlling the Company's activity. It has sole powers regarding general strategy and policies on corporate governance, corporate social responsibility, remuneration of the Board and senior management, shareholder remuneration, and strategic investments.

In order to strengthen the corporate governance of the Company, the Board of Directors of Telefónica, S.A. has eight committees (including the Executive Commission) which are charged with examining and overseeing areas of particular relevance. Pursuant to its regulation, the Board also confers responsibility for day-to-day management of the businesses to Telefónica's executive bodies (primarily through the Executive Committee) and management team.

Economic results of Telefónica, S.A.

Telefónica, S.A. obtained net profit of 2,604 million euros in 2014. Highlights of the 2014 income statement include:

- Revenue from operations, amounting to 8,727 million euros has decreased year on year, primarily due to the lower dividend distributions from Group companies and associates. The most significant variation comes from Telefónica Internacional, S.A.U. with 3,238 million euros (4,500 million euros in 2013), Compañía de Inversiones y Teleservicios, S.A.U. distributed 440 million euros in 2013 and there has been no distribution in 2014 and Telefónica Czech Republic, a.s. which distributed 158 million euros in 2013 and its sale has been completed in January 2014, therefore no new dividends have been received from this subsidiary in 2014.
- The figure of "Impairment and gains (losses) on disposal of financial instruments" amounting to 3,679 million euros has decreased considerably compared to 2013 due to impairment charges recognized to investments in Telefónica Brasil, S.A. and Sao Paulo Telecomunicações, S.A. totalling 735 million euros (in 2013 the write down was 3,863 million euros).
- Net financial expense totaled 2,535 million euros in 2014, compared to 2,491 million euros in 2013. This was mainly due to finance costs with Group companies and associates, of which the largest came from Telefónica Europe, B.V. amounting to 431 million euros (238 million euros in 2013), Telefónica Emisiones, S.A.U. totalling 1,550 million euros (1,712 million euros in 2013) and the impact of the change in the valuation of Telco, S.p.A as "available for sale" financial asset (270 million euros in 2014 and no impact in the previous year).

Investment activity

2014

On January 28th, 2014 Telefónica announces that after obtaining the relevant regulatory approval, the sale transaction of the 65.9% of the capital share of Telefónica Czech Republic, a.s. to PPF Group N.V.I. has been completed. This concept was registered in 2013 balance under caption "Non-current assets held for sale" for an amount of 2,302 million euros.

On June 16, 2014 the three Italian shareholders of Telco, S.p.A. requested the initiation of the process of "demerger" (spin off) of the Company, as provided in the Shareholders Agreement. Implementation of the demerger, approved by the General Meeting of Shareholders of Telco, S.p.A. held on July 9, 2014, is subject to obtaining any required anti-trust and telecommunications approvals (including Brazil and Argentina). Once the aforementioned approvals are obtained, this decision will be implemented by transferring all the current stake of Telco, S.p.A. in Telecom Italia to four newly created companies. The share capital of each of these companies will belong in its entirety to each of the shareholders of Telco, S.p.A. and each of these companies will receive a number of shares of Telecom Italia S.p.A. proportional to the current economic stake in Telco, S.p.A. of its respective shareholder.

The application process of the aforementioned anti-trust and telecommunications approvals (including Brazil and Argentina) to proceed to the "demerger" (spin off) of Telco, S.p.A. has already started, once completed in Italy the corresponding corporate documents.

At a meeting on December 22, 2014, the Brazilian telecommunications regulator (ANATEL) approved the demerger on condition of suspension of Telefónica's voting rights in Telecom Italia, S.p.A. and its subsidiaries, among certain other measures. Telefónica has agreed with the aforementioned suspension of voting rights and has offered the presentation of a formal statement to ANATEL in this regard. Therefore, on the same date Telefónica ceased to have significant influence through its indirect holding in Telecom Italia, S.p.A. and reclassified this investment as an available-for-sale financial asset.

2013

On April 29, 2013, Telefónica, S.A. signed an agreement with Corporación Multi Inversiones ("CMI") to incorporate jointly a Spanish company to manage the Group's investments in Guatemala, El Salvador, Nicaragua and Panama.

The resulting company, Telefónica Centroamérica Inversiones, S.L. ("TCI") was incorporated through the initial contribution by Telefónica, S.A. of its entire shareholdings in Guatemala and El Salvador, along with 31.85% of its interest in Telefónica Móviles Panamá, S.A. at its net carrying amount equivalent to 633 million euros. The new company was incorporated and the corresponding contributions made on June 7, 2013.

On August 2, 2013 and having obtained the necessary regulatory authorisations, TCI's capital was increased in 500 million US dollars (equivalent to 377 million euros on the payment date), subscribed in full by TLK Investments, C.V. (a company part of the CMI group), thereby completing the operation. Consequently, TLK Investments, C.V. holds a 40% interest in TCI and Telefónica, S.A. the remaining 60%. On the same date, Telefónica, S.A. sold the remainder of its stake in Telefónica Móviles Panamá, S.A. (24.5%) for 83 million euros.

On November 5, 2013, Telefónica announced that it had reached an agreement to sell 65.9% of the capital of Telefónica Czech Republic, a.s. ("Telefónica Czech Republic") to PPF Group N.V.I. ("PPF") for, approximately, 306 Czech crowns/share (around 2,467 million euros at the agreement date). This consideration is to be settled in two tranches:

- (i) 2,063 million euros in cash on completion of the sale; and
- (ii) 404 million euros in cash as a deferred payment over four years.

Subsequent to the transaction, Telefónica held a stake of 4.9% in Telefónica Czech Republic until the date of the sale.

At the date of the agreement, Telefónica, S.A. measured its stake in Telefónica Czech Republic at its total market value, recognising a provision for its investment portfolio of 643 million euros under the *"Impairment losses and gains (losses) on disposal of financial instruments"* heading of the income statement.

The agreed price for the stake being sold, updated at year end exchange rates, were reclassified to the *"Non-current assets held for sale"* until the pertinent authorisations were received from the regulators. The market value of the 4.9% stake that it is retained totaling 178 million euros has been reclassified to the *"Equity instruments"* heading under non-current financial assets.

On September 24, 2013, Telefónica and the other shareholders of the Italian company Telco, S.p.A. (which holds a 22.4% stake with voting rights of Telecom Italia, S.p.A.) reached an agreement whereby Telefónica, S.A. subscribed and paid out a share capital increase in Telco, S.p.A., through a cash contribution of 324 million euros, in exchange for shares with voting rights in Telco, S.p.A. As a result of this capital increase, the interest held by Telefónica in the voting share capital of Telco, S.p.A. remains unchanged (i.e. 46.18 %, as Telefónica currently holds), although its interest in the total share capital of Telco, S.p.A. is increased to 66%.

Assessment of impairment of investments in group companies, joint ventures and associates

At each year end, the Company re-estimates the future cash flows derived from its investments in Group companies and associates. The estimate is made based on the discounted cash flows to be received from each subsidiary in its functional currency, net of the liabilities associated with each investment (mainly net borrowings and provisions) and translated to euros at the official closing rate of each currency at December 31, 2014.

As a result of these estimations and the effect of the net investment hedge in 2014, an impairment provision of 3,679 million euros was recognized (7,998 million euros in 2013). This amount derives mainly from the following companies:

- (a) write down recognized for Telefónica Europe, plc. Amounting to 2,352 million euros in 2014 (2,423 million euros in 2013), increased by 148 million euros for the effect of the net investment hedge (70 million euros in 2013).
- (b) write down of 559 million euros for Telefónica Brasil, S.A. (2,948 million euros in 2013) and 176 million euros for Sao Paulo Telecomunicações, S.A. (915 million euros in 2013).
- (c) write down of 92 million euros for Telco, S.p.A. (359 million euros in 2013), the owner of a stake in Telecom Italia.
- (d) write down of 126 million euros for Telefónica México, S.A. de C.V. (211 million euros in 2013).
- (e) write down of 300 million euros for Telefónica Digital Holding, S.A.U. (166 million euros in 2013).

In 2013, a write down recognised for Telefónica Czech Republic of 643 million euros was also included.

The write down in Telefónica Europe, plc. is mainly due to the impact of the 1,304 million-euro dividend distribution in 2014 and the changes in the present value of the expected turnover of the subsidiary. In this regard, the Operating Income Before Depreciation and Amortization (OIBDA) margin used to calculate long term cash flows is 1.7 p.p. lower compared with the same parameter used in 2013 plan.

The write down of the stake in Telefónica Brasil, S.A. and Sao Paulo Telecomunicações, S.A. in 2014 results from the changes in the macroeconomic scenario. The estimate of GDP growth in the country, prepared by Focus Economics and analysts, was estimated in 2.3% for 2014 and it has finally been 0.2% and it will be no higher than 0.7% in 2015. The change in expectations has been reflected in the decrease of OIBDA used to calculate future cash flows. The OIBDA margin used to calculate long term cash flows, has decreased 2 p.p. compared with those used in 2013.

Share price performance

The main European stock markets made gains in 2014 thanks to the general fall in risk aversion amid a gradual economic recovery in the US and to a lesser extent in Europe, and announcements of stimulus packages by central banks. The Ibex-35 (+3.7%) outperformed its peers (ESTOXX-50 +1.2%; DAX +2.7%; CAC-40 -0.5%; FTSEMIB +0.2% and FTSE-100 -2.7%) on the strength of better macroeconomic prospects in Spain and a lower yield on the Spanish 10-year bond, which closed the year at 1.5% (a far cry from the 4.1% observed at year-end 2013), bringing the spread over German bonds to 104.8 basis points (218.3 at the end of 2013).

The European telecommunications sector posted profitability of 7.5%, outstripping the general DJ Stoxx 600 index by 3.1 p.p. (+4.4%), as a result of: i) corporate consolidation transactions in a number of markets, ii) better business fundamentals, driven by macroeconomic improvements and the first positive signals arising from technological transformation; monetization of mobile data and fiber, iii) expectations of a regulatory environment more conducive to investment by the new European Commission, iv) high dividend yields, and v) attractive valuations.

Against this backdrop, Telefónica shares rose by 0.7%, with total shareholder return of 7.0% including dividends distributed in 2014, to close the year at 11.92 euros per share. This was thanks to successful implementation of the strategy to transform Telefónica into a Digital Telco, stronger competitive positioning due to consolidation in major markets, and a gradual improvement in the trend in results, offsetting the negative currency effect observed mostly in Latin America.

By company, the best performances were produced by operators that began the year with valuation levels below the standard for the sector and that were exposed to potential corporate transactions: Orange (+57.2% - expectations of consolidation in its domestic market-) and Telecom Italia (+22.3% - expectations of consolidation in Brazil and Italy). KPN closed the year with up 12.2%, Deutsche Telekom was up +6.6%, BT up +5.8% and Telefónica Deutschland up +0.7%. The negative side of things featured Portugal Telecom (-72.7% - failed investments in Banco Espírito Santo commercial paper and the adjustment to the exchange ratio of its merger with Oi as a result) and Vodafone (-7.6% after returning part of the Verizon Wireless divestment to its shareholders).

At the 2014 year end, Telefónica featured among the world's ten largest telecommunications companies by market cap (55,514 million euros). Daily trading volume in Telefónica shares on Spain's continuous market was 33.6 million shares.

Research, development and innovation

Telefónica remains firmly committed to technological innovation as an essential tool for achieving competitive advantages, trying to anticipate market trends and differentiating its products. By introducing new technologies and developing new products and business processes, we seek to become a more effective, efficient and customer-oriented Group.

Telefónica has developed an open innovation model for the management of technological innovation to boost the application of technical research in the development of new commercial products and services. Telefónica focuses on certain applied research and development (R&D) priorities that are aligned with its strategy. Open innovation initiatives driving this model include the creation of a venture capital fund and involvement in business collaboration forums, among others. The model also promotes the use of knowledge developed at technology centers, universities and start-ups, among other sources, and encourages innovation in conjunction with other agents (e.g. customers, universities, public administrations, suppliers, content providers and other companies), making them "technological partners." Within this open innovation strategy, the Open Future program was reinforced during 2014. This program is designed to connect entrepreneurs, startups, investors and public and private organizations from all over the world with a view to fostering innovation and developing viable projects.

Telefónica believes it cannot rely solely on acquired technology to differentiate its products from those of its competitors and to improve its market positioning. It is also important to encourage R&D initiatives in an effort to achieve this differentiation and make inroads in other innovation activities. The Group's R&D policy is geared towards:

- developing new products and services in order to win market share;
- boosting customer loyalty;
- increasing revenue;
- enhancing innovation management;
- improving business practices;
- increasing the quality of infrastructure services to improve customer service and reduce costs;
- promoting global products;
- supporting open innovation; and
- creating value from the technology generated.

In 2014, the technological innovation projects undertaken focused on sustainable innovation, process efficiency, creation of new revenue streams, customer satisfaction, consolidation of operations in new markets and technological leadership.

Technical innovation activities are a key part of Telefónica's strategy of creating value through latest-generation network communications and services.

In 2014, projects were undertaken to promote greater access to information technology, new services focused on new internet business models, advanced user interfaces, TV distribution, multimedia content and other added-value services leveraging on the potential of the new infrastructures. These initiatives, among others, were undertaken based on our objective of rapidly identifying emerging technologies that could have a relevant impact on our businesses and pilot testing these technologies in new services, applications and platform prototypes.

Most of our R&D activities are carried out by Telefónica Investigación y Desarrollo, S.A.U. (Telefónica I+D), a wholly-owned subsidiary, which works mainly for the lines of business. In its operations, Telefónica I+D receives the assistance of other companies and universities. Telefónica I+D's mission is centered on enhancing the Company's competitive positioning by leveraging technological innovation and product development. Telefónica I+D undertakes experimental and applied research and new product development with the overriding goal of broadening the range of services offered and reducing operating costs.

Telefónica I+D's technological innovation activities focus on two big areas:

- Telefónica I+D's works on new networks, primarily in collaboration with Telefónica's Global Resources team. These activities are related to radio access technologies and fiber; network virtualization technologies, in line with the technology trend known as software defined networks (SDN); and network optimization and zero touch developments making networks more flexible and moldable and able to adapt dynamically to new digital consumer and service requirements.
- R&D activities to develop new products and services are conducted as part of the digital services strategy. These activities include the following:
 - Natural P2P communication of the future, using the Internet, Web 2.0 and smartphones.
 - Video and multimedia services (combining text, audio, images and video) offering a user experience in all connected devices.
 - Advanced solutions in emerging ITC businesses such as cloud computing, security, financial services or e-health.
 - M2M (machine-to-machine) service management associated with energy efficiency and mobility and with the Internet of Things and their adoption in the urban and industrial scenario, and as a service creation enabler.
 - Making use of user communication profiles to exploit opportunities to operate different products and business models (marketing campaigns, target marketing, contextual services, churn reduction, cross-selling, etc.).

Telefónica I+D's also boasts scientific work groups with a more medium- to long-term focus and aims to look into opportunities relating to new networks and services and solutions to the technological challenges that arise.

In 2014, Telefónica in collaboration with the Chilean government launched a new R&D center in Chile, with focus on Internet of Things and Big Data, in the field of Smart Cities, Smart Industry and Smart Agro.

At December 31, 2014, Telefónica I+D had 652 employees (689 employees in 2013).

Total I+D expense in the Group for 2014 amounted to 1,111 million euros, up 6.2% from the 1,046 million euros incurred in 2013 (1,071 million euros in 2012). This expense represents 2.2%, 1.8% and 1.7% of the Group's consolidated revenue for 2014, 2013 and 2012, respectively. These figures were calculated using guidelines of the Organization for Economic Co-operation and Development (OECD).

During 2014, Telefónica filed 27 new patent applications, all of them registered through the Spanish Patent and Trademark Office (OEPM), of which 25 are European applications (EP) and 2 are International applications (PCT). Additionally 2 utility models were filed, also through OEPM.

Environment

Objectives and policies related to environmental management and the control of environmental risks

Telefónica has an Environmental Policy applicable to all its companies, and a Global Environmental Management System that ensures compliance with environmental aspects and extends a culture of environmental responsibility to customers. Currently over 50% of the Group companies, which represent 70% of global billing, have Environmental Management Systems in accordance with ISO 14001, certified by an external entity.

Telefónica's environmental risks are controlled and managed by the Company's global risk management model. Although the environmental aspects of telecommunication operations are low-intensity, the extremely disperse geography makes environmental management based on processes absolutely essential.

Telefónica has a global team of environmental management experts, who address environmental issues at local level.

Guidelines

Telefónica's activities are regulated, in environmental matters, by local laws, especially in activities related to the network infrastructure. These activities entail obtaining environmental permits for operations, waste management, noise control, and the monitoring of electromagnetic fields, among others.

The Global Environmental Management System guarantees compliance with environmental legislation at local level, and enables checks to be extended to suppliers and contractors.

Main initiatives aimed at improving environmental quality and management results

Among the main initiatives carried out by the Group to effectively manage the environmental aspects of its operations, is the optimal selection of sites for the rollout of the network, always promoting the sharing of infrastructure with other operators (over 34,000 sites in 2014), and the development of technical adaptations to reduce the visual impact of mobile telephony antennae.

Waste produced by networks and customers, especially waste from electric and electronic equipment, is handled by approved managers in due adherence to environmental legislation and always in the following order: reduce, reuse, recycle. All group companies have waste management schemes and recycling and/or reuse initiatives to manage customer waste.

The Climate Change and Energy Efficiency Office is responsible for rolling out processes to boost energy efficiency and shrink Telefónica's carbon footprint. The company has a structured corporate governance model and an energy manager in each country for proper management of energy and carbon. Telefónica has corporate targets for the reduction of energy and emissions: 30% of electricity consumption in the network by 2015 and 30% of CO2 by 2020; both measured by equivalent customer access. In 2014 a new energy/financial target was introduced to reduce Telefónica's energy bill by 50 million euros by 2017 through energy-efficiency measures. In 2014 Telefónica was recognized by the Carbon Disclosure Project, the largest climate change investment index worldwide, as a sectoral leader in terms of management of energy and carbon.

These initiatives enabled Telefónica to extend its environmental responsibility to residential customers and companies, and to meet the ongoing demand by investors and shareholders for responsible environmental management.

Human Resources

Social objectives and policies

At Telefónica people are important and are the core of the business, representing one of the Group's greatest assets. The aim is to build capacities in people, the culture and the organisation in order to become a Digital Telco.

Our vision is based on three main pillars:

- To construct and develop people's capacity and ensure the company's diversity strategy in its recruiting, empowering the best professionals and future leaders.
- To accelerate the transformation of Telefónica, raising awareness regarding the necessity and urgency of this transformation.
- To encourage the productivity of employees with a headcount that is more adapted to the business and ensures the correct management of the company's simplification process.

Telefónica faces a great transformation in order to continue as a leader in the new digital environment. Therefore, human resources policies have been rolled out to create a work environment in which each professional contributes the best they have to offer. As a result of these policies, in the Global Climate and Commitment index that was carried out in the final months of the year, Telefónica, S.A. reached 72% (76% in 2013).

Employee training

Just like in the rest of Telefonica's business operation units, in Telefónica S.A. employee training is an absolute priority, in these times of deep change and evolution for the company. In 2014 most of the L&D efforts were devoted to transforming the company into a "Digital Telco", leveraging on specific training programs by Universitas Telefonica.

Universitas Telefonica operates at two levels: on premises and virtual programs. On premises programs are delivered both at our campus in Barcelona where more than 500 executives from TSA participated in our leadership transformation programs, plus 250 mid managers more, trained in our local offices in Madrid and Brazil. In all cases the programs are focused in Telefonica's transformation and delivered by Universitas Telefonica mostly internal faculty.

On the other hand, Universitas Telefonica operates also virtually through its on-line learning platform. In 2014 all on-line contents related to the digital transformation were promoted, resulting in a 30% increase of the use of our on-line learning services, incorporating new units like TGS and CCDO for a much broader use of the on-line learning platform.

In 2014, over 37,000 training hours were carried out. For the Company, managing knowledge is a priority. In 2014, the cost of training amounted to over 1 million euros.

Equality in Diversity at Telefónica

Diversity is a competitive advantage. Having a team of professionals that accurately reflects the societies in which we operate, allows us to better understand our clients and surprise them with new products that fit their needs. It also makes it possible to offer them high quality services, which subsequently have an impact on our profits.

Our Business Principles include the fundamental right to equality:

"We promote equal opportunities and we treat all individuals fairly and impartially, without discriminating on the basis of race, color, nationality, ethnic origin, religion, gender, sexual orientation, marital status, age, disability or family responsibilities."

However the concept of diversity goes much further, it is a fundamental value. The reasons why diversity is a critical management factor for us are many. But from these we can highlight, first, the need to use all of our talent, and second, the importance of other market segments, of other non-traditional groups with a large purchasing capacity, such as women, handicapped individuals, elderly, etc. The intended impact is achieved through proper management of employee

diversity; these employees come from over 24 countries (four of which are represented on the Board of Directors) and which belong to more than 100 nationalities.

The headcount distribution by gender and professional scales has been disclosed in Note 19.4.

Telefónica has a "*Women in Leadership*" programme that seeks to establish a solid network of female leaders that extends throughout Telefónica's European companies. These initiatives seek to promote female talent among the leaders in the sector.

Telefónica is committed to society and makes important investments in innovation related to social innovation and initiatives in favour of the disabled. Among other initiatives, we would highlight the "*Telefónica Ability Awards*" which recognise the companies or institutions that have incorporated the disabled into their value chains, and developed sustainable business models that integrate solutions, products, and services that meet the needs of disabled people and promote their incorporation into society.

Talent management

Talent is a global asset, and at Telefónica we boost it through benchmark training programmes, promoting diversity and facilitating ways to achieve a work-life balance. Developing the talent of our employees, giving them opportunities of personal and professional development, and supporting their personal growth constantly are the distinctive purposes at Telefónica.

The evaluation of talent lets us have a map of the management talent of the whole Company, as well as a structured succession plan. This is a fundamental tool of differential management and boosts a meritocratic culture which should facilitate decision-making on aspects such as development, organisation, pay, etc.

Occupational health and safety

One of Telefónica's priorities is to offer its staff the best possible working conditions at their place of work or when they are on the move.

As per its Business Principles, Telefónica ensures staff work in a safe environment. Appropriate mechanisms are therefore in place to avoid workplace accidents, injuries and illness associated with professional activities by fully complying with prevailing regulations, implementing safe working procedures, providing training and managing occupational risks.

The Occupational Risk Management System ensures worker health and safety is at the heart of all Telefónica's processes and services; offering an end-to-end model for rolling out joint action, procedures and policies. This system enables Telefónica to identify and disseminate practices that are proven to have an impact on staff welfare and therefore on reducing accident rates.

Liquidity and capital resources

Financing

The main financing transactions carried out in the bond market in 2014 are as follows:

Description	Issue date	Maturity date	Nominal amount (millions)		Currency of issue	Coupon
			Currency	Euros ⁽¹⁾		
Telefónica Emisiones, S.A.U. ⁽²⁾						
EMTN bonds	03/26/14	03/26/16	200	200	EUR	Euribor 3M + 0.65%
	04/10/14	04/10/17	200	200	EUR	Euribor 3M + 0.75%
	05/27/14	05/27/22	1,250	1,250	EUR	2.242%
	06/04/14	04/10/17 ⁽³⁾	100	100	EUR	Euribor 3M + 0.75%
	10/17/14	10/17/29	800	800	EUR	2.932%
SHELF bond	06/23/14	06/23/17	500	412	USD	Libor 3M + 0.65%
Telefónica, S.A.						
Bond mandatory exchangeable into Telecom Italia ordinary shares	07/24/14	07/24/17	750	750	EUR	6.00%

(1) Exchange rate as at December 31, 2014.

(2) Guaranteed by Telefónica, S.A.

(3) Retap bond of the 200 million euros issuance dated on April 10, 2014.

The main financing transactions carried out in the bank market in 2014 are as follows:

Item	Limit	Currency	Outstanding balance (millions of euros)	Arrangement Date	Maturity date
Telefónica, S.A.					
Syndicated Tanche B (1)	3,000	EUR	-	02/18/14	02/18/19
Bilateral loan	2,000	EUR	2,000	06/26/14	06/26/17

(1) On 02/18/14 a syndicated credit revolving facility for 3,000 million euros was signed, entering into effect on 02/25/14, canceling the syndicated credit facility dated on 07/28/10 scheduled to mature originally on 07/28/15.

Available funds

At December 31, 2014, available funds from undrawn lines of credit in different financial institutions totaled 7,445 million euros. Out of this figure, around 6,841 million euros have a maturity longer than 12 months. Additionally, cash and cash equivalents other than Telefonica's share in Telco, S.p.A.'s bond with a nominal amount of 1,225 million euros, as of December 31, 2014 amount to 4,584 million euros.

Additional information on sources of liquidity and undrawn lines of credit available to the Company, on liquidity risk management, on the Company's debt levels, and on capital management is provided in Notes 13, 14, 15 and 16 of the financial statements.

Contractual commitments

Note 19.5 to the financial statements provides information on firm commitments giving rise to future cash outflows and associated with operating leases, primarily.

Credit risk management

The credit risk in Telefónica, S.A. mainly refers to the one associated with financial derivative instruments arranged with different entities. The detailed description of how those risks are managed and hedged is included in Note 16.

Credit rating

At December 31, 2014, Telefónica, S.A.'s long-term issuer default rating is "BBB+/stable outlook" from Fitch, "Baa2/negative outlook" from Moody's and "BBB/stable outlook" from Standard & Poor's. The most recent updates on these ratings were issued by Standard and Poor's on May 19, 2014, Fitch on March 21, 2014 and Moody's on July 25, 2013. The only change in the long-term issuer default rating and outlook for Telefónica, S.A. during 2014 was that Standard and Poor's revised the outlook to "stable" from "negative" on May 19, 2014.

In 2014, among the measures taken to help to protect the credit rating, it is noteworthy an intensive and prudent financing activity together with a conservative liquidity policy, the implementation of a scrip dividend (instead of cash only dividend) in November 2014, a portfolio rationalization through the total or partial sale of certain assets such as Telefonica Ireland, Telefónica Czech Republic and China Unicom, the issuance of financial instruments with high equity content to finance the E-Plus acquisition (such as bond mandatorily convertible into Telefónica shares) and the issuance of undated deeply subordinated securities as a solvency protection measure to mitigate negative impacts on our consolidated financial statements deriving from unforeseen events such as the devaluation in Venezuela.

Dividend policy

Telefónica, S.A.'s dividend policy is revised yearly based on the Group's earnings, cash generation, solvency, liquidity, flexibility to make strategic investments, and shareholder and investor expectations. Given circumstances in 2014, it was resolved to pay a dividend, via scrip dividend of approximately 0.35 euros per share in November 2014, and the Board announced its intention to take corporate actions to approve another cash dividend of 0.40 euros per share in the second quarter of 2015.

In November 2014, Telefónica launched a scrip dividend issue to allow shareholders to choose to receive new shares in place of a cash dividend (which may be replaced by selling the associated subscription rights to the Company at a pre-established price), while enabling the Company to reduce its debt, depending on the take-up rate of the conversion.

Treasury shares

Telefónica has performed, and may consider performing, transactions with treasury shares and financial instruments or contracts that confer the right to acquire treasury shares or assets whose underlying is Company shares.

Treasury share transactions will always be for legitimate purposes, including:

- Undertaking treasury share acquisitions approved by the Board of Directors or pursuant to General Shareholders' Meeting resolutions.
- Honoring previous legitimate commitments assumed.
- Covering requirements for shares to allocate to employees and management under stock option plans.
- Other purposes in accordance with prevailing legislation. In the past, treasury shares purchased on the stock market were exchanged for other shares-securities (as in the case of preferred capital securities), swapped for stakes in other companies (e.g. China Unicom or Telco S.p.A.), or acquired to reduce the number of shares in circulation (by redeeming the shares acquired), thereby boosting earnings per share.

Treasury share transactions will not be performed in any event based on privileged information or in order to intervene in free price formation. In particular, any of the conduct referred to in Articles 83.ter.1 of the Spanish Securities Market Law and 2 of Royal Decree 1333/2005 of November 11 implementing the Spanish Securities Market Law, with regards to market abuse will be avoided.

At December 31, 2014 and 2013, Telefónica, S.A. held the following treasury shares:

	Number of shares	Euros per share		Market value (1)	%
		Acquisition price	Trading price		
Treasury shares at 14/12/31	128,227,971	11.68	11.92	1,528	2.75332%

(1) Millions of euros

	Number of shares	Euros per share		Market value (1)	%
		Acquisition price	Trading price		
Treasury shares at 13/12/31	29,411,832	11.69	11.84	348	0.64627%

(1) Millions of euros

The movement in treasury shares of Telefónica, S.A. in 2014 and 2013 is as follows:

	Number of shares
Treasury shares at 12/12/31	47,847,809
Acquisitions	113,154,549
Disposals	(131,590,526)
Treasury shares at 13/12/31	29,411,832
Acquisitions	100,723,415
Disposals	(129,177)
GESP share plan delivery	(1,778,099)
Treasury shares at 14/12/31	128,227,971

Acquisitions

The amount paid to acquire treasury shares in 2014 and 2013 was 1,176 million euros and 1,216 million euros, respectively.

Disposals

Treasury shares sold in 2014 and 2013 amounted to 1 million euros and 1,423 million euros, respectively. The main transactions were as follows:

- On March 26, 2013 Telefónica, S.A. reached an agreement with qualified and professional investors whereby the Company disposed of all the treasury shares it held (90,067,896 shares) at a price of 10.80 euros per share.
- On September 24, 2013 Telefónica, S.A. acquired the remaining shareholders of Telco, S.p.A. 23.8% of the non-convertible bonds issued in 2013 by Telco, S.p.A. The payment of this transaction consisted of the transmission of 39,021,411 treasury shares of the Company. (See Note 8.5 of the financial statements).

In addition to these disposals, on November 28, 2014, 1,778,099 shares were delivered to Group employees when the second phase of the Global Employee Share Plan ("the GESP") matured.

Options on treasury shares

At December 31, 2014, Telefónica held 76 million call options on treasury shares subject to physical delivery at a fix price (134 million options on treasury shares at December 31, 2013) which are presented as a reduction in equity under the caption "treasury share instruments". They are valued at the amount of premium paid, and upon maturity if the call options are exercised the premium is reclassified as treasury shares together with the price paid. If they are not exercised upon maturity their value is recognized directly in reserves.

The Company also has a derivative on Telefónica shares, to be settled by offset, which has increased from 30 million shares in 2013 to 32 million shares in 2014, and is recognized under "Derivatives" (financial liabilities, current) both in 2014 and 2013.

Lastly, details of the applicable conditions and time periods governing any resolutions of the General Shareholders' Meeting to purchase and/or transfer treasury shares are provided hereon.

At Telefónica's Ordinary General Shareholders' Meeting held on June 2, 2010, the shareholders granted the Board of Directors authorization (with express powers to delegate duties to the Executive Commission, Executive Chairman, Chief Operating Officer, or any other individual to which the Board of Directors confers powers for the same purpose) for the derivative acquisition by Telefónica, S.A. – either directly or through any of the subsidiaries of which it is the controlling company – at any time and as many times as it deems appropriate, of fully-paid treasury shares through purchase and sale, exchange or any other legal transaction.

The minimum price or consideration for the acquisition shall be equal to the par value of the treasury shares acquired, and the maximum acquisition price or consideration for the acquisition shall be equal to the listing price of the treasury shares acquired by the Company on an official secondary market at the time of the acquisition.

Such authorization is granted for 5 years as from the date of the General Shareholders' Meeting and is expressly subject to the limitation that the par value of the treasury shares acquired pursuant to this authorization added to those already held by Telefónica, S.A. and any of its controlled subsidiaries shall at no time exceed the maximum amount permitted by the Law (currently 10% of Telefónica, S.A.'s share capital).

The aforesaid authorization granted to acquire treasury shares may be used in whole or in part to acquire shares of Telefónica, S.A. that it must deliver or transfer to directors or employees of the Company or of Group companies, directly or as a result of the exercise by them of option rights, all within the framework of duly approved compensation systems linked to the trading price of the Company's shares.

Risks and Uncertainties Facing the Company

The Telefónica Group's business is conditioned by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the financial statements, and are as follows:

Group-related risks

Worsening of the economic and political environment could negatively affect Telefónica's business.

Telefónica's international presence enables the diversification of its activities across countries and regions, but it is affected by various legislations, as well as the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the business, financial position, cash flows and/or the performance of some or all of the Group's financial indicators.

With respect to the economic environment, the Telefónica Group's business is impacted by overall economic conditions in each of the countries in which it operates. Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group. Factors such as high debt levels, ongoing restructuring of the banking sector, the implementation of pending structural reforms and continued fiscal austerity measures could hinder more dynamic growth in Europe and, in turn, the consumption and volume of demand for the Group's services, which could materially adversely affect the Group's business, financial condition, results of operations and cash flows.

The soft economic recovery in Europe together with low inflation rates, and the risk of deflation, has led and may still lead to monetary and fiscal easing from key players, with a view to creating a relatively benign scenario for Europe. In this region, the Telefónica Group generated 23.9% of its total revenues in Telefónica Spain, 14.0% in the Telefónica United Kingdom and 11.0% in Telefónica Germany in 2014.

In addition, the Group's business may be affected by other possible effects from the economic crisis, including possible insolvency of key customers and suppliers.

In Latin America, the most important challenge is the exchange-rate risk in Venezuela and Argentina, given the negative impact that depreciation in their currencies could have on cash flows from both countries. International financial conditions may be unfavorable and may lead to potential periods of volatility linked to the evolution of the developed financial markets (especially long-term interest rates in the United States affected by the U.S. Federal Reserve's intervention that are not discounted in the market), an economic slowdown in Asia (a key region for Latin America) and slow progress with structural reforms projects in the majority of these countries limiting potential for higher growth rates. Among the most significant macroeconomic risk factors in the region are the high inflation rates, negative economic growth and high internal and external funding needs in Venezuela. These funding needs are significant and are affected by the recent fall in oil prices, which is the main and almost sole source of foreign currency in the country. These factors are affecting Venezuela's competitiveness and may result in a currency devaluation. Other risks in the region are Argentina's high level of inflation coupled with a phase of economic slowdown and weak public finances. Moreover, the recent decline in the prices of oil and other commodities could have a negative impact on the external accounts of countries such as Brazil, Chile, Peru and Colombia.

In relation to the political environment, the Group's investments and operations in Latin America could be affected by a series of risks related to economic, political and social factors in these countries, collectively denominated "country risk". For the year ended December 31, 2014, Telefónica Hispanoamérica and Telefónica Brazil represented 26.1% and 22.3% of the Telefónica Group's revenues, respectively. Moreover, approximately 9.6% of the Group's revenues in the telephony business are generated in countries that do not have investment grade status (in order of importance, Argentina, Venezuela, Ecuador, Nicaragua, Guatemala, El Salvador and Costa Rica), and other countries are only one notch away from losing this threshold. It is also significant that, despite clear improvements in Brazil, the uncertainty surrounding the political situation, fiscal policy stimuli and a relatively high inflation rate could result in a rating downgrade that, depending on the extent of such downgrade, could result in strong exchange-rate volatility due to an outflow of investments, especially in relation to fixed-income.

"Country risk" factors include the following:

- government regulation or administrative policies may change unexpectedly, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approvals), which could negatively affect the Group's business in such countries;
- abrupt exchange-rate fluctuations may occur mainly due to high levels of inflation and both fiscal and external deficits with the resulting exchange-rate overvaluation. This movement could lead to strong exchange-rate depreciation in the context of a floating exchange rate regime, a significant devaluation off the back of

abandoning fixed exchange rates regimes or the introduction of varying degrees of restrictions on capital movement. For example, in Venezuela, the official U.S. dollar to bolívar fuerte exchange rate is established by the Central Bank of Venezuela and the Minister of Finance, with an alternative market for attracting foreign currency through the Complementary System for Administration of Foreign Currency (*Sistema Complementario de Administración de Divisas* or "SICAD") regular and selective auctions. In February 2015, a new Exchange Rate Agreement was established, including the regulations for the Foreign Exchange Marginal System (SIMADI), and the Central Bank of Venezuela published on February 18, 2015 a weighted average exchange rate equal to 172.1 bolívares to the U.S. dollar for the markets referred to in chapters II and IV of such Exchange Rate Agreement. Additionally, the acquisition or use of foreign currencies by Venezuelan or Argentinean companies (in some cases) to pay foreign debt or dividends is subject to the pre-authorization of the relevant authorities. Also, the Argentinean peso, despite its recent stability, continues to be under the threat of a sustained accelerated depreciation against the U.S. dollar;

- governments may expropriate or nationalize assets, make adverse tax decisions or increase their participation in the economy and in companies;
- economic-financial downturns, political instability and civil disturbances may negatively affect the Telefónica Group's operations in such countries; and
- maximum limits on profit margins may be imposed in order to limit the prices of goods and services through the analysis of cost structures. For example, in Venezuela, a maximum profit margin has been introduced that will be set annually by the Superintendence for Defense of Socioeconomic Rights.

Any of the foregoing may adversely affect the business, financial position, results of operations and cash flows of the Group.

The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates, interest rates or financial investment risks.

At December 31, 2014, 70% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for a period greater than one year, while 27% was denominated in a currency other than the euro.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2014: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica has a financial position at that date would lead to an increase in financial expenses of 111 million euros, (ii) whereas a 100 basis points decrease in interest rates in all currencies except the euro, the U.S. dollar and the pound sterling (these to zero rates in order to avoid negative rates), would lead to a reduction in financial expenses of 68 million euros. These calculations were made using the same balance position in each currency and same balance position equivalent at such date and bearing in mind the derivative financial instruments arranged.

According to the Group's calculations, the impact on results and specifically changes in the value of a 10% depreciation of Latin American currencies against the U.S. dollar and a 10% depreciation of the rest of the currencies against the euro would result in exchange losses of 76 million euros, primarily due to the weakening of the Venezuelan bolívar and the Argentinean peso. These calculations were made using the same balance position in each currency with an impact on profit or loss at such date, including derivative instruments in place. For the year ended December 31, 2014, 22.8% of the Telefónica Group's operating income before depreciation and amortization (OIBDA) was concentrated in Telefónica Brazil, 26.2% in Telefónica Hispanoamérica and 11.2% in the Telefónica United Kingdom.

The Telefónica Group uses a variety of strategies to manage these risks, mainly through the use of financial derivatives, which themselves also expose us to risk, including counterparty risk. Furthermore, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and cash flows.

Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.

The performance, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the development and implementation of the Company's strategic plan, the

development and implementation of new technologies or the renewal of licenses as well as expansion of our business in countries where we operate may require a substantial amount of financing.

The performance of financial markets in terms of liquidity, cost of credit, access and volatility, continues to be overshadowed by persisting uncertainty regarding certain factors such as the pace of economic recovery, the health of the international banking system and concerns regarding the burgeoning deficits of some European countries. The worsening international financial market credit conditions caused by some of these factors could make it more difficult and more expensive to refinance existing financial debt or arrange new debt if necessary, and more difficult to raise funds from the Group's shareholders, and may negatively affect the Group's liquidity. At December 31, 2014, gross financial debt scheduled to mature in 2015 amounted to 8,491 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2016 amounted to 8,407 million euros. Despite having covered gross debt maturities of 2015, 2016 and part of 2017 by available cash and lines of credit at December 31, 2014, possible difficulties in maintaining the current safety margin, or the risk that this could be significantly and unexpectedly exhausted, could force Telefónica to use resources allocated for other investments or commitments for payment of its financial debt, which could have a negative effect on the Group's businesses, financial position, results of operations or cash flows.

In 2013 the Telefónica Group issued bonds mainly (i) in euro totaling 3,250 million euros with an average coupon of 3.690%; (ii) in dollars totaling 2,000 million U.S. dollars with an average coupon of 3.709%; and (iii) in Swiss Francs totaling 225 million Swiss francs with an annual coupon of 2.595%. The Telefónica Group also issued undated deeply subordinated securities in euros totaling 1,750 million euros with an average coupon of 6.902%; and in sterling pounds totaling 600 million sterling pounds with a coupon of 6.750%. In 2014 the Telefónica Group issued bonds mainly in the European market with a maturity of eight years totaling 1,250 million euros with an annual coupon of 2.242%, and bonds with a fifteen-year maturity totaling 800 million euros with an annual coupon of 2.932%. In addition, the Telefónica Group issued undated deeply subordinated securities in 2014 totaling 2,600 million euros with an average coupon of 5.075%.

Despite having its gross debt maturities profile covered for more than two years, obtaining financing on the international capital markets could also be restricted, in terms of access and cost, if Telefónica's credit ratings are revised downwards, either due to lower solvency or operating performance, or as a result of a downgrade in the rating for Spanish sovereign risk by rating agencies. Any of these situations could have a negative impact on the Group's ability to meet its debt maturities.

Moreover, market conditions could make it harder to renew existing undrawn credit lines, 8% of which, at December 31, 2014, were scheduled to mature prior to December 31, 2015.

In addition, the impact of the sovereign debt crisis and the rating downgrades in certain Eurozone countries should be taken into account. Any deterioration in the sovereign debt markets, doubts about developments in European projects (such as implementation of the banking union project, the results of the elections in Europe, including Spain among others, or progress towards fiscal integration), as well as further credit restrictions by the banking sector could have an adverse effect on the Telefónica Group's ability to access funding and/or liquidity, which could have a significant adverse effect on the Group's businesses, financial position, results of operations and cash flows.

Risks Relating to the Group's Industry

The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.

The telecommunications sector is subject to laws and regulations in different countries, and additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to spectrum availability. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality.

Thus, as the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting of new licenses to competitors for the provisions of services in a specific market.

In this regards, the Telefónica Group pursues its license renewals in the terms referred in their respective contractual conditions, though it cannot guarantee that it will always complete this process successfully or under the most beneficial

terms for the Group. In many cases complying with certain obligations is required, including, among others, minimum specified quality, service and coverage standards and capital investment. Failure to comply with these obligations could result in the imposition of fines, revision of the contractual terms, or even the revocation of the license, authorization or concession. Additionally, the Telefónica Group could be affected by regulatory actions carried out by the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses.

Regulation of spectrum and government concessions

In Europe, the amendments by the EU Parliament to the Commission's proposal on the "Digital Single Market" (the "DSM") package of measures are currently being discussed by the European Council. The "DSM" measures include important measures affecting, inter alia, spectrum regulation. Although these measures are not yet final, they could have significant implications as they include new provisions on secondary markets, criteria to apply at auctions, renewals and terms of licenses, etc.

In addition, the main allocation criteria for the 700 MHz band of "Digital Dividend II" (the second spectrum allocation process from television operators to electronic communications services) will be defined in the coming years. This could require new cash outflows ahead of the Group's previously anticipated schedule (it is expected that the spectrum will be available between 2018 and 2021).

Nevertheless, Germany will be the first country in Europe to award spectrum in the 700 MHz band. On January 29, 2015, the German regulator ("BNetzA") published respective final decisions on the spectrum allocation proceedings and on the auction conditions of the 700 MHz and 1500 MHz bands. The auction will also include the spectrum corresponding to GSM licenses – the entire 900 MHz band and most of the 1800 MHz band (which will expire at the end of 2016) –. Interested bidders may submit applications by March 6, 2015. The auction (Simultaneous Multi-Round Auction) will take place in the second quarter of 2015.

On July 4, 2014, BNetzA adopted a decision concerning the frequency aspects of the Telefónica Deutschland Holding AG merger with E-Plus Mobilfunk GmbH & Co KG ("E-Plus"). BNetzA has instructed Telefónica Deutschland (the surviving entity after the merger takes place) to anticipate the termination of its rights of use in the 900 / 1800 MHz bands by December 31, 2015, (instead of December 31, 2016), if Telefónica Deutschland (the surviving entity) does not reacquire these frequencies at the above-mentioned auction proceeding. Both Telefónica Deutschland and E-Plus have legally challenged this BNetzA decision on August 4, 2014. The German regulator also announced that, once the auction of spectrum mentioned above mentioned is over, it will perform a frequency distribution analysis, and determine whether any additional action is needed, particularly in the area of the 2GHz spectrum band granted to Telefónica Deutschland. In addition, and within the framework of the conditions imposed by the European Commission in connection with the merger, the surviving entity of the merger is obliged to offer up to 2x10 MHz in the 2600 MHz as well as up to 2x10 MHz in the 2100 MHz spectrum band to one potential new mobile network operator. This offer is open to any potential new mobile network operator that had declared a respective interest by December 31, 2014, and to the operator with whom Telefónica Deutschland has signed the network access agreement (Drillisch Group).

On December 26, 2014, the Spanish Government adopted a law in which it delayed, to a maximum period ended on April 1, 2015, the effective delivery of the frequencies in the 800 MHz spectrum which are part of the "Digital Dividend" (the spectrum allocation process from television operators to electronic communications services), and which were expected to be delivered on January 1, 2015 to the already awarded mobile operators. The license term has been extended accordingly to April 24, 2031.

In the United Kingdom a significant increase in the annual license fees charged for the use of the spectrum in 900 MHz and 1800 MHz bands has been proposed by the regulator (the Office of Communications ("Ofcom")). The outcome of it remains uncertain. Separately, the United Kingdom Government announced recently an agreement with the United Kingdom mobile operators, including Telefonica UK, under which the mobile operators would accept a 90% geographic coverage obligation for voice and text services. Given the agreement, Ofcom has agreed to consider the impact of the geographic coverage obligation on its valuation of annual fees for 900 MHz and 1800 MHz spectrum. This is expected to delay Ofcom's decision. In addition, on November 7, 2014, Ofcom released a public consultation on the award of 2.3 GHz and 3.4 GHz bands that is expected to take place in late 2015 or early 2016.

In Latin America, spectrum auctions are expected to take place implying potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2015 are:

- Peru: The government announced plans to auction the 700 MHz spectrum band in the first half of 2015 (three blocks of 2x15 MHz have been defined).
- Costa Rica: Costa Rica's government has communicated its intention to auction spectrum in the 1800 MHz and AWS bands during 2015.
- Mexico: The Federal Institute of Telecommunications (Instituto Federal de Telecomunicaciones) ("IFT") published its Annual Program for Frequency Use and Development 2015. The program specifies IFT's intention to award Advanced Wireless Services "AWS" concessions during the course of 2015.

Further to the above, certain administrations may not have announced their intention to release new spectrum and may do so during the year. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Telefónica may also seek to acquire spectrum on the secondary market should opportunities arise.

In Argentina, on December 1, 2014, the Secretary of Communication through Resolution 85/2014 officially awarded Telefónica Argentina the block 1710-1720/2110-2120 for a period of 15 years and the 700 MHz block (703-713/758-768 MHz) is expected to be officially transferred to Telefónica Argentina during 2015.

In the state of São Paulo, Telefónica Brasil provides local and national long-distance Commuted Fixed Telephony Service (CFTS) under the public regime, through a concession agreement, which will be in force until 2025. In this regard, in June 27, 2014, as established in the concession agreement, the National Telecommunications Agency (Agência Nacional de Telecomunicações) ("ANATEL") issued a public consultation for the revision of the concession agreement. Such public consultation revising the concession agreement ended on December 26, 2014 and allowed contributions on certain topics such as service universalization, rates and fees and quality of services, among others. Definitive conditions will be published in 2015.

Additionally, in Colombia the Information and Communication Technologies ("ITC") Ministry issued a Resolution on March 27, 2014 to renew 850 MHz/1900 MHz licenses for 10 additional years. The reversion of assets and the liquidation of the concession contract will be discussed until May 2015, taking into consideration the terms of the contract, and the Constitutional Court's review of Law 422 of 1998, which established the reversion of only the radio-electric frequencies.

In Peru, an application for partial renewal of the concessions for the provision of the fixed-line service for another five years has been issued, although assurance has been given by the "Ministry of Transport and Communications" (Ministerio de Transportes y Comunicaciones) in previous renewals, that the concession will remain in force until November 2027. Also, a new law has been enacted establishing mobile virtual network operator (MVNOs) and Rural Mobile Infrastructure Operators (RMIOs) in the Peruvian market.

In Mexico, in light of the constitutional reform resulting from the "Pact for Mexico" political initiative, it is expected that a publicly-owned wholesale network, which will offer wholesale services in the 700 MHz band, will be created. As of today, the funding and the marketing model of this project have not yet been determined.

Telefónica Móviles Chile, S.A. was awarded spectrum on the 700 MHz (2x10 MHz) band in March 2014. A third party provider opposed this allocation of spectrum on the basis that it would exceed the limit spectrum of 60 MHz established by a judgment of the Supreme Court of January 27, 2009. This cap was established for the AWS auction held in 2009, but not for subsequent auctions (2600 MHz and 700 MHz). In a judgment on December 31, 2014, the court of appeals rejected the third party claim. Consequently, the regulator is in a position to adopt a Decree awarding the concession to Telefónica.

The consolidated investment in spectrum acquisitions and renewals in 2014 amounted to 1,294.2 million euros.

The Company's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed above or any others in which it operates or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on the Company's ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and cash flows.

Regulation of wholesale and retail charges

In terms of roaming, the regulated "Eurotariffs" were reduced on July 1, 2014 (in the wholesale market, the price of data was reduced by 67%, the price of call by 50%; and in the retail market, the price of data was reduced by 55%, the price of outgoing voice call by 21%, the price of incoming voice call by 28% and the price of outgoing texts by 25%), as per the regulation approved in 2012. The structural roaming solutions which could lead to a price decrease in the intra-European Union roaming services also took effect in July 2014. Furthermore, the package of DSM measures mentioned above, which is under discussion, also includes a proposal to eliminate European Union roaming charges as of a yet to be determined date. However, the European Parliament proposed the "end of roaming" by December 15, 2015 in a proposal known as "Roaming Like at Home".

The decreases in wholesale mobile network termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, wholesale MTRs have been reduced to 0.845 ppm (pence/minute) from April 1, 2014 (representing a 0.3% reduction compared to the previous rates). In a consultation document published in June 2014, Ofcom has proposed a further reduction to 0.545 ppm, from April 1, 2015.

In Germany, on September 3, 2014, the BNetzA adopted a proposal to reduce MTRs. The new prices will gradually decrease to 0.0172 euro/minute from December 1, 2014, and in a second stage, from 0.0172 euro/minute to 0.0166 euro/minute from December 1, 2015 until the end of November 2016. The European Commission has requested that the German regulator withdraw or amend its latest decision on mobile termination rates, in force as at the date of this Annual Report. There is a risk that the European Commission will initiate infringement proceedings against Germany, and rates may be further reduced.

In Spain, the National Regulatory & Competition Authority (*Comisión Nacional de los Mercados y la Competencia*) has adopted a final decision on the third round analysis of the wholesale market for fixed call termination. From November 1, 2014, a symmetric fixed termination rate ("FTR") of 0.0817 euro cents/minute applies, based on pure bottom-up long run incremental costs ("BU-LRIC") meaning that billing must be entirely conducted on a "per second" basis, without a peak/off-peak differentiation. The decision therefore eliminates the asymmetry in FTRs that existed since 2006 when alternative network operators were allowed to charge up to 30% above Telefónica's per minute local FTR. It also brings forth an important reduction in average termination prices for Telefónica (by 80%) in comparison to the former applicable tariffs.

In Latin America, there are also moves to review MTRs leading to these being reduced. Thus, for example, developments in Mexico are among the most relevant, where the IFT has declared the América Móvil Group a preponderant operator in the telecommunications market. As a result, on March 26, 2014, it introduced, among others, special regulations on asymmetric interconnection rates. In that sense, the Federal Telecommunications and Broadcasting law, effective as of August 13, 2014, imposed several obligations on the preponderant operator, which are quite extensive and, in principle, potentially significantly beneficial to Telefónica's competitive position, particularly with regards to the measures imposed on preponderant operators (to the extent they nominally retain such qualification). With regards to MTR, Telefónica México filed an administrative appeal against the 2011 resolutions of the Federal Telecommunications Commission of México (Cofetel) regarding mobile network termination rates (representing a 61% reduction compared to the previous rates). As of the date of this Annual Report, no ruling has been made on this appeal. Recently, IFT determined the mobile termination rates for 2012, and Telefónica México filed an injunction against this rate. Once these appeals have been concluded, the rates applied may be further reduced retroactively. As of the date of this Annual Report, IFT has not approved the termination rates for 2013, 2014 or 2015 for Telefónica México.

In Brazil, at the end of 2012, ANATEL launched the "*Plano Geral de Metas de Competição*" ("PGMC") regarding fixed-mobile rate adjustment reductions until February 2016 and amending the previous reduction conditions (75% of the 2013 rate in 2014 and 50% of the 2013 rate in 2015). In order to complement reductions and approach the cost of the services according to a financial cost model, on July 7, 2014, ANATEL published reference values for MTR taking effect from 2016 to 2019. Such reductions are approximately 44% per year. Furthermore, there are several legislative initiatives that aim to abolish the basic fee of fixed-telephony service. "Price protection" practices (reimbursement of differences in prices of a product to customers if this falls within a relative short period of time) may also have a negative impact in Telefónica Brasil, in both economic and image terms.

In Chile, a tariff decree was issued to set fixed-line termination charges for the 2014-2019 periods. The new tariff entered into effect on May 8, 2014 and applies a reduction of 37% in prices against those charged for the period prior to such tariff. A tariff decree has been issued for mobile networks covering the 2014-2019 five-year period. Such tariff decree

entered into effect on January 25, 2014 and implies a reduction of 74.7% with respect to the previous rates. After a review by the general comptroller (*Contraloría General*) an additional 1.7% reduction was approved on May 27, 2014.

In Ecuador the rate-related risks relate to a reduction in rural and urban telephony charges, a reimbursement of top-up balances, as well as rounding to the nearest minute.

The implementation of the Enabling Act (*Ley Habilitante*) in Venezuela also confers full powers to the President to implement price control measures. Under this Act, in January 2014, an organic fair price law was issued, which caps the revenue of related enterprises at 30% of their operating costs. In relation to MTRs with the national operator of reference (Compañía Anónima Nacional Teléfonos de Venezuela) ("CANTV"), these have been reduced by 6% compared to the previous rates. In November 2014, near the end of the term allowing the enactment of laws autonomously granted to the President of the Republic, new important decree-laws were enacted, in particular, the Reform of the Law on Foreign Investment, in which, among other things, new requirements for the return of foreign investment were established; the Reform of the Antitrust Law, which was predominantly aimed at enhancing monopoly control regulation and increasing penalties for infringement; and the Reform of the Exchange Crimes Law, which increased economic sanctions.

In Colombia, on December 30, 2014, the Colombian regulator ("CRC") enacted Resolution 4660 establishing a gradual reduction for MTRs. The glide path initiates in 2015 in 32.88 Colombian pesos per minute representing a decrease of 41.7% and then descends approximately 42.2% in 2016 and 42.2% in 2017 (each such reduction being as compared to the previous year). This regulatory measure also imposes asymmetric MTRs to the dominant provider (the América Móvil Group), imposing the final rate established in the glide path from 2015 to 2017. The CRC also regulated the charges for national roaming and the SMS termination rates, setting a reduction of 41.5% in 2015, 39.6% in 2016 and 43.3% in 2017 (each such reduction being as compared to the previous year).

Regulation of universal services

Further to its formal obligation to review the scope of the Universal Service Directive (the set of basic electronic communication services whose provision is guaranteed to any user requesting it, regardless of its location, with a specified quality at an affordable price), the European Commission is expected to undertake a public consultation in the months following the date of this Annual Report, which may include both the potential inclusion of broadband in its scope and a possible reduction of some of the current universal service obligations. Depending on the terms that will be set forth in the new regulation, implementation at a local level could lead to higher costs for both the universal service provider and the operators forced to finance the universal service.

The last *Plano Geral de Metas de Universalização* ("PGMU") was published in Brazil on June 30, 2011 and applies to the 2011-2015 period. This sets goals for public phones, low cost fixed-lines and coverage density in rural and poor areas with 2.5GHz/450 MHz. Also according to such PGMU, the assets assigned to the provision of the services described in the public concession agreement are considered reversible assets. In 2014, ANATEL issued a public consultation with its proposals for the 2015-2020 period universalization targets. The agency's proposal focuses on reducing the distance between public telephones and backhaul's expansion.

Regulation of fiber networks

In December 2014, the Spanish National Regulatory & Competition Authority (*Comisión Nacional de los Mercados y la Competencia*) has conducted a public consultation on the regulatory obligations for broadband market regulation in Spain. As a result of this consultation, the new regulation that will apply to NGN (Next Generation Networks) could be approved in the fourth quarter of 2015 and will last for at least three years. This could increase Telefónica's regulatory obligations in Spain and the ability of other operators to compete in such market.

In Colombia, the regulatory authority CRC published a regulatory project for transmission capacity between municipalities through fiber networks or connectivity to impose open network and elements access through a mandatory offer for those enterprises that have overcapacity and have some unused installed network elements. This project will be discussed in the first half of 2015.

Regulations on privacy

In Europe, a new Data Protection Regulation is undergoing the European legislative process which, as the date of this Annual Report, is not expected to end before mid-2015. This could lead to certain critical provisions laid down in the

current draft of the regulation (presently under debate) being worded in such a way that stops or hinders Telefónica from launching some services, that focus on the processing of personal data.

In Brazil, triggered by the approval of Civil Rights Framework for Internet Governance, which provides certain generic rules about data protection, the Ministry of Justice could in the near future, adopt the final version of the Draft Personal Data Protection Act. This could lead to a greater number of obligations for operators in relation to the collection of personal data of telecom services users and further restrictions on the treatment of such data.

Regulation of functional separation

The principles established in Europe's common regulatory framework, adopted in 2009 and transposed in the national legislation of each Member State in which Telefónica operates could result in greater regulatory pressure on the local competitive environment. Specifically, this framework supports the possibility of national regulators (in specific cases and under exceptional conditions) forcing operators with significant market power and vertically-integrated operators to separate their wholesale and retail businesses at a functional level. They would therefore be required to offer equal wholesale terms to third-party operators that acquire these products.

Regulation of network neutrality

In Europe, national regulators are seeking to strengthen their supervision of operators with regard to the blocking of access, discrimination of applications or Internet service quality. The European Parliament and the Council are simultaneously debating the draft of the European DSM Regulation proposed by the European Commission that, among other things, deals with the principle of network neutrality. The regulation of network neutrality could directly affect possible future business models of Telefónica and may affect the network management or differentiation of characteristics and quality of Internet access service.

Telefónica is present in countries where net neutrality has already been ruled, such as Chile, Colombia, Peru and more recently Brazil, but this remains a live issue and with varying degrees of development in other countries where it operates. In Germany, the Economy Minister withdrew a draft law that it published on June 20, 2013, to regulate net neutrality, especially with regard to the blocking and discrimination of content and Internet services. It plans to submit a new draft after the EU has settled on a position on net neutrality within the DSM approach, which might occur in early 2015. In addition, one German region (Bundesland of Thuringia) has passed a new law (which applies only in such region) with the aim that broadcasting and tele-media may not be blocked, limited or treated differently from other data traffic.

If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and cash flows.

The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to the U.S. Foreign Corrupt Practices Act of 1977 ("FCPA") and the United Kingdom Bribery Act of 2010 (the "Bribery Act"), and economic sanction programs, including those administered by the United Nations, the European Union and the United States, including the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"). The FCPA prohibits providing anything of value to foreign officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered foreign officials for purposes of the FCPA. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could have a material adverse effect on the Group's business, reputation, results of operations and financial condition.

Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects the Company's competitive position relative to other technology sector companies, and its ability to extract the value generated during this process of transformation. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

Company may not be able to adequately foresee and respond to technological changes and sector trends.

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances.

Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

New products and technologies arise constantly, and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, and which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 1,111 million euros and 1,046 million euros in 2014 and 2013, respectively; representing an increase of 6.2% from 1,046 million euros in 2013. These expenses represented 2.2% and 1.8% of the Group's consolidated revenue, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development (OECD) manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed of up to 100MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of incomes and additional efficiencies to those followed traditionally. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond the Company's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency.

The Company depends on its suppliers.

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect the Company's operations, and may cause legal contingencies or damages to the Company's image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2014, the Telefónica Group depended on six handset suppliers and 11 network infrastructure suppliers, which together accounted for 80% of the awarded contracts for the year then ended. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

Unanticipated network interruptions can lead to quality loss or the interruption of the service.

Unanticipated network interruptions as a result of system failures, including those due to network, hardware or software, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telefónica attempts to mitigate these risks through a number of measures, including backup systems and protective systems such as firewalls, virus scanners and other physical and logical security. However, these measures are not always effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

The telecommunications industry may be affected by the possible effects of electromagnetic fields, emitted by mobile devices and base stations, may have on human health.

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization (WHO), that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee (ICNIRP) have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to the Company being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may negatively affect the business, financial conditions, results of operations and cash flows of the Telefónica Group.

Possible regulatory, business, economic or political changes could lead to asset impairment.

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairment in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. For example, with respect to the investment in Telco, S.p.A. ("Telco"), value adjustments were made in fiscal years 2013 and 2014 with a negative impact of 267 million euros and 464 million euros, respectively.

The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and

consumer segments. Despite its best efforts to prevent it, the Telefónica Group may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.

Any of the foregoing could have an adverse impact on the business, financial position, results of operations and cash flows of the Group.

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.

Telefónica and Telefónica Group companies are party to lawsuits, tax claims and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and cash flows. In particular, regarding tax and antitrust claims, the Telefónica Group has open judicial procedures in Peru concerning the clearance of previous years' income tax, for which a contentious-administrative appeal is currently pending; as well as in Brazil, with CADE's (Conselho Administrativo de Defesa Econômica) resolution with regard to the acquisition of a 50% stake in Vivo and with certain open tax procedures, primarily relating to the CIMS (a Brazilian tax on telecommunication services). Further details on these matters are provided in the Note 17 and 20 of the financial statements.

Trend evolution

Telefónica is an integrated diversified telecommunications group that offers a wide range of services, mainly in Europe and Latin America. Its core business is the provision of fixed and mobile telephony, broadband, internet, data, pay TV and value-added services, among others. The Group's operations in 25 countries, managed through a regional organization geared towards certain businesses in global units, enable it to leverage the strong local positioning, as well as the advantages afforded by its scale.

As a multinational telecommunications company that operates in regulated markets, Telefónica is subject to different laws and regulations in each of the jurisdictions in which it provides services. Among other developments, Telefónica may face pressure from regulatory initiatives in some European countries regarding tariffs, the reform of rights of spectrum use and allocation, issues related to the quality of service, and the regulatory treatment of new broadband infrastructure deployments.

Telefónica faces intense competition in the vast majority of the markets where it operates in, and is therefore subject to the effects of actions taken by its competitors. The intensity of the competition may deepen which could have an impact on tariff structures, consumption, market share and commercial activity and negatively affect the number of customers, revenues and profitability.

However, Telefónica believes that it is in a strong competitive position in most of the markets where it operates, which it expects to help enable it to continue taking advantage of the growth opportunities that arise in these markets, such as by boosting both fixed and mobile broadband services and by furthering the development of services beyond connectivity, information technology services and related businesses.

In 2014, Telefónica took a further step towards its transformation into a leading digital telecommunications company, in a sector which we believe still offers excellent growth potential. Digital capacities were boosted, new products were developed, and new business models were set up. This was achieved as a result of a transformation drive implemented throughout the Company.

2013 marked a turning point with the launch of a multinational program, "Be More", focused on transformation and growth and the deleveraging of our business in Ireland, Czech Republic and 40% of Central America. This program aims to take advantage of our customer insight, the capture of future Business to Business (B2B) opportunities, further data monetization of our services and reinforcing our video business. In addition, we will seek to simplify our operating model and increase investments in fiber and LTE, transforming the IT in our operating business. In 2014, we made progress in the transformation process of Telefónica, simplifying the Company and building the bases for a new organization, simplifying operations, making provisions for a leaner staffing at a number of group operators and making key changes to our structure.

We believe that both the completion of the consolidation of our operations in Germany and the acquisition of GVT in Brazil (which is still pending approval by the regulator), which entail structural changes to the Company's positioning in two of its largest markets, points to, and strengthens, our capacity for future growth.

The pace of addition of high-value customers was stepped up in 2014, with more than 21 million new smartphones, 1.5 million new Pay TV accesses and 927 new fiber accesses. We believe these figures indicate a growing generalization of usage-intensive data and content services.

Intense commercial activity in the area of high-value services was attributable mainly to greater investment, which allowed us to double the size of our FTTH network to 14.7 million premises passed, securing LTE coverage of 41% of the outdoor population in the regions where we operate, thereby increasing the number of LTE base stations to more than 20 thousand in 2014 (2.2X compared to 2013).

Telefónica Spain showed a change in trend due to the in-depth transformation process rolled out by the company to steady the pace of the year-on-year fall in revenue, with the assistance of intense commercial activity, especially in terms of fiber and Pay TV. "Movistar Fusión" continued to grow steadily mainly as a result of the offering of the new bundled portfolio including TV in almost all our portfolio with a competitive price from 60 euros/month, which continued to attract customers to value-added offers.

Telefónica United Kingdom continued to work on the deployment of its LTE network, reaching 58% outdoor coverage at year-end, keeping the focus on offering a positive network experience and an exclusive content proposition to 4G

customers. The operator is still migrating its high-value customers to LTE, with a view to boosting the network experience and customer satisfaction. Telefónica United Kingdom continues to deliver a good commercial performance with its "Refresh" offer, helping improve the market distribution dynamics towards more efficient channels.

On August 29, 2014 the Company was given the green light from the European Commission to purchase the E-Plus Group, and the transaction was completed on October 1, 2014. The E-Plus Group has been part of Telefónica Deutschland since that date. The new company is intent on becoming Germany's leading digital telecommunications company, and aims to secure synergies of more than 5 billion euros of present value, mainly produced by the network, customer service, overheads and new opportunities for generating income.

Telefónica Germany continued to perform well in 2014, mainly in the mobile contract segment, thanks to a strategy focusing on data monetization. This performance was achieved against a more competitive backdrop with growing demand for LTE offers and terminals. Year-on-year revenue stabilized, and mobile revenue rose again year-on-year.

As part of the transformation process, embarked by the Group, a significant provision was recorded for E-Plus in connection with the planned downsizing of its staffing, which aims to lay the foundations for future growth.

In Brazil, we consolidated the leadership in the higher-value mobile segments, maintaining our dominance of the market. The Company was awarded one of the three blocks of radioelectric spectrum for LTE auctioned in the 700 MHz band (2x10 MHz) on September 30, 2014, for the minimum reserve price of the block (approximately 619 million euros). This gave Telefónica Brazil the spectrum it needed to expand the 4G services in the medium and long term, and accelerate adoption of data (in 2014, data revenue accounted for 38.6% of the total).

In the fixed business, fiber deployment was key, with 14.7 million premises passed by December 2014, and the number of connected homes gradually rose to 1.8 million.

On September 19, 2014 the Company entered into an agreement with Vivendi to purchase GVT, with a view to creating an integrated operator with national coverage focused on higher-value customers to give a major boost to the Company's market positioning. The purchase is pending approval by the regulator.

Strong commercial activity by Telefónica Hispanoamérica, along with robust investment to improve service quality, continued to drive steady year-on-year growth of revenue and OIBDA, especially in Mexico, Colombia and Peru.

In summary, in the context of intense competition and regulatory pressure on pricing, Telefónica aims to continue strengthening its business model to make it more efficient and capture the synergies arising from the integrated approach of businesses, processes and technologies, while focusing even more on the client and staying ahead of trends in the new digital world.

Events after the reporting period

The following events regarding the Company took place between the reporting date and the date of preparation of the accompanying financial statements:

Financing

- On January 9, 2015 Telefónica Europe, B.V. made an early repayment for 844 million US dollars (695 million euros) of its bilateral loan on supplies signed on August 28, 2012 and originally scheduled to mature on October 31, 2023. This loan was guaranteed by Telefónica, S.A.
- On January 15, 2015, Telefónica Emisiones, S.A.U. redeemed 1,250 million US dollars (1,068 million euros) of its notes, issued on July 6, 2009. The notes were guaranteed by Telefónica, S.A.
- On January 30, 2015, the 375 and 100 million euros loan facilities arranged between Telefónica Finanzas S.A.U. and the European Investment Bank (EIB) matured as scheduled. These loans were guaranteed by Telefónica, S.A.
- On February 19, 2015, Telefónica, S.A. signed a 2,500 million euros syndicated credit facility maturing in 2020, with two twelve month extension options requiring mutual agreement of the parties (which could extend the maturity to as late as 2022). This agreement entered into effect on February 26, 2015 and allowed us to cancel in advance the syndicated loan facility of Telefónica Europe, B.V. dated on March 2, 2012 with two tranches of 756 million euros and 1,469 million pounds sterling originally scheduled to mature in 2017. On the same date, Telefónica S.A. signed an amendment to its 3,000 million euros syndicated credit facility arranged on February 18, 2014 maturing in 2019 in which the parties mutually agreed two twelve month extension options (which could extend the maturity to as late as 2021).

Exclusive negotiations with Hutchison Whampoa Group

Telefónica and Hutchison Whampoa Group agreed to enter into exclusive negotiations for the potential acquisition by the latter of Telefónica's subsidiary in the UK (O2 UK) for an indicative price in cash (firm value) of £10.25bn (approximately €13.5bn); composed of (i) an initial amount of £9.25bn (approximately €12.2bn) which would be paid at closing and (ii) an additional deferred payment of £1.0bn (approximately €1.3bn) to be paid once the cumulative cash flow of the combined company in the UK has reached an agreed threshold.

The exclusivity period will last several weeks, allowing Telefónica and Hutchison Whampoa Group to negotiate definitive agreements, while Hutchison Whampoa Group completes its due diligence over Telefónica's subsidiary in the UK (O2 UK).