REPORT ON THE COMPENSATION POLICY OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A.

February 2013

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I. INTRODUCTION

The compensation of members of Boards of Directors has become highly significant and one of the most-heavily regulated aspects of corporate governance at listed companies.

In recent years, many recommendations have been published on this matter in order, among other goals, to establish an ever closer link between compensation and the creation of value for the shareholders and to ensure the long-term financial sustainability of companies –avoiding schemes that could encourage excessive risk-taking– as well as to increase the information provided by companies to their shareholders and the markets as a whole concerning the compensation paid to the members of their Boards of Directors.

In Spain, following publication of the first Good Governance Code by the National Securities Market Commission (*Comisión Nacional del Mercado de Valores)* in 1997 and the approval of Law 26/2003 of July 17, amending Law 24/1988 of July 28 on the Securities Market and the restated text of the Companies Act (*Ley de Sociedades Anónimas*) in order to enhance the transparency of such companies, the National Securities Market Commission approved the Unified Good Governance Code for listed companies in 2006.

Such Code was created in order to compile and further develop the corporate governance principles published to that date and to have Spanish companies include in their practices European Commission Recommendations 2004/913/EC of December 14, 2004 and 2005/162/EC of February 15, 2005 in connection with certain aspects of the compensation of the members of the Boards of Directors of listed companies. Such Code included the following recommendations regarding compensation, among others:

- That the Board of Directors approve a compensation policy that, at a minimum, establishes the amount of fixed components, variable compensation items, the main features of benefit systems and the conditions to be observed by the contracts of those performing Senior Management duties as Executive Directors.

- That the Board of Directors put a report on the Director compensation policy to a consultative vote at the next Ordinary General Shareholders' Meeting, as a separate item on the agenda, and that such report be made available to the shareholders.

The aforementioned recommendations were subsequently made a part of Spanish law through the approval of Law 2/2011 of March 4 on Sustainable Economy, which amends Law 24/1988 of July 28 on the Securities Market and adds two new sections, 61 *bis* and 61 *ter*.

This duty has been set forth in the internal regulations of Telefónica, S.A. ("Telefónica" or the "Company"). In fact, pursuant to Article 36 of the Regulations of the Board of Directors of Telefónica, each year the Board must approve, at the proposal of the Nominating, Compensation and Corporate Governance Committee, a Report on the Compensation of Directors, providing a description of the Company's compensation policy approved by the Board for the current year (in this case, for fiscal year 2013) and of any policy approved for future years. Such Report must also include an overall summary of the compensation system applied during the prior fiscal year (i.e., the application of the aforementioned policy in 2012) as well as a breakdown of the individual compensation accruing to each of the Directors.

The policy regarding compensation of the Board of Directors of Telefónica has been formulated in accordance with the provisions of the By-Laws and the Regulations of the Board of Directors.

Furthermore, within the context of a process of continuous improvement of its compensation system and of adherence to best market practices, Telefónica has reviewed the requirements and recommendations established in the new regulatory framework applicable to listed corporations.

Consequently, based upon a proposal made by the Nominating, Compensation and Corporate Governance Committee, this Report was approved by the Board of Directors of the Company at its meeting of February 27, 2013.

To prepare this document, the Board drew on the advice and cooperation of the Company's Directorate of Corporate Human Resources, as well as on the assistance of the Human Capital Services Division of J&A Garrigues, S.L.P.

As provided by Article 36 of the Regulations of the Board of Directors, this Report will be made available to the shareholders on the occasion of the call to the Ordinary General Shareholders' Meeting of the Company and will be submitted to a consultative vote of the shareholders as a separate item on the agenda.

II. DIRECTOR COMPENSATION POLICY FOR THE CURRENT YEAR

This section contains a thorough description of the Director compensation policy applicable in the current year 2013, including (i) a summary of the regulatory sources thereof and of the decision-making process (sub-section A); (ii) a reference to the principles underpinning the compensation system (sub-section B); and (iii) a breakdown of the compensation structure and of the various compensation items of which the system consists, together with information on the standards to be followed for application of the policy during the current fiscal year (sub-section C).

A. PROCESS OF PREPARATION OF THE COMPENSATION SYSTEM AND POLICY

The compensation system and policy applicable to the Board of Directors of Telefónica, as well as the process of preparation thereof, are established in the By-Laws (Article 28) and in the Regulations of the Board of Directors (Article 35) of the Company. Pursuant to such texts, the Board of Directors, at the proposal of the Nominating, Compensation and Corporate Governance Committee, determines, within the maximum limit set by the shareholders at the Ordinary General Shareholders' Meeting of the Company, the amount that the Directors are to receive for discharging the duties of supervision and collective decision-making inherent in the position of Director.

In addition to and independently of the compensation mentioned above, the By-Laws also provide that the shareholders at the Ordinary General Shareholders' Meeting may approve the establishment of compensation systems for the Directors that are linked to the listing price of the shares or that entail the delivery of shares or of stock options.

The aforementioned compensation, deriving from membership on the Board of Directors of Telefónica, is compatible with other compensation received by the Directors by reason of the executive duties they perform at the Company or by reason of any other advisory duties they may perform for the Company, other than those inherent in their capacity as Directors.

To determine the amount to be paid to the Directors, the Board of Directors endeavors to ensure, at all times, that the compensation of the Directors is commensurate with that paid at comparable companies in the market in terms of volume, size and/or business, and that any variable compensation takes into account the professional performance of the beneficiaries and the performance of the Company itself and does not merely stem from the circumstances prevailing in the market.

In addition, the Nominating, Compensation and Corporate Governance Committee performs an annual review of the Director compensation policy, in order to propose to the Board of Directors, if required, the adoption of any resolutions deemed appropriate in connection with this matter.

In determining the compensation amounts, the Board of Directors of the Company also takes into account the responsibility and the level of commitment entailed by the role that each Director is called upon to play, as well as market requirements, using standards of moderation for such purpose that have been duly verified by reports provided by professional experts on the matter. In this regard, and pursuant to the guidelines for action set forth in Article 7 of the Regulations of the Board of Directors, the Board carries out its duties in accordance with the corporate interest, meaning the interests of the Company.

The important role played by the Nominating, Compensation and Corporate Governance Committee in the determination of the compensation system and policy applicable to the Directors is worthy of mention. Article 22.b) of the Regulations of the Board of Directors of the Company provides that such Committee shall have the following powers and duties, among others, and without prejudice to any other tasks that the Board of Directors may assign thereto:

1. To report, following standards of objectivity and conformity to the corporate interest, on the proposals for appointment, re-election and removal of Directors and Senior Executive Officers of the Company and its Subsidiaries, and evaluate the qualifications, knowledge and experience required of candidates to fill vacancies.

2. To report on the proposals for appointment of the members of the Executive Commission and of the other Committees of the Board of Directors, as well as the Secretary and the Deputy Secretary.

3. To organize and coordinate, together with the Chairman of the Board of Directors, a periodic assessment of the Board, pursuant to the provisions of Article 13.3 of the Regulations of the Board of Directors.

4. To propose to the Board of Directors, within the framework established in the By-Laws, the compensation for the Directors, and review it periodically to ensure that it is in keeping with the tasks performed by them, as provided in Article 35 of the Regulations of the Board of Directors.

5. To propose to the Board of Directors, within the framework established in the By-Laws, the extent and amount of the compensation, rights and remuneration of a financial nature of the Chairman, the Executive Directors and the Senior Executive Officers of the Company, including the basic terms of their contracts, for purposes of contractual implementation thereof.

6. To prepare and propose to the Board of Directors an annual report regarding the Director compensation policy.

7. To supervise compliance with the Company’s internal codes of conduct and the corporate governance rules thereof in effect from time to time.

As regards its composition, Article 22.a) of the Regulations of the Board of Directors provides that the Nominating, Compensation and Corporate Governance Committee shall consist of not less than three nor more than five Directors appointed by the Board of Directors. All members of such Committee must be External Directors, and the majority thereof must be Independent Directors. The aforementioned article also provides that the Chairman of this Committee shall in all events be an independent Director, appointed from among its members.

In this connection, and fully in compliance with the above-cited provisions, the Nominating, Compensation and Corporate Governance Committee is currently made up as follows:

- Mr. Alfonso Ferrari Herrero (Chairman)

  (External Independent Director)

- Mr. Carlos Colomer Casellas

  (External Independent Director)

- Mr. Peter Erskine

  (External Independent Director)

- Mr. Gonzalo Hinojosa Fernández de Angulo

  (External Independent Director)

- Mr. Pablo Isla Álvarez de Tejera

  (External Independent Director)

There were no changes in the composition of the Nominating, Compensation and Corporate Governance Committee during 2012.

All of the Directors have a proven capacity to serve on the Committee, based on their broad experience and their expertise in compensation or senior management matters.

In addition, the meetings of such Committee are customarily attended, in addition to the members thereof, by the members of Telefónica’s management team who, because of their duties and the responsibilities assigned to them, can provide support and assistance to the members of the Committee on the matters reviewed at each of its meetings.

As far as the operation of the Nominating, Compensation and Corporate Governance Committee is concerned, it meets as many times as is deemed appropriate to review the matters within its purview (in most cases, prior to a meeting of the Board of Directors of Telefónica), when called by the Chairman of the Committee.

A valid quorum of the Committee shall exist with the presence, in person or by proxy, of at least one-half of its members, and resolutions are adopted by the majority of those present. In the event of a tie, the Chairman has the tie-breaking vote.

Specifically, in 2012, the Nominating, Compensation and Corporate Governance Committee held 11 meetings. Among the matters the Committee reviewed, discussed and studied at the meetings held during the fiscal year, the following are worthy of note:

1. Proposed Appointments relating to the Board of Directors and the Committees thereof and to the Boards of Directors of Subsidiaries:

   During the meetings held and exercising the powers assigned thereto, the Committee reviewed and reported on the proposed appointments of Directors, of members of the Committees of the Board of Directors of Telefónica and of Directors at its most significant Subsidiaries.

2. Proposed Appointments relating to Senior Executive Officers and Organizational Changes:

   The Committee reviewed and reported on proposals relating to the Senior Executive Officers of the Company and of its Subsidiaries, and reviewed the proposed appointments and the qualifications and professionalism of candidates, along with their CVs and their track record within and outside of the Company.

3. Compensation System for Directors and Senior Executive Officers:

   At various meetings, the Committee reviewed the current compensation of the Board of Directors (and reported favorably, as explained below, on the 20% reduction in the amounts received by the members of the Board in their capacity as such, approved by the Board of Directors on July 25, 2012), as well as the variable compensation for fiscal year 2011, the variable compensation system for 2012 and the review of fixed compensation for fiscal year 2012.

   In addition, the Committee reviewed and analyzed the proposal of the Directorate of Corporate Human Resources of Telefónica in connection with various aspects of the Long-Term Incentive Plan, known as the Performance & Investment Plan (PIP), approved by the shareholders at the Ordinary General Shareholders' Meeting of the Company on May 18, 2011, for members of the management team of the Telefónica Group (Executive Directors, members of the Executive Committee of Telefónica and other Executive Officers).

B. DESCRIPTION OF THE BASIC OBJECTIVES OF THE COMPENSATION SYSTEM AND POLICY

As regards the basic objectives of the compensation system and policy applicable to the Directors of Telefónica, a distinction must be made between External Directors (who do not perform any executive duties within the Telefónica Group) and Executive Directors, who perform senior management duties or are employees of the Company or of its Group.

1. External Directors

As far as External Directors are concerned (i.e., proprietary, independent and other external Directors), the aim of the compensation policy is to adequately compensate the Directors for their professional merit and experience, as well as for the dedication provided and the responsibility assumed by them, seeking to ensure that the compensation paid does not compromise their independence.

2. Executive Directors

The basic standard underlying Telefónica's compensation policy for Executive Directors is to establish compensation packages that will make it possible to attract, retain and motivate the most distinguished professionals, so as to enable the Company to achieve its strategic objectives within the ever more competitive and internationalized scenario in which it operates.

Considering the foregoing, the principles that govern Telefónica's compensation policy are the following:

(i) Transparency: Telefónica considers transparency in compensation to be a fundamental principle of corporate governance, and has been publishing the Report on the Compensation Policy of the Board of Directors since 2008.

(ii) Competitiveness: Telefónica seeks to ensure that the compensation package of its Executive Directors, in terms of structure and overall amount, is competitive with that of comparable international entities at the international level, in order to have the best professionals in the market.

(iii) Link between compensation and results: a significant portion of the total compensation of the Executive Directors of Telefónica is variable, and receipt thereof is tied to the achievement of pre-established, specific and quantifiable financial, business and value-creation objectives aligned with the Company's interests.

(iv) Creation of value for the shareholders: the goal of Telefónica's compensation policy is to create value for the shareholders in a manner that is sustainable over time.

To that end, the Company has established variable compensation schemes, tied to objectives relating to the creation of value in the medium and long term, that foster the acquisition of equity interests by the Executive Directors and the alignment of their interests with those of Telefónica's shareholders.

C. STRUCTURE OF DIRECTOR COMPENSATION

Based on the foregoing, below is a description of the structure established for the compensation of Directors:

1. Structure of the Compensation of Directors for their Activities as Such

The compensation accruing to the Directors for their activities as such is structured, within the framework established by the law and the By-Laws, in accordance with the standards and compensation items described below, within the maximum limit determined for such purpose by the shareholders acting at the Ordinary General Shareholders' Meeting, pursuant to the provisions of Article 28 of the By-Laws.

In accordance with the foregoing, the shareholders acting at the Ordinary General Shareholders' Meeting held on April 11, 2003 set the sum of 6 million euros as the annual gross maximum amount of the compensation to be received by the Directors in their capacity as members of the Board of Directors. It is not planned to submit a modification of this maximum amount to the shareholders at the Ordinary General Shareholders' Meeting to be held during the current fiscal year, and therefore, such limit will in principle continue to apply to the compensation that the Directors will receive this year in their capacity as such.

It falls upon the Board of Directors to set the exact amount to be paid within the aforementioned limit and to decide how it is to be distributed among the Directors. In fiscal year 2007, the Nominating, Compensation and Corporate Governance Committee, in the performance of the duties assigned thereto and based on current market information, carried out a review of the standards for distribution of the compensation established for the Directors of the Company for serving as such and submitted to the Board of Directors a proposal for review of the compensation to be received by the Directors for their membership on the Board of Directors, in the Executive Commission and in the Advisory or Control Committees thereof, because the amount established during fiscal year 2004 had not been modified since then.

The compensation paid to the Directors of Telefónica for serving on the Board of Directors, the Executive Commission and/or the Advisory or Control Committees consists of a fixed amount, payable monthly, and of attendance fees for attending the meetings of the Advisory or Control Committees.

Finally, the Board of Directors of the Company, upon a prior proposal of the Nominating, Compensation and Corporate Governance Committee and acting in line with current international policies and best practices of corporate governance in the compensation of executives, resolved that, beginning in September 2007, the Members of the Board who have the status of Executive Directors of the Company are to receive only the amounts to which they are entitled for performance of their executive duties, in accordance with the provisions of their respective contracts.

A breakdown of such distribution standards can be found in sub-section IV.1 below.

1.1. Fixed Amount

Each Director receives a fixed monthly amount, commensurate with market standards, according to the positions held on the Board and the Committees thereof.

It is stated for the record that, as of the date hereof, provision is made for payment of a fixed amount for sitting on the Board of Directors, the Executive Commission and the Advisory or Control Committees, on the terms and conditions described later in this Report.

1.2. Attendance Fees

Directors are entitled to be paid specified amounts as attendance fees. However, as of the date hereof, Directors only receive fees for attending meetings of the Advisory or Control Committees, as further explained below.

1.3. Other Compensation

It should be noted that some Directors are members of: (i) certain management decision-making bodies of some Subsidiaries and affiliates of Telefónica, and receive the compensation established by such bodies for their directors, and (ii) various Territorial Advisory Councils and the Advisory Council of the Corporate University, and receive the compensation established for such duties.

In addition, at present Directors do not receive, merely for serving as such, any compensation as pension or life insurance, nor do they participate in compensation plans tied to the listing price of Telefónica's shares, even though such form of compensation is contemplated in the By-Laws of the Company.

2. Structure of the Compensation of Executive Directors

The compensation payable to Executive Directors for the performance of executive duties at the Company consists of (i) fixed compensation, (ii) variable short-term (annual) compensation, (iii) variable medium- and long-term compensation, (iv) benefits and (v) other compensation.

In order to determine the total compensation package of the Executive Directors of the Company, and considering the size of the Telefónica Group and its multinational character, the largest European multinational companies are taken as the main reference; the Dow Jones Global Titans 50 index has also been taken into account.

In addition, there are specific executive compensation studies prepared by specialized international consulting firms. Specifically, in order to determine the compensation package of its Executive Directors for 2013, the Company has taken the following studies particularly into account: (i) the "Executive Remuneration Guide" of the Mercer consulting firm, and (ii) "Comprehensive Market Compensation for Senior Executive Officers," prepared by the Towers Watson consulting firm.

Below is a detailed description of each of the items making up the compensation of the Executive Directors of Telefónica:

Compensation item		Measurement Period	Objective	Description
Fixed annual compensation		N/A	• Attract and retain talent.	Compensation in cash determined according to the Company's reference market and to the individual contribution of the Executive Director.
Short-term variable compensation		1 year	• Link compensation to the Company's short-term results. • Strengthen the commitment to Telefónica.	Variable short-term compensation, the amount of which, established as a percentage of fixed annual compensation, is calculated according to the level of achievement of the following objectives: • Operating Income Before Depreciation and Amortization (OIBDA); • Operating revenues; • Operating cash flow; • Satisfaction level of the Group's customers.
Medium- and long-term variable compensation	Performance Share Plan (through 2010) / Performance & Investment Plan (as from 2011)	3 years	• Foster retention and motivation of Executive Directors. • Tie compensation to the medium- and long-term results of the Company. • Reward the creation of value for shareholders.	Variable long-term compensation consisting of the delivery of Telefónica, S.A. shares linked to compliance with certain conditions and achievement of certain objectives, measured in three-year cycles: • Continued employment by the Group. • Performance of Telefónica's Total Shareholder Return (TSR) throughout each cycle compared to TSR performance at the companies included in the comparison group.
Benefits	Pension/Retirement Plan	N/A	Ensure the provision of benefits in line with current market practices.	General Pension Plan for employees of the Telefónica Group.
	Benefit Plan for Executive Officers	N/A	Supplement the Company's General Pension Plan.	Defined contribution Retirement Plan, calculated as a percentage of the fixed compensation of Executive Directors.

In-kind compensation		N/A	Ensure the provision of benefits in line with current market practices.	General health insurance and dental coverage, in line with the policy applicable to the other employees of the Telefónica Group.
				Life insurance with death or disability coverage, in line with the policy applicable to the other employees of the Telefónica Group.
Other compensation	Global Employee Share Plan	N/A	• Strengthen Telefónica's image as a global employer, creating a common compensation culture across the Company. • Encourage the acquisition of equity interests by all employees of the Group. • Foster motivation and loyalty.	Share Purchase Plan for all employees of the Group, including Executive Directors, whereby they may acquire Telefónica shares over a twelve-month period, up to a maximum of 1,200 euros per annum, with the commitment by the Company to deliver, free of charge, a number of shares equal to the number of shares acquired, provided certain requirements are met.

2.1 *Fixed Compensation*

The portion of compensation that is determined according to the competitive level in the reference market and to the individual contribution of the Executive Director.

2.2 *Variable Short-Term (Annual) Compensation*

In order to link the compensation of Executive Directors to the Company's short-term results, strengthen their commitment to Telefónica and promote their performance, a significant portion of the compensation of Executive Directors is variable and is linked to the achievement of objectives established by Telefónica at the beginning of each fiscal year, according to the duties discharged by each of them.

To that end, Telefónica has a short-term variable compensation system in place in which the Executive Directors of the Company participate, under which such Directors may receive, annually and following verification of the achievement of the objectives established at the beginning of each fiscal year, a specified percentage of their annual fixed compensation.

For the current fiscal year 2013, the amount of the short-term variable compensation that the Executive Directors of Telefónica could receive, within the limits described above, will be determined by the level of achievement of a number of objectives that ensure a balance between the financial and the operating aspects of the management of the Company, as follows:

- OIBDA (Operating Income Before Depreciation and Amortization);
- Operating Revenue;
- Operating Cash Flow; and
- Level of satisfaction of the Group's customers.

The conditions of the annual variable compensation system applicable to Executive Directors, including the structure and maximum levels of compensation, the objectives established and the weight of each are reviewed by the Company on an annual basis in accordance with its strategy and needs and the situation of the business.

2.3 *Variable Medium- and Long-Term Compensation*

In order to foster the retention and motivation of Executive Directors and their alignment with the creation of value for the shareholders of Telefónica in a sustained fashion over time, the Company has a variable compensation policy that consists of the delivery of Telefónica shares linked to the achievement of medium- and long-term goals.

This policy provides for the delivery to the participants selected for that purpose (executive officers of Telefónica and other companies of the Telefónica Group, including Executive Directors) of a specified number of shares of Telefónica as variable compensation upon prior compliance with the requirements established in such policy.

The application of such compensation policy is approved by the shareholders at the General Shareholders' Meeting, who determine the value of the shares used as a reference for the allotment, the maximum number of shares to be allotted to each Director, the duration of such compensation system and such other conditions as they deem appropriate.

As of the date hereof, Telefónica's medium- and long-term variable compensation policy is implemented through the following plans:

- The Performance Share Plan (PSP), approved by the shareholders at the Ordinary General Shareholders' Meeting of Telefónica held on June 21, 2006, the fifth and last cycle of which began in 2010 and will end in 2013.

- The Performance & Investment Plan (PIP) approved by the shareholders at the Ordinary General Shareholders' Meeting held on May 18, 2011, to replace the PSP, the first cycle of which began in 2011 and will end in 2014, and the second cycle of which began in 2012 and will end in 2015.

The main features of both plans are described below:

2.3.1 Performance Share Plan (PSP)

The Performance Share Plan (PSP) is a long-term incentive plan of five cycles of three years each, consisting of the delivery to the participants therein, upon prior compliance with the requirements set out in the Plan, of a specified number of shares of Telefónica as variable compensation.

At the beginning of each cycle, each participant is assigned a maximum number of shares at the Company's discretion. In principle, the delivery of the shares is contingent upon continued employment of the participant by Telefónica during the three years of each cycle, as well as upon achievement of the objective established in the Plan.

The specific number of shares to be delivered to the participant at the end of the cycle is obtained by multiplying such maximum number by the achievement level reached at the end of such cycle. The achievement level is determined by means of the Total Shareholder Return (TSR), which makes it possible to measure the performance of a company on the basis of the value created for the shareholders through the change in the listing price of its shares and the dividends generated.

The performance of Telefónica's TSR throughout each cycle of the PSP is compared to TSR performance at the companies included in the FTSE Global Telecoms Index during the same period, according to the following ranges:

TSR percentile range / TELEFÓNICA TSR percentile	**Plan Objective** (% of allotted shares that are vested)
Below the median	0%
Median	30%
Upper quartile	100%

If Telefónica's TSR stays between the third quartile of the comparison group and the median, a linear interpolation will be made, and if it is below the median, no shares will be delivered.

In fact, no shares were delivered following the end of the fourth cycle of the PSP (2009-2012) in July 2012.

As of the date of this Report, the PSP is in its fifth cycle (2010-2013), which began on July 1, 2010, and the delivery of the shares, if any, to each participant on the basis of the TSR achievement level will take place beginning on July 1, 2013.

2.3.2 Performance & Investment Plan (PIP)

The Performance & Investment Plan (PIP) is a long-term incentive plan of three cycles of three years each, consisting of the delivery to the participants therein, upon prior compliance with the requirements and conditions established therein, of a specified number of shares of Telefónica as variable compensation.

Such Plan was approved by the shareholders at the Ordinary General Shareholders' Meeting held on May 18, 2011, in order to bring the interests of participants into line with those of the shareholders of the Company, promote the acquisition of equity interests therein and foster the retention of its executive officers, as a result of the conclusion, during fiscal year 2013, of the last cycle of the PSP described above.

At the beginning of each cycle, the Company determines, at its sole discretion, the number of shares that may be delivered to participants under the Plan, subject to the established maximum number.

In order to foster the creation of value for the shareholders by strengthening the alignment between their interests and those of the management team of Telefónica, the PIP includes, as an innovation with respect to the PSP, the possibility of “co-investment.” This means that, for each of the cycles of the PIP, participants who acquire a specific number of shares established prior to the beginning of each cycle and maintain such status as Telefónica shareholders during the effectiveness thereof, on the terms and conditions established in the Plan, will increase their initial allotment of shares for such cycle by 25%.

The delivery of the allotted shares, including those, if any, deriving from the aforementioned “co-investment,” is contingent upon attainment of the level of achievement of the objective established in the Plan as well as, in principle, upon the continued employment of the participant by Telefónica during the three years of such cycle.

The level of achievement will be measured and determined by means of the TSR. Changes in Telefónica’s TSR throughout each cycle of the PIP will be compared to the changes in TSR at the companies included on the Dow Jones Sector Titans Telecom Index during the same period, in accordance with the following ranges:

TSR percentile range/ TELEFÓNICA TSR percentile	**Plan Objective** (% of allotted shares that are vested)
Below the median	0%
Median	30%
Upper quartile	100%
Upper decile	125%

If the Company’s TSR is between the median and the upper decile of the comparison group, vesting will be linear and prorated between the relevant points. Intermediate points will be calculated by linear interpolation.

As of the date of this Report, the following cycles of the PIP are in effect:

- First cycle (2011-2014): it began on July 1, 2011, and the delivery of the shares, if any, to which each participant is entitled on the basis of the level of achievement of the TSR will take place beginning on July 1, 2014.

- Second cycle (2012-2015): it began on July 1, 2012, and the delivery of the shares, if any, to which each participant is entitled on the basis of the level of achievement of the TSR will take place beginning on July 1, 2015.

The third and last cycle of the PIP (2013-2016) will begin in the current fiscal year 2013, and the delivery of the shares, if any, to which each participant is entitled will take place beginning on July 1, 2016.

2.4 Benefits

As part of their in-kind compensation, Executive Directors have the following benefits, which are in line with current market practices:

- General health insurance and dental coverage, in line with the benefits enjoyed by the other employees of the Telefónica Group.

- Life insurance with death or disability coverage that is also in line with the benefits enjoyed by the other employees of the Telefónica Group.

- Pension/Retirement Plan: Executive Directors participate in the General Pension Plan for employees of the Telefónica Group (the "Pension Plan").

Furthermore, in order to supplement the current Pension Plan, an Executive Officer Benefit Plan (Retirement Plan) was approved in 2006 in which Executive Directors participate. Under such Plan, Telefónica makes contributions calculated on the basis of a percentage of the fixed compensation of each executive officer, which varies according to their professional level in the organization of the Company, and that such executive officers may receive, on the terms and conditions established in the Plan, in the instances expressly established in applicable legal provisions governing pension plans and pension funds.

2.5 Other Compensation

In order to strengthen Telefónica's status as a global employer, creating a common compensation culture across the Company, promote the acquisition of equity interests by all employees of the Group and foster their motivation and loyalty, the shareholders at the Ordinary General Shareholders' Meeting of the Company held on June 23, 2009 approved the implementation of a Telefónica incentive share purchase plan for all employees of the Group at the international level (including executive officers and Executive Directors) known as "Global Employee Share Plan" ("GESP").

Through this Plan, employees are offered the possibility of acquiring Telefónica shares during a maximum period of twelve months, and the Company undertakes to deliver to them, without charge, a number of shares equal to the number acquired, provided certain requirements are satisfied.

The employees participating in the Plan may acquire Telefónica shares by means of monthly contributions of up to 100 euros (or the equivalent thereof in domestic currency), subject to a maximum amount of 1,200 euros and a minimum amount of 300 euros over a twelve-month period (purchase period). If the employee remains at the Telefónica Group and retains the shares for one additional year as from the end of the purchase period (vesting period), the employee will be entitled to receive one free share for each share acquired and held through the end of the vesting period.

Following the success of the GESP and as a result of the termination thereof, the shareholders at the Ordinary General Shareholders' Meeting of the Company held on May 18, 2011, approved a new edition of such Plan, on the same terms and conditions as the previous one, which the Company implemented during fiscal year 2012.

The Executive Directors of the Company were invited to participate in the two editions of the GESP, on the same terms and conditions and with the same limitations on contributions to the Plan as all other employees of the Group, in order to maximize the success thereof, with which the Company promoted the participation of the employees of the Group and encouraged them to show their confidence in the performance of Telefónica's shares.

2.6 Basic Terms of the Contracts of Executive Directors: Termination, Non-competition and Exclusivity Agreement

The contracts of Executive Directors and some of the members of the Company's management team in general provide that they will be entitled to receive the financial compensation described below in the event of termination of the relationship for a reason attributable to the Company, and in some cases also due to the occurrence of objective circumstances, such as a change of control in the Company.

Conversely, if the relationship is terminated because of a breach attributable to the Executive Director, or because of his/her own free decision, s/he shall not be entitled to any compensation.

However, it should be noted that, in certain cases, the compensation that Executive Directors are entitled to receive under their contract does not result from the application of these general standards, but rather depends on their personal and professional circumstances and on the time when the contract was signed.

The financial compensation agreed in the event of termination of the relationship, where appropriate, consists of a maximum of three times annual salary and an additional annual salary amount according to length of service at the Company. Annual salary amounts consist of the last fixed compensation and the arithmetic mean of the sum of the last two annual variable compensation payments received pursuant to their contract.

The contracts executed with Executive Directors include a non-competition agreement. Such agreement provides that, upon termination of the respective contract and for the term of the agreement, the Executive Director may not render services, directly or indirectly, for his/her own account or on behalf of others, personally or through third parties, to Spanish or foreign companies whose business is the same as or similar to that of the Telefónica Group.

The above-mentioned agreement not to compete has a duration of one year following termination of the contract for any reason. There is an exception in the event of dismissal that is wrongful or void and without reinstatement, so declared by a final court decision, arbitration award or administrative ruling without the possibility of appeal, in which case the Executive Director shall be released from the agreement not to compete.

The contracts with the Executive Directors also prohibit, during the term thereof, the signing (whether personally or through intermediaries) of other employment, commercial or civil contracts with other companies or entities carrying out activities similar in nature to those of the Telefónica Group.

Finally, the contracts executed with the Executive Directors provide that their employment relationship is compatible with the holding of other representative and management positions and with other professional situations in which the Director may be engaged at other entities within the Telefónica Group or at any other entities unrelated to the Group with the express knowledge of the Board of Directors of Telefónica or of the Chairman thereof.

III. EXPECTED COMPENSATION POLICY FOR FUTURE FISCAL YEARS

As of the date of this Report, no significant changes are expected in the application of the Director compensation policy described in section II above.

Nevertheless, within the framework of its policy of continuous review of the Company's corporate governance system, the Board of Directors believes that the Company should have a Director compensation policy that is appropriate for the circumstances prevailing at any time, paying particular attention to changes in laws and regulations, best practices, recommendations and trends –both at the domestic and at the international level– in connection with the compensation of directors of listed companies and the conditions of the market.

In the specific case of Executive Directors, in the future the Company intends to continue to apply a policy that provides for a combination of fixed and variable compensation, to be determined in accordance with the principles described in sub-section II.C above, i.e., following standards and parameters that will allow for the retention, motivation and commitment of the persons performing executive duties for the Group, that are also aligned with the achievement of the strategic and business objectives established at the Telefónica Group at any time. In this connection, it is expected that in future fiscal years, as the life cycles of current plans are completed, new long-term variable compensation plans for Executive Directors and employees of the Group will be designed and submitted to the shareholders at the General Shareholders' Meeting.

IV. DIRECTOR COMPENSATION DURING FISCAL YEAR 2012: OVERALL SUMMARY AND BREAKDOWN OF INDIVIDUAL COMPENSATION

The features, structure and general standards for application of the Director compensation policy for fiscal year 2012 are basically those described in section II above in connection with the compensation policy for the current year.

Below is a description of some more specific aspects of the application of such policy in fiscal year 2012, including a breakdown of the individual compensation accruing to each Director, both for their activities as such and for the performance of executive duties, where applicable.

1. Compensation of Directors for their Activities as Such

The annual gross maximum amount of the compensation to be received by the members of the Board of Directors in their capacity as such, approved by the shareholders at the Ordinary General Shareholders' Meeting of April 11, 2003, totaling 6 million euros, continued to apply during fiscal year 2012.

As noted in sub-sections II.A and II.C.1 above, it falls upon the Board of Directors to set the overall amount of the compensation to be received by the Directors of Telefónica for serving in such capacity, within the amount mentioned above, as well as to distribute such amount among the Directors.

The compensation of the Directors of Telefónica for serving on the Board of Directors, the Executive Commission and/or the Advisory or Control

Committees consists of a fixed amount, payable monthly, and of fees for attending the meetings of the Advisory or Control Committees.

For fiscal year 2012, such amount totaled 4,001,151 euros.

In fiscal year 2012, such overall amount was distributed among the Directors in accordance with the same standards approved by the Board in 2007, mentioned in sub-section II.C.1 above. However, at its meeting held on July 25, 2012, the Board of Directors of the Company resolved to reduce by 20% the amounts received by the members of such Board in their capacity as such.

Below is a description of such standards:

1.1 Fixed Amount

Set forth below are the amounts established as fixed compensation for sitting on the Board of Directors, the Executive Commission and the Advisory or Control Committees of Telefónica:

- A fixed amount, stated in annual terms, applicable until the Board of Directors approved a 20% reduction in such amount at its meeting of July 25, 2012:

(Amounts in euros)

Position	Board of Directors	Executive Commission	Advisory or Control Committees (*)
Chairman	300,000	100,000	28,000
Vice-Chairman	250,000	100,000	-
Member	-	-	-
Executive	-	-	-
Proprietary	150,000	100,000	14,000
Independent	150,000	100,000	14,000
Other external	150,000	100,000	14,000

(*) In addition, the amount of the fee for attending each of the meetings of the Advisory or Control Committees was 1,250 euros.

- A fixed amount, stated in annual terms, applicable following the approval by the Board of Directors, at its meeting of July 25, 2012, of a 20% reduction in such amount, which was applied to payments for the period between July 1 and December 31, 2012:

(Amounts in euros)

Position	Board of Directors	Executive Commission	Advisory or Control Committees (*)
Chairman	240,000	80,000	22,400
Vice-Chairman	200,000	80,000	-
Member	-	-	-
Executive	-	-	-
Proprietary	120,000	80,000	11,200
Independent	120,000	80,000	11,200
Other external	120,000	80,000	11,200

(*) In addition, the amount of the fee for attending each of the meetings of the Advisory or Control Committees is 1,000 euros.

1.2 Attendance Fees

As mentioned above, the Directors do not receive any kind of fees for attending meetings of the Board of Directors or of the Executive Commission, and only receive the fees established for attending meetings of Advisory or Control Committees. The amount established for such item was 1,250 euros per meeting until July 2012, and is 1,000 euros per meeting since such date.

1.3 Summary of the Total Compensation Received by the Directors during Fiscal Year 2012

The table below contains a breakdown, by director and by item of compensation, of the compensation and benefits received from Telefónica by the members of the Board of Directors of the Company during fiscal year 2012 (it should be noted that a more detailed breakdown of the compensation of the Executive Directors set forth in this table is provided in sub-section IV.2 below):

(Amounts in euros)

Director	Salary/ Compens-ation [1]	Fixed compensation Board Committees [2]	Attend-ance fees[3]	Variable short-term compensation[4]	Other items[5]	TOTAL 2012
Executive						
Mr. César Alierta Izuel	2,500,800	90,000	-	3,493,433	264,899	6,349,132
Mr. José María Álvarez-Pallete López	1,474,284	-	-	1,042,088	93,338	2,609,710
Ms. Eva Castillo Sanz	461,670	29,400	19,000	-	7,684	517,754
Mr. Santiago Fernández Valbuena	-	-	-	-	-	-
Proprietary						
Mr. Isidro Fainé Casas	225,000	90,000	-	-	11,500	326,500
Mr. José María Abril Pérez	225,000	115,200	12,750	-	-	352,950
Mr. Antonio Massanell Lavilla	135,000	63,000	26,000	-	11,250	235,250
Mr. Ignacio Moreno Martínez	135,000	-	-	-	-	135,000
Mr. Chang Xiaobing	135,000	-	-	-	-	135,000
Independent						
Mr. David Arculus	105,000	19,600	4,500	-	-	129,100
Mr. Carlos Colomer Casellas	135,000	140,400	24,750	-	21,250	321,400
Mr. Peter Erskine	135,000	140,400	33,000	-	3,750	312,150
Mr. Alfonso Ferrari Herrero	135,000	190,800	50,750	-	21,500	398,050
Mr. Luiz Fernando Furlán	135,000	12,600	1,000	-	-	148,600
Mr. Gonzalo Hinojosa Fernández de Angulo	135,000	178,200	45,250	-	22,750	381,200
Mr. Pablo Isla Álvarez de Tejera	135,000	63,000	13,750	-	-	211,750
Mr. Francisco Javier de Paz Mancho	135,000	140,400	12,500	-	10,000	297,900
Other External						
Mr. Julio Linares López	1,688,216	-	-	5,966,275	25,159,663	32,814,154
Mr. Fernando de Almansa Moreno-Barreda	135,000	50,400	19,500	-	9,000	213,900

1 **Salary:** Cash compensation, payable at pre-established intervals, whether or not to be vested over time and paid by the Company for the mere fact of being employed by it, irrespective of actual attendance by the Director at the meetings of the Board of Telefónica, S.A. It also includes non-variable compensation, if any, accruing to the Director for the performance of executive duties.

2 **Fixed compensation – Committees of the Board**: Amount of items other than attendance fees, of which the Directors are beneficiaries for sitting on the Executive Commission or on the Advisory or Control Committees of the Board of Telefónica, S.A., irrespective of their actual attendance at the meetings of such Committees.

3 **Attendance fees:** Total amount of fees for attending meetings of the Advisory or Control Committees of the Board of Telefónica, S.A.

4 **Short-term variable compensation:** Variable amount linked to performance or to the achievement of a number of (quantitative or qualitative) individual or group objectives and on the basis of other compensation, or of any other reference in euros, within a period of one year or less. As regards Mr. Julio Linares López, the amount shown is that corresponding to two annual payments (2011-2012).

5 **Other items:** Includes, among other things: (i) 24,748,696 received as severance by Mr. Julio Linares López, as a result of his having ceased to perform his executive duties, and (ii) other amounts received for membership in the various Territorial Advisory Committees existing in Spain and in the Advisory Board of the Corporate University.

In connection with the information set forth in the preceding table, it is hereby stated for the record that: (i) On December 31, 2012, five years after he stopped performing executive duties at the Telefónica Group (as an employee and as a Director), the status of Mr. Peter Erskine changed from “Other External [Director]” to “Independent Director”; (ii) On September 17, 2012, Mr. Julio Linares López, theretofore Chief Operating Officer (COO) of the Company, stopped performing executive duties at the Telefónica Group, and his status therefore changed from “Executive Director” to “Other External [Director]”; (iii) On September 17, 2012, Ms. Eva Castillo Sanz was appointed Chair of Telefónica Europe and her status therefore changed from “Independent Director” to “Executive Director”; the table above shows the compensation she received as Chair of Telefónica Europe as from October 2012; (iv) On September 17, 2012, Mr. Santiago Fernández Valbuena was appointed Director of the Company with the status of “Executive Director,” and the table “Other Amounts Received from Other Companies of the Group” (on page 27) shows the compensation he received as Chairman of Telefónica Latin America as from October 2012; and (v) On September 17, 2012, Mr. David Arculus stepped down as Director of the Company, and the table sets forth the compensation he received through October 2012.

In addition, further specifying the figures set forth in the preceding table, below is the compensation received by the Directors of Telefónica for membership in the various Advisory or Control Committees during fiscal year 2012, including both the fixed amount and attendance fees:

Directors	Audit & Control	Nominating, Compensation and Corporate Governance	HH.RR., Reputation and CR	Regulation	Service Quality and Commercial Service	International Affairs	Innovation	Strategy	**TOTAL 2012**
Mr. César Alierta Izuel	-	-	-	-	-	-	-	-	-
Mr. Isidro Fainé Casas	-	-	-	-	-	-	-	-	-
Mr. Julio Linares López	-	-	-	-	-	-	-		-
Mr. José María Abril Pérez	-	-	-	-	-	14,850	23,100	-	37,950
Mr. José María Álvarez-Pallete López	-	-	-	-	-	-	-	-	-
Mr. José Fernando de Almansa Moreno-Barreda	-	-	-	17,100	-	28,450	-	24,350	69,900
Mr. David Arculus	-	-	-	13,300	-	10,800	-	-	24,100
Ms. Eva Castillo Sanz	-	-	-	13,300	14,550	-	-	20,550	48,400
Mr. Carlos Colomer Casellas	-	19,850	-	-	17,350	-	37,950	-	75,150
Mr. Peter Erskine	-	23,100	-	-	-	-	23,350	36,950	83,400
Mr. Santiago Fernández Valbuena	-	-	-	-	-	-	-	-	-
Mr. Alfonso Ferrari Herrero	23,100	36,700	17,350	17,100	18,350	14,600	-	24,350	151,550
Mr. Luiz Fernando Furlán	-	-	-	-	-	13,600	-	-	13,600
Mr. Gonzalo Hinojosa Fernández de Angulo	35,700	24,100	17,350	-	17,100	14,850	-	24,350	133,450
Mr. Pablo Isla Álvarez de Tejera	-	21,850	12,600	29,700	12,600	-	-	-	76,750
Mr. Ignacio Moreno Martínez	-	-	-	-	-	-	-	-	-
Mr. Antonio Massanell Lavilla	19,850	-	14,850	-	30,950	-	23,350	-	89,000
Mr. Francisco Javier de Paz Mancho	-	-	29,950	17,100	-	15,850	-	-	62,900
Mr. Chang Xiaobing	-	-	-	-	-	-	-	-	-
TOTAL	78,650	125,600	92,100	107,600	110,900	113,000	107,750	130,550	866,150

1.4. Other Amounts Received from Other Companies of the Telefónica Group

The table below contains an individual breakdown of the amounts received by the Directors of the Company from companies of the Telefónica Group other than Telefónica for the performance of executive duties or for sitting on the Boards of Directors and/or Advisory Boards of such companies:

(Amounts in euros)

Director	Salary/ Compensation[1]	Attendance Fees[2]	Short-term variable compensation[3]	Other Items[4]	TOTAL
Executive		-	-		
Ms. Eva Castillo Sanz	48,034	-	-	136,500	184,534
Mr. Santiago Fernández Valbuena	361,143	-	-	48,605	409,748
Independent		-	-		
Mr. David Arculus	-	-	-	63,565	63,565
Mr. Peter Erskine	-	-	-	84,754	84,754
Mr. Alfonso Ferrari Herrero	100,950	-	-	175,500	276,450
Mr. Luiz Fernando Furlán	105,991	-	-	175,500	281,491
Mr. Gonzalo Hinojosa Fernández de Angulo	17,322	-	-	-	17,322
Mr. Francisco Javier de Paz Mancho	658,688	-	-	175,500	834,188
Other External					
Mr. Fernando de Almansa Moreno-Barreda	216,293	-	-	175,500	391,793

1 **Salary:** Cash compensation, payable at pre-established intervals, whether or not to be vested over time and paid by the companies of the Group for the mere fact of being employed by them, irrespective of actual attendance by the Director at the meetings of the Board of Directors or similar bodies of the company of the Telefónica Group in question. It also includes non-variable compensation, if any, accruing to the Director for the performance of executive duties.

2 **Attendance fees:** Total amount of the fees for attending meetings of the Board of Directors or of similar bodies of any company of the Telefónica Group.

3 **Short-term variable compensation**: Variable amount linked to performance or to the achievement of a number of (quantitative or qualitative) individual or group objectives and on the basis of other compensation or any other reference in euros, within a period of one year or less.

4 **Other items:** These include, among others, the amounts received for membership in Territorial Advisory Boards.

2. Compensation of Executive Directors

2.1. Fixed and Variable Short-Term (Annual) Compensation

The following table shows the changes in the fixed and variable annual compensation paid to Executive Directors for the performance of their executive duties over the last two fiscal years (Executive Directors who had such status as of December 31 of each fiscal year are included):

Amounts in euros (except percentages)

	2012	**2011**	**2012/2011**
Variable compensation [1]	4,535,521	8,167,158	-44.47%
Fixed compensation	4,837,424	5,938,408	-18.54%
Total salary compensation	**9,372,945**	**14,105,566**	-33.55%
Percentage of total salaries represented by variable compensation	48.39%	57.90%	n/a

1 Note: The variable compensation shown for a given year is the compensation paid in such year for the performance and results of the prior fiscal year.

2.2. *Medium- and Long-term Variable Compensation*

2.2.1. *Performance Share Plan* (*PSP*)

As regards the shares allotted in connection with the PSP (the features of which are described in sub-section II.C.2.3.1 above), the table below sets forth the maximum number of shares for the fifth (and last) cycle (2010-2013) of the Plan that shall only be delivered (beginning on July 1, 2013) to each of the Executive Directors of Telefónica if the conditions set for such delivery have been satisfied:

	Maximum Number of Shares Allotted Fifth Cycle
Mr. César Alierta Izuel	170,897
Mr. Julio Linares López	128,173
Mr. José María Álvarez-Pallete López	77,680
Mr. Santiago Fernández Valbuena	77,680

It is also stated for the record that, as regards the fourth cycle (2009-2012) of this Plan, pursuant to the general terms and conditions thereof, no shares had to be delivered and, accordingly, no shares were delivered to the Executive Directors.

2.2.2 *Performance & Investment Plan (PIP)*

Below is the number of shares allotted, as well as the maximum number of shares to be received, if the beneficiary elected the "co-investment" alternative described in the PIP (the features of which are described in sub-section II.C.2.3.2 above) and in the event of maximum achievement of the target TSR set for the first and second cycles, that the Directors of Telefónica would be entitled to receive for performing executive duties:

(First Cycle / 2011-2014)

Name and Surnames	*Notional Shares Allotted*	*Maximum Number of Shares**
Mr. César Alierta Izuel	249,917	390,496
Mr. Julio Linares López	149,950	234,298
Mr. José María Álvarez-Pallete López	79,519	124,249
Mr. Santiago Fernández Valbuena	79,519	124,249

* Maximum possible number of shares to be received in the event of satisfaction of the "co-investment" requirement and of maximum achievement of the target TSR.

(Second cycle / 2012-2015)

Name and Surnames	*Notional Shares Allotted*	*Maximum Number of Shares**
Mr. César Alierta Izuel	324,417	506,901
Mr. Julio Linares López (1)	13,878	21,685
Mr. José María Álvarez-Pallete López	188,131	293,955
Ms. Eva Castillo Sanz	95,864	149,787
Mr. Santiago Fernández Valbuena	103,223	161,287

(1) The number of shares allotted to Mr. Linares has been determined in proportion to the time during which he performed his executive duties as Chief Operating Officer -COO- (from July 1, 2012 until September 17, 2012), during this second cycle of this Plan.

* Maximum possible number of shares to be received in the event of satisfaction of the "co-investment" requirement and of maximum achievement of the target TSR .

2.3. Benefits

Set forth below is a breakdown of the contributions made, during fiscal year 2012, both to long-term savings plans (including retirement and any other survivor benefits) funded in whole or in part by the Company for the benefit of the Directors for the performance of executive duties (which are described in sub-section II.C.2.4 above) and for other in-kind compensation received by the Directors during such fiscal year:

(Amounts in euros)

Directors	Pension plan contributions	Contributions to the Benefits Plan [1]	In-kind compensation [2]
Mr. César Alierta Izuel	8,402	1,014,791	45,917
Mr. Julio Linares López	9,468	474,895	39,141
Mr. José María Álvarez-Pallete López	7,574	414,716	12,765
Ms. Eva Castillo Sanz	8,402	98,443	1,617
Mr. Santiago Fernández Valbuena	-	110,112	6,564

1 Contributions to the **Executive Officer Benefit Plan** established in 2006, funded solely by the Company, to supplement the current Pension Plan, which entails defined contributions equal to a specified percentage of the fixed compensation of Executive Officers, depending on their professional levels in the organization of the Telefónica Group.

2 The "**In-kind compensation**" item includes contributions for life and other insurance, such as general medical insurance and dental coverage.

2.4 Other Contributions

As regards the first edition of the plan known as the Global Employee Share Plan (GESP 2010-2011), approved in fiscal year 2009 (the features of which are described in sub-section II.C above), the Directors who participated therein because they were performing executive duties within the Group acquired a total of 604 shares (which include those received free of charge, in accordance with the general conditions of such Plan).

As for the second edition of such Employee Plan (GESP 2012-2013), approved in fiscal year 2011, the Executive Directors who decided to participate in this Plan with the maximum contribution (i.e., 100 euros a month), for twelve months, had acquired a total of 84 shares under this Plan as of the date of preparation of this Report; such Directors are entitled to receive, free of charge, an equal number of shares, provided, among other conditions, that they have held the shares acquired during the vesting period (twelve months following the end of the purchase period).