

TELEFONICA S A  
Form 20-F  
February 23, 2017

As filed with the Securities and Exchange Commission on February 23, 2017

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 20-F**

(Mark One)

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**OR**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the fiscal year ended December 31, 2016**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**OR**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Commission file number: 001-09531**

**TELEFÓNICA, S.A.**

(Exact name of Registrant as specified in its charter)

**KINGDOM OF SPAIN**

(Jurisdiction of incorporation or organization)

**Distrito Telefónica, Ronda de la Comunicación, s/n  
28050 Madrid, Spain**

(Address of principal executive offices)

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(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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

Title of each class

Name of each exchange on which registered

**Ordinary Shares, nominal value 1.00 euro per share\***    **New York Stock Exchange**  
**American Depositary Shares, each representing one**    **New York Stock Exchange**  
**Ordinary Share**

**Guarantees\*\* by Telefónica, S.A. of the \$700,000,000 Fixed Rate Guaranteed Senior Notes Due 2017; \$500,000,000 Floating Rate Guaranteed Senior Notes Due 2017; \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2018; \$1,000,000,000 Fixed Rate Notes Due 2019; \$1,400,000,000 Fixed Rate Guaranteed Senior Notes Due 2020; \$1,500,000,000 Fixed Rate Guaranteed Senior Notes Due 2021; \$750,000,000 Fixed Rate Guaranteed Senior Notes Due 2023; \$2,000,000,000 Fixed Rate Guaranteed Senior Notes Due 2036; each of Telefónica Emisiones, S.A.U.; and of the \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2030 of Telefónica Europe, B.V.** **New York Stock Exchange**

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

Not for trading, but only in connection with the listing of the \$700,000,000 Fixed Rate Guaranteed Senior Notes Due 2017; \$500,000,000 Floating Rate Guaranteed Senior Notes Due 2017; \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2018; \$1,000,000,000 Fixed Rate Notes Due 2019; \$1,400,000,000 Fixed Rate Guaranteed Senior Notes Due 2020; \$1,500,000,000 Fixed Rate Guaranteed Senior Notes Due 2021; \$750,000,000 Fixed Rate Guaranteed Senior Notes Due 2023; and \$2,000,000,000 Fixed Rate Guaranteed Senior Notes Due 2036; each of Telefónica Emisiones, S.A.U., and the \$1,250,000,000 Fixed Rate Guaranteed Senior Notes Due 2030 of Telefónica Europe, B.V. (each a wholly-owned subsidiary of Telefónica, S.A.)

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

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

The number of outstanding shares of each class of capital stock of Telefónica, S.A. at December 31, 2016 was:

**Ordinary Shares, nominal value 1.00 euro per share: 5,037,804,990**

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

Yes No

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If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes No

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large Accelerated Filer    Accelerated Filer    Non-accelerated Filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

**U.S. GAAP**

**International Financial Reporting Standards as issued by the International Accounting Standards Board**

**Other**

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

**Item 17    Item 18**

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes    No

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”), as amended, and the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The forward-looking statements in this Annual Report can be identified, in some instances, by the use of words such as “will,” “shall,” “target,” “expect,” “aim,” “hope,” “anticipate,” “should,” “may,” “might,” “assume,” “estimate,” “plan,” and similar language or other formulations of a similar meaning or, in each case, the negative formulations thereof. Other forward-looking statements can be identified in the context in which the statements are made or by the forward-looking nature of discussions of strategy, plans or intentions. These statements appear in a number of places in this Annual Report including, without limitation, certain statements made in “Item 3. Key Information—Risk Factors,” “Item 4. Information on the Company,” “Item 5. Operating and Financial Review and Prospects” and “Item 11. Quantitative and Qualitative Disclosures About Market Risk” and include statements regarding our intent, belief or current expectations with respect to, among other things:

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

the outcome of pending or future litigation or other legal proceedings.

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

changes in general economic, business or political conditions in the domestic or international markets in which we operate or have material investments that may affect demand for our services;

exposure to currency exchange rates, interest rates or credit risk related to our treasury investments or in some of our financial transactions;

existing or worsening conditions in the international financial markets;

the impact of new accounting standards current, pending or future legislation and regulation in countries where we operate, as well as any failure to renew or obtain the necessary licenses, authorizations and concessions to carry out our operations and the impact of limitations in spectrum capacity;

compliance with anti-corruption laws and regulations and economic sanctions programs;

customers' perceptions of services offered by us;

the potential effects of technological changes and sector trends;

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- failure of suppliers to provide necessary equipment and services on a timely basis;
- the impact of unanticipated network interruptions including due to cyber-security actions;
- the effect of reports suggesting that electromagnetic fields may cause health problems;

the impact of impairment charges on our goodwill and assets as a result of changes in the regulatory, business, economic or political environment;

potential liability resulting from our internet access and hosting services arising from illegal or illicit use of the internet, including the inappropriate dissemination or modification of consumer data; and

- the outcome of pending or future litigation or other legal proceedings.

Readers are cautioned not to place undue reliance on those forward-looking statements, which speak only as of the date of this Annual Report. We do not undertake any obligation to update any forward-looking statements that may be made to reflect events or circumstances after the date of this Annual Report including, without limitation, changes in our business or acquisition strategy or planned capital expenditures, or to reflect the occurrence of unanticipated events.

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CERTAIN TERMS AND CONVENTIONS

Our ordinary shares, nominal value 1.00 euro per share, are currently listed on each of the Madrid, Barcelona, Bilbao and Valencia stock exchanges (collectively, the “**Spanish Stock Exchanges**”) and are quoted through the Automated Quotation System under the symbol “TEF.” They are also listed on the London and Buenos Aires stock exchanges. American Depositary Shares (“**ADSs**”), each representing the right to receive one ordinary share, are listed on the New York Stock Exchange and on the Lima Stock Exchange. ADSs are evidenced by American Depositary Receipts (“**ADRs**”) issued under a Deposit Agreement with Citibank, N.A., as Depositary.

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

As used herein, “**Atento**” means Atento Holding, Inversiones y Teleservicios, S.A. and its consolidated subsidiaries, unless the context requires otherwise.

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

“**Access**” refers to a connection to any of the telecommunications services offered by Telefónica. A single fixed customer may contract for multiple services, and Telefónica believes that it is more useful to count the number of accesses a customer has contracted for, than to merely count the number of Telefónica’s customers. For example, a customer that has fixed line telephony service and broadband service is counted as two accesses rather than as one customer.

“**ARPU**” is the average revenues per user per month. ARPU is calculated by dividing total gross service revenues (excluding inbound roaming revenues) from sales to customers for the preceding 12 months by the weighted average number of accesses for the same period, and then dividing by 12.

“**Bundles**” refer to combination products that combine fixed services (wirelines, broad band and television) and mobile services.

“**Churn**” is the percentage of disconnections over the average customer base in a given period.

“**Cloud computing**” is the delivery of computing as a service rather than a product, whereby shared resources, software and information are provided to computers and other devices as a utility over a network (typically the Internet).

“**Commercial activity**” includes the addition of new lines, replacement of handsets and migrations.

“**Data ARPU**” is the average data revenues per user per month. Data ARPU is calculated by dividing total data revenues from sources such as Short Message Service (SMS), Multimedia Messaging Services (MMS), other mobile data services such as mobile connectivity and mobile Internet, premium messaging, downloading ringtones and logos, mobile mail and wireless application protocol (WAP) connectivity from sales to customers for the relevant period by the weighted average number of accesses for the same period, and then dividing by the relevant period.

“**Data revenues**” include revenues from SMS, MMS, other mobile data services such as mobile connectivity and mobile Internet, premium messaging, downloading ringtones and logos, mobile mail and WAP connectivity from sales to customers.

“**Data traffic**” includes all traffic from Internet access, messaging (SMS, MMS) and connectivity services that is transported by the networks owned by Telefónica.

“**FaaST**” is a cybersecurity technology that scans an organization’s system 24 hours a day, seven days a week, in order to prevent cybernetic attacks.

“**Fixed telephony accesses**” includes public switched telephone network, or PSTN, lines (including public use telephony), and integrated services digital network, or ISDN, lines and circuits. For purposes of calculating Telefónica’s number of fixed line accesses, Telefónica multiplies its lines in service as follows: PSTN (x1); basic ISDN (x1); primary ISDN (x30, x20 or x10); 2/6 digital accesses (x30).

“**Fixed termination rates**” is an established fixed network tariff that applies when a customer makes a call to someone in a network operated by another operator.

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“**FTTx**” is a generic term for any broadband network architecture that uses optical fiber to replace all or part of the metal local loop.

“**Gross adds**” means the gross increase in the customer base measured in terms of accesses in a period.

“**HDTV**” or “high definition TV” has at least twice the resolution of standard definition television (SDTV), allowing it to show much more detail than an analog television or digital versatile disc (DVD).

“**Interconnection revenues**” means revenues received from other operators which use Telefónica’s networks to connect or to finish their calls and SMS or connect to their customers.

“**Internet and data accesses**” include broadband accesses (including retail asymmetrical digital subscriber line “ADSL,” very high bit-rate digital subscriber line “VDSL”, satellite, fiber optic and circuits over 2 Mbps), narrowband accesses (Internet service through the PSTN lines) and the remaining non-broadband final customer circuits. Internet and data accesses also include “Naked ADSL”, which allows customers to subscribe for a broadband connection without a monthly fixed line fee.

“**IPTV**” (**Internet Protocol Television**) refers to distribution systems for television subscription signals or video using broadband connections over the IP protocol.

“**ISP**” means Internet service provider.

“**IT**”, or information technology, is the acquisition, processing, storage and dissemination of vocal, pictorial, textual and numerical information by a microelectronics-based combination of computing and telecommunications.

“**Latch**” is a cybernetic application, protecting accounts and on-line services.

“**Local loop**” means the physical circuit connecting the network termination point at the subscriber’s premises to the main distribution frame or equivalent facility in the fixed public telephone network.

“**LTE**” means Long Term Evolution, a 4G mobile access technology.

“**M2M**”, or machine to machine, refers to technologies that allow both mobile and wired systems to communicate with other devices of the same ability.

“**Market share**” is the percentage ratio of the number of final accesses or operator revenues over the existing total market in an operating area.

“**Metashield**” is a cybernetic product for protecting metadata (information on data) in digital documents and archives.

“**Mobile accesses**” includes accesses to the mobile network for voice and/or data services (including connectivity). Mobile accesses are categorized into contract and prepaid accesses.

“**Mobile broadband**” includes Mobile Internet (Internet access from devices also used to make voice calls such as smartphones), and Mobile Connectivity (Internet access from devices that complement fixed broadband, such as PC Cards/dongles, which enable large amounts of data to be downloaded on the move).

“**MTR**” means mobile termination rate, which is the charge per minute or SMS paid by a telecommunications network operator when a customer makes a call to another network operator.

“**MVNO**” means mobile virtual network operator, which is a mobile operator that is not entitled to use spectrum for the provision of mobile services. Consequently, an MVNO must subscribe to an access agreement with a mobile network operator in order to provide mobile access to their customers. An MVNO pays a determined tariff to such a mobile network operator for using the infrastructure to facilitate coverage to their customers.

“**Net adds**” means the number of new accesses in a certain period.

“**Non SMS data revenues**” means data revenues excluding SMS revenues.



**“OTT services” or “over the top services”** means services provided through the Internet (such as television).

**“P2P SMS”** means person to person short messaging service (usually sent by mobile customers).

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“**Pay TV**” includes cable TV, direct to home satellite TV, or DTH, and Internet Protocol TV, or IPTV.

“**Revenues**” means net sales and revenues from rendering of services.

“**Service revenues**” means revenues less revenues from handset sales. Service revenues are mainly related to telecommunications services, especially voice revenues and data revenues (SMS and data traffic download and upload revenues) consumed by Telefónica’s customers.

“**SIM**” means subscriber identity module, a removable intelligent card used in mobile handsets, USB modems, etc. to identify the user in the network.

“**Tacyt**” is a cybersecurity tool that supervises, stores, analyzes, correlates and classifies mobile applications.

“**Unbundled local loop**” or “**ULL**” includes accesses to both ends of the copper local loop leased to other operators to provide voice and DSL services (fully unbundled loop, fully ULL) or only DSL service (shared unbundled loop, “shared ULL”).

“**VoiceTraffic**” means voice minutes used by Telefónica’s customers over a given period, both outbound and inbound.

“**VoIP**” means voice over Internet protocol.

“**Wholesale accesses**” means accesses Telefónica provides to its competitors, who then sell services over such accesses to their residential and corporate clients.

“**Wholesale ADSL**” means accesses of broadband or fiber that we provide to our competitors, who then sell services over such accesses to their residential and corporate clients.



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PRESENTATION OF CERTAIN FINANCIAL INFORMATION

In this Annual Report, references to “U.S. dollars,” “dollars” or “\$,” are to United States dollars, references to “pounds sterling,” “sterling” or “£” are to British pounds sterling, references to “reais” refer to Brazilian reais and references to “euro”, “euros” or “€” are to the single currency of the participating member states in the Third Stage of the European Economic and Monetary Union pursuant to the treaty establishing the European Community, as amended from time to time.

Our consolidated financial statements as of December 31, 2015 and 2016, and for the years ended December 31, 2014, 2015 and 2016 included elsewhere in this Annual Report including the notes thereto (the “Consolidated Financial Statements”), are prepared in conformity with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

**Retrospective revisions**

The consolidated income statement and cash flow data for the years ended December 2014 and 2015 (and also for the years ended December 2012 and 2013 in “Item 3. Key Information Selected Financial Data”) included in this Annual Report has been retrospectively amended to show the reclassification of the results attributable to our operations in the United Kingdom as continuing operations.

On March 24, 2015, Telefónica, S.A. reached an agreement with Hutchison Whampoa Group for the acquisition of Telefónica’s operations in the United Kingdom “O2 UK”. In accordance with IFRS 5, companies under the sale agreement were classified as a disposal group held for sale at that date, and their operations qualified as discontinued operations in the consolidated financial statements for the year ended December 31, 2015.

Following the European Commission’s (the “EC”) decision to prohibit such sale to Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica’s operations in the United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, these items are presented line by line in the Consolidated Financial Statements. Comparative financial information has been amended accordingly.

In addition, our 2015 and 2014 financial information by operating segment has been amended to reflect our current reporting structure: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (formed by the Group's operators in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay), which is the same as our organizational structure prior to the elimination of our Telefónica United Kingdom operating segment, which was approved by the Board of Directors of Telefónica, S.A. on February 26, 2014.

Moreover, our consolidated statement of financial position as of December 31, 2014 has been adjusted to reflect the finalization of the purchase price allocation for the acquisition of E-Plus Mobilfunk GmbH Co KG ("**E-Plus**"). The impact of such finalization on our 2014 net income was immaterial and adjusted against retained profits as of December 31, 2014. As a result, we have not restated the consolidated income statement for the year ended December 31, 2014 in connection with this finalization.

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PART I

Item 1. Identity of Directors, Senior Management and Advisors

A. Directors and Senior Management

Not applicable.

B. Advisers

Not applicable.

C. Auditors

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

A. Selected Financial Data

The following table presents certain selected consolidated financial data. It is to be read in conjunction with “Item 5. Operating and Financial Review and Prospects”, “Item 4. Information on the Company—Business Overview” and the Consolidated Financial Statements. The consolidated income statement and cash flow data for the years ended December 31, 2014, 2015 and 2016 and the consolidated statement of financial position data as of December 31, 2015 and 2016 set forth below are derived from, and are qualified in their entirety by reference to the Consolidated

Financial Statements.

The consolidated income statement and cash flow data for the year ended December 31, 2015 set forth below has been retrospectively amended in 2016 to show the reclassification of the results attributable to our operations in the United Kingdom as continuing operations and is not derived from Telefónica, S.A.'s consolidated financial statements for such year, which are not included herein. See "Presentation of Certain Financial Information Retrospective revisions".

The consolidated income statement and cash flow data for the year ended December 31, 2014 set forth below is derived from Telefónica, S.A.'s consolidated financial statements for that year. The consolidated statement of financial position data as of December 31, 2014 set forth below have been retrospectively amended to show the finalization of the purchase price allocation for the acquisition of E-Plus and is not derived from Telefónica, S.A.'s consolidated financial statements for such year, which are not included herein. See "Presentation of Certain Financial Information Retrospective revisions".

The consolidated statement of financial position as of December 31, 2012 and 2013 and the consolidated income statement and cash flow data for the years ended December 31, 2012 and 2013 set forth below are derived from Telefónica, S.A.'s consolidated financial statements for such years, which are not included herein.

Our Consolidated Financial Statements have been prepared in accordance with IFRS as issued by the IASB.

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The basis of presentation is described in detail in Note 2 to our Consolidated Financial Statements.

| Millions of euros   | 2012          | 2013         | 2014         | 2015         | 2016         |
|---|---------------|--------------|--------------|--------------|--------------|
| Revenues  | 62,356        | 57,061       | 50,377       | 54,916       | 52,036       |
| Other income  | 2,323         | 1,693        | 1,707        | 2,011        | 1,763        |
| Supplies  | (18,074)      | (17,041)     | (15,182)     | (16,547)     | (15,242)     |
| Personnel expenses  | (8,569)       | (7,208)      | (7,098)      | (10,349)     | (8,098)      |
| Other expenses  | (16,805)      | (15,428)     | (14,289)     | (16,802)     | (15,341)     |
| Depreciation and amortization   | (10,433)      | (9,627)      | (8,548)      | (9,704)      | (9,649)      |
| <b>OPERATING INCOME</b>   | <b>10,798</b> | <b>9,450</b> | <b>6,967</b> | <b>3,525</b> | <b>5,469</b> |
| Share of profit (loss) of investments accounted for by the equity method                    | (1,275)       | (304)        | (510)        | (10)         | (5)          |
| Net finance expense   | (3,062)       | (2,696)      | (2,519)      | (2,341)      | (2,706)      |
| Net exchange differences  | (597)         | (170)        | (303)        | (268)        | 487          |
| Net financial expense   | (3,659)       | (2,866)      | (2,822)      | (2,609)      | (2,219)      |
| <b>PROFIT BEFORE TAX</b>  | <b>5,864</b>  | <b>6,280</b> | <b>3,635</b> | <b>906</b>   | <b>3,245</b> |
| Corporate income tax  | (1,461)       | (1,311)      | (383)        | (155)        | (846)        |
| <b>PROFIT AFTER TAX FROM CONTINUING OPERATIONS</b>  | <b>4,403</b>  | <b>4,969</b> | <b>3,252</b> | <b>751</b>   | <b>2,399</b> |
| <b>PROFIT FOR THE YEAR</b>  | <b>4,403</b>  | <b>4,969</b> | <b>3,252</b> | <b>751</b>   | <b>2,399</b> |
| Attributable to equity holders of the Parent  | 3,928         | 4,593        | 3,001        | 616          | 2,369        |
| Attributable to non-controlling interests   | (475)         | (376)        | 251          | 135          | 30           |
| Weighted average number of shares-Basic (thousands)(1)                                      | 4,847,311     | 4,872,974    | 4,850,311    | 5,070,588    | 5,060,519    |
| Basic and diluted earnings per share attributable to equity holders of the parent (euro)(1) | 0.81          | 0.94         | 0.58         | 0.07         | 0.42         |
| Basic and diluted earnings per ADS (euro)(1)  | 0.81          | 0.94         | 0.58         | 0.07         | 0.42         |
| Weighted average number of ADS-Basic (thousands)(1)   | 4,847,311     | 4,872,974    | 4,850,311    | 5,070,588    | 5,060,519    |
| Dividends per ordinary share (cash and scrip) (euro)  | 0.83          | 0.35         | 0.75         | 0.75         | 0.75         |
| Dividends per ordinary share (cash and scrip) (\$) (2)                                      | 1.06          | 0.47         | 0.98         | 0.83         | 0.82         |
| <b>Consolidated Statement of Financial Position Data</b>                                    |               |              |              |              |              |
| Cash and cash equivalents   | 9,847         | 9,977        | 6,529        | 2,615        | 3,736        |
| Property, plant and equipment   | 35,021        | 31,040       | 33,156       | 33,910       | 36,393       |



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|   |         |         |         |          |         |
|---|---------|---------|---------|----------|---------|
| Total assets                              | 129,773 | 118,862 | 122,348 | 120,329  | 123,641 |
| Non-current liabilities                   | 70,601  | 62,236  | 62,318  | 60,509   | 59,805  |
| Equity net                                | 27,661  | 27,482  | 30,321  | 25,436   | 28,385  |
| Capital stock                             | 4,551   | 4,551   | 4,657   | 4,975    | 5,038   |
| Consolidated Cash Flow Data               |         |         |         |          |         |
| Net cash provided by operating activities | 15,213  | 14,344  | 12,193  | 13,615   | 13,338  |
| Net cash used in investing activities     | (7,877) | (9,900) | (9,968) | (12,917) | (8,208) |
| Net cash used in financing activities     | (1,243) | (2,685) | (4,041) | (3,612)  | (4,220) |

The per share and per ADS computations for all periods presented have been reported using the weighted average number of shares and ADSs, respectively, outstanding for each period, and have been adjusted to reflect the stock dividends which occurred during the periods presented, as if these had occurred at the beginning of the earliest period presented and have also been adjusted for mandatorily convertible notes issued in 2014. In accordance with (1) IAS 33 (“Earnings per share”), the weighted average number of ordinary shares and ADSs outstanding for each of the periods covered has been restated to reflect the issuance of shares pursuant to Telefónica’s scrip dividend in June 2012, December 2014, December 2015 and December 2016. As a consequence, basic and diluted earnings per share have also been restated from 2012 to 2015.

(2) Quantities in U.S. dollars are calculated in accordance with the conversion rate published by the Depositary (Citibank, N.A.) in connection with each dividend payment.

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## Exchange Rate Information

As used in this Annual Report, the term “Noon Buying Rate” refers to the rate of exchange for euro, expressed in U.S. dollars per euro, in the City of New York for cable transfers payable in foreign currencies as certified by the Federal Reserve Bank of New York for customs purposes. The Noon Buying Rate certified by the New York Federal Reserve Bank for the euro on February 10, 2017 was \$1.065= 1.00 euro. The following tables describe, for the periods and dates indicated, information concerning the Noon Buying Rate for the euro. Amounts are expressed in U.S. dollars per 1.00 euro.

**Noon Buying Rate**

| Year ended December 31,          | Period end | Average (1) | High   | Low    |
|----------------------------------|------------|-------------|--------|--------|
| 2012                             | 1.3186     | 1.2909      | 1.3463 | 1.2062 |
| 2013                             | 1.3779     | 1.3303      | 1.3816 | 1.2774 |
| 2014                             | 1.2101     | 1.3155      | 1.3816 | 1.2447 |
| 2015                             | 1.0859     | 1.1032      | 1.2015 | 1.0524 |
| 2016                             | 1.0552     | 1.1075      | 1.1516 | 1.0375 |
| 2017 (through February 10, 2017) | 1.0650     | 1.0661      | 1.0802 | 1.0416 |

Source: Federal Reserve Bank of New York.

(1) The average of the Noon Buying Rates for the euro on the last day reported of each month during the relevant period.

**Noon Buying Rate**

| Month ended        | High   | Low    |
|--------------------|--------|--------|
| August 31, 2016    | 1.1334 | 1.1078 |
| September 30, 2016 | 1.1271 | 1.1146 |
| October 31, 2016   | 1.1212 | 1.0866 |
| November 30, 2016  | 1.1121 | 1.0560 |
| December 31, 2016  | 1.0758 | 1.0375 |

January 31, 2017 1.0794 1.0416

February 10, 2017 (through February 10, 2017) 1.0802 1.0650

Source: Federal Reserve Bank of New York.

Monetary policy within the member states of the euro zone is set by the European Central Bank.

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

Our consolidated results are affected by fluctuations between the euro and the currencies in which the revenues and expenses of some of our consolidated subsidiaries are denominated and recorded (principally the Brazilian real, the pound sterling, the Argentine peso, the Peruvian nuevo sol, the Chilean peso, the Colombian peso, the Mexican peso and the Venezuelan bolívar fuerte). See Note 3 (b) to our Consolidated Financial Statements for information on the exchange rate translation methodology we used in preparing our consolidated financial information.

#### B. Capitalization and Indebtedness

Not applicable.

#### C. Reasons for the Offer and Use of Proceeds

Not applicable.

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D. Risk Factors

The Telefónica Group's business is affected 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 Consolidated 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 exposes Telefónica to various legislation, as well as to 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 Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

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.

Growth in Europe and financial stability may be affected by political uncertainty in some European countries due to upcoming general elections, a possible revival of the crisis in Greece, restructuring of the banking sector and due to the impact of steps taken towards an EU banking union and a capital markets union. In particular, the British exit process from the European Union following the vote to leave in the recent referendum, will require an adjustment of the economy to whatever new trade and investment relationships are put in place in the future, with the consequences in the meantime being uncertainty regarding investment, activity and financial market volatility. In 2016, the Telefónica Group obtained 24.5% of its revenues in Spain (22.6% in 2015), 14.4% in Germany (the same percentage as in 2015) and 13.2% in United Kingdom (14.3% in 2015).

In Latin America, there is an increasing exchange rate risk brought on by external factors such as increasing interest rates in the United States amid still low commodity prices and doubts about growth and imbalances in China; as well as internal factors as a consequence of the still high fiscal and external deficits in the most important Latin American

countries or the low liquidity in exchange markets as it is the case in Argentina.

Some of the most significant macroeconomic risk factors in the region affect Mexico, as it is the country with the highest commercial and financial exposure to the United States. In this sense, increasing interest rates and the possible overhaul of trade agreements between both countries could imply higher restrictions on imports into the United States that would affect negatively the economic activity in Mexico.

Brazil is undertaking several measures principally focused on adjusting its public finances. A constitutional amendment limiting public spending has been approved and the government has submitted a new social security reform bill to Congress. However, the possibility of a new bout of political turmoil, which could weaken the support of the reforms, is not negligible. While signs of stabilization have emerged, economic growth continues to be negative and the unemployment rate has hit double digits, having a sizable effect on consumption spending. Moreover, despite financing external needs have decreased, internal needs are still high. All these elements have led to new downgrades to the country's credit rating during 2016, which now is below investment grade.

In countries such as Chile, Colombia and Peru, the recent uptick in commodity prices is having a positive impact on its fiscal and external accounts, but growth continues to be below its potential level due to the lower external inflows, which have affected investment and, to a lower extent, consumption.

In Argentina, the new government is focused on resolving Argentina's macroeconomic and financial imbalances and on recovering international confidence. Although reforms taking place may have positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate amid an economic contraction.

During 2016, Telefónica Hispanoamérica represented 24.2% of the Telefónica Group's revenues (26.2% in 2015), of which 23.8% proceeded from revenues in Argentina, 19.9% in Peru and 17.2% in Chile. During 2016, Telefónica Brazil represented 21.3% of the Telefónica's Group revenues (20.1% in 2015). In this respect, approximately 30.4% of the Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Ecuador, Nicaragua, Venezuela, Guatemala, Costa Rica and El Salvador), and other countries are only one notch away from losing this threshold.

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“Country risk” factors include the following, among others:

unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);

abrupt exchange rate movements;

high inflation rates;

expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;

economic-financial downturns, political instability and civil disturbances; and

maximum limits on profit margins 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 is 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 or interest rates.**

At December 31, 2016, 50.8% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for over a year, while 20% was denominated in a currency other than the euro. At December 31, 2016, the net financial debt ratio in Latin American currencies was 13%.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2016: (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 232 million euros for the year ended December 31, 2016, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative interest rates are reached), would lead to a reduction in financial expenses of 201 million euros for the year ended December 31, 2016. These calculations were made assuming a constant currency and balance position equivalent to the position at year end

taking into account the derivative financial instruments arranged.

According to the Group's calculations, the impact on results arising from a 10% depreciation of Latin American currencies against the US dollar and a 10% depreciation of other global currencies against the euro, excluding the pound sterling, would result in exchange losses of 43 million euros for the year ended December 31, 2016, primarily due to the depreciation of the Venezuelan bolívar and, to a lesser extent, the Argentinean peso. These calculations were made assuming a constant currency financial position with an impact on profit or loss for the year ended December 31, 2016, including derivative instruments in place.

During 2016, Telefónica Brazil represented 24.6% (27.0% in 2015), Telefónica Hispanoamérica represented 23.0% (32.9% in 2015) and Telefónica United Kingdom represented 11.3% (14.6% in 2015) of the operating income before depreciation and amortization (OIBDA) of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, 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 implementation of Telefónica's strategic plan and new technologies, the renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

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A decrease in the liquidity of Telefónica, a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to the uncertainties regarding the hikes in interest rates on the part of the US Federal Reserve and the oil prices instabilities, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

At December 31, 2016, gross financial debt scheduled to mature in 2017 amounted to 13,326 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2018 amounted to 7,195 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities over the next twelve months with cash and credit lines available at December 31, 2016. Telefónica's liquidity could be affected if market conditions make it difficult to renew existing undrawn credit lines, 8% of which, at December 31, 2016, were scheduled to mature prior to December 31, 2017.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

**Adoption of new accounting standards could affect reported results and financial position.**

Accounting Standardization Bodies and other authorities may periodically change accounting regulations that govern the preparation of the Group's consolidated financial statements. Those changes could have a significant impact on the way the Group accounts and presents its financial position and its operating income. In some instances, a modified standard or a new requirement with retroactive nature must be implemented, which requires the Group to restate previous financial statements.



See details of the implementation of new standards and interpretations issued in Note 3 of the Consolidated Financial Statements. In particular, Telefónica is required to adopt the new accounting standards IFRS15 Revenue from Contracts with Customers, effective from January 1, 2018, and IFRS 16 Leases, effective for the financial years from January 1, 2019. These standards present significant changes that could affect both the amount and moment of recognition of revenues and expenses related with certain sales transactions, as well as the accounting treatment for all lease contracts (other than short-term leases and leases of low-value assets). These changes could have a material impact on the Group's financial statements. Such impact is under analysis as of the date of this Annual Report.

### **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 sector-specific regulations in the majority of the countries where the Group provides its services. 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 the acquisition of spectrum. 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. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

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 regard, the Telefónica Group pursues its license renewals on 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.

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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. Regarding the merger of Telefónica Deutschland Holding AG and E-Plus, other providers such as United Internet and the regional cable operator Airdata lodged an appeal before the General Court against the decision of the EU which authorized such merger. Telefónica Deutschland has been accepted as an interested party of the process and it has presented its statements in both cases. United Internet has lodged a second appeal against the EC in relation to the content of the letter of commitment assumed by Telefónica Deutschland regarding the implementation of remedies for non-network operators. In December 2016, each of Mass Response Service GmbH and Multiconnect GmbH filed an appeal before the General Court against the decision of the EU that Telefónica Deutschland is not obliged to grant access to Full-Mobile Virtual Network Operators (“**MVNO**”) under the non-MNO remedy of the commitments. Telefónica Deutschland will apply for leave to intervene as an interested party.

Regulation of spectrum and access to new government licenses/concessions of spectrum

On September 14, 2016, the EC adopted, among other texts, a proposed Directive for the establishment of a European Electronic Communication Code, which could have significant implications, inter alia, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service, consumer protection, audiovisual services and platforms. It is estimated that the approval of such regulatory framework will take place in a year and a half.

On December 14, 2016, the European Parliament and Council agreed on a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2017 and 2022 in both the United Kingdom and Spain, where it is expected that the 700 MHz band will be available between 2020-2022. In connection with spectrum auctions for 2.3 and 3.4 GHz band, in the United Kingdom, Ofcom issued a consultation document on November 21, 2016. Responses were due by January 30, 2017, and a decision is expected in the second quarter of 2017. In Germany, the regulatory agency for electricity, gas, telecommunications, post and railway (“**BNetzA**”) initiated a proceeding for the demand-oriented allocation of new frequencies for the further rollout of digital 5G infrastructures, which include the timely allocation of the 2 GHz spectrum expiring at the end of 2020 and 2025 (so called UMTS spectrum) and further spectrum (inter alia 3.5 GHz). A decision about the allocation procedure is expected towards the end of 2017 and an auction may take place in 2018 or 2019.

In Latin America, spectrum auctions are expected to take place requiring 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 2017-2018, in the relevant jurisdiction for the Group, are:

Mexico: An auction spectrum in the 2500 MHz band is expected to take place between the third quarter of 2017 and the second quarter of 2018. A wholesale network tender, which will offer services in the 700 MHz band was concluded on November 17, 2016. Altán was the tender winner and the commercial operations must begin no later than March 31, 2018.

Colombia: During 2017 the Ministry of Information Technologies and Communications published for commentaries until March 7, 2017, the project of resolution with the conditions for an auction of 70 MHz of spectrum band in 700 MHz and 5 MHz in 1900 MHz. In addition, the Ministry published a project of decree increasing the spectrum cap for lower bands to 45 MHz and 90 MHz for upper bands. The schedule for the auction has not been set yet.

Argentina: The Government instructed the regulatory authority to issue new regulations during 2017 to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services and enables the reassignment of frequencies previously granted to other provider.

However, it is likely that some of these spectrum tender procedures will not be completed, or even initiated in the mentioned dates. In addition to the above, it may be the case that certain administrations may not yet have announced their intention to release new spectrum but may do so during 2017. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

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*Risks relating to concessions and licenses previously granted*

The terms of concessions and licenses granted to the Group and necessary for the provision of its services may be challenged or amended by the regulators at any time, which may materially adversely affect its business, financial condition, results of operations and cash flows.

The German regulator initiated consultations in March and July 2016 on the frequency distribution after the merger between Telefónica Deutschland and E-Plus, particularly in the 2 GHz band and on the future spectrum allocation for 5G band. The result of such consultations could lead, among others, to proposals by the regulator reorganizing the spectrum that Telefónica Deutschland holds on the 2 GHz band.

In the United Kingdom, Telefónica has an obligation in its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland) and an obligation in its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass, both by the end of 2017, and to be maintained, thereafter. Inherent with these obligations is a risk of Telefónica United Kingdom not meeting the required targets. Telefónica United Kingdom is actively working towards mitigating the risk through the continuous investment in an infrastructure improvement program, upgrading its 2G and 3G Networks and continued roll-out of its 4G Network.

In the state of São Paulo, Telefônica Brazil provides local and national long-distance Fixed Switched Telephony Service ("STFC") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefônica Brasil informed the Brazilian regulatory authority (Agencia Nacional de Telecomunicações or "ANATEL") that the net value, as of December 31, 2015, of assets assigned to the provision of STFC (which include, among others, switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment) were estimated to total 7.8 billion Brazilian reais. At December 31, 2016, this value is estimated to total 8,813,916 Brazilian reais (this value will be updated in the second half of 2017). In principle, the assets assigned to the provision of STFC were considered reversible assets. During the last months, a bill amending the regulatory framework in Brazil has been processed, establishing, among others, that such assets will no longer be reversible under the new licenses regime in exchange for significant broadband investment commitments. Recently, the processing at the Senate of such bill has been challenged before the Federal Supreme Court. Such Court and, consequently, the Senate's governing board has decided to send the bill for voting in plenary. With the bill being sent to the plenary, it could be understood that there is no more dispute for the Supreme Court to decide upon. In case that the bill is finally approved, ANATEL will be entitled to adopt the pertinent administrative decisions for the transformation of the respective licenses with the consequent modification of the future binding obligations to STFC providers.

In Colombia, the Ministry of Information Technologies and Communications (“**ITC**”) issued Resolution 597 on March 27, 2014, to renew 850 MHz/1900 MHz licenses for 10 additional years. However, the reversion of assets (other than radio frequencies, which it is clear that must be returned) and its scope was widely discussed between the relevant mobile operators (including Telefónica Colombia) and the ITC in the context of the liquidation of the previous concession contract, taking into consideration the terms of the contract, and the Constitutional Court’s interpretation of Law 422 of 1998 and Law 1341 of 2009. Discussions on the matter concluded on February 16, 2016, when the ITC convened an arbitration proceeding, in accordance with in the terms of the relevant concession contract. The relevant concession holders (including Telefónica Colombia) filed a response to the claim prompted by the ITC. The arbitration process is still ongoing.

In Peru, Telefónica has concessions for the provision of the fixed-line service until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016, Telefónica also filed a renewal request for twenty more years in relation to a concession for the provision of local carrier service and one of the concessions to provide mobile-line services in provinces, respectively. As of the date of this Annual Report, the decision of the Ministry of Transport and Communications (Ministerio de Transportes y Comunicaciones) in all such proceedings is still pending and according to the legislation, the concessions subject of these procedures remain in force as long as the procedures are in progress.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. A claim was brought by a consumer organization against the 700 MHz assignments. The decision by the Supreme Court on the appeal presented by such consumer organization is still pending.

During the year ended December 31, 2016, the Group’s consolidated investment in spectrum acquisitions and renewals amounted to 345 million euros.

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The Group'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 Telefónica'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*

The European Regulation 2015/2120 on Net Neutrality and Roaming was adopted on November 25, 2015. From June 15, 2017, operators may not charge roaming users within the EU an additional fee on their domestic prices for roaming calls, SMS and data services. However, in some circumstances, operators may apply consumption limits and additional surcharge under a "fair use policy". In January 2017, wholesale roaming caps have been agreed between the Council and the Parliament and the maximum wholesale caps have been set at the following limits: 0.01€/sms; 0.032€/minute; data services glide path: 7.7€/GB (June – December 2017); 6€/GB (2018); 4.5€/GB (2019); 3.5€/GB (2020); 3€/GB (2021) and 2.5€/GB (2022).

On September 14, 2016, the EC presented its proposal of the regulatory framework which, among other measures, intends to incorporate a European methodology and a European upper limit for the call-termination prices for landline phone/ mobile phone applicable in EU.

The decreases in wholesale mobile termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, the current rate is 0.503 ppm. A further cut to 0.495 ppm will come into effect from April 1, 2017.

In Germany, on August 30, 2016, BNetzA adopted a regulatory decision, which considers with pure long run incremental cost ("LRIC") a new cost model for the calculation of MTR. Telefónica Deutschland has appealed the decision in court, but the appeal has not yet been decided. BNetzA approved new MTR on November 30, 2016, in a provisional decision, which sets the rates to 0.011 euro/minute as of December 1, 2016, to 0.0107 euro/minute as of December 1, 2017, and to 0.0095 euro/minute as of December 1, 2018, until the end of November 2019. Before taking a final decision, the new MTR are nationally consulted and notified to the EC. There is consequently a risk that when the new MTR are approved (which will be retroactively enforceable from December 1, 2016), and with the new termination rates applicable from January 1, 2017, the rates will significantly decrease. Regarding fixed networks termination rates, BNetzA adopted at the end of January 2017 a provisional decision which establish a tariff of 0.0010 euro/minute.

In Spain, on July 1, 2016, the Spanish National Regulatory and Competition Authority (Comisión Nacional de los Mercados y la Competencia or "CNMC") initiated the process of reviewing the prices of mobile termination, with a

final decision expected to be adopted during 2017.

Additionally, on January 17, 2017, the CNMC issued the analysis of the market for access and call origination on fixed networks. The CNMC maintains the obligation of Telefónica, as an operator with significant market power, to provide a wholesale interconnection offer and a wholesale line rental ("WLR"), both with cost-oriented prices regarding manufacturing costs and the adoption of a management accounting system. Telefónica is equally obliged to non-discrimination, transparency and separation of accounts. In Latin America, it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, ANATEL has issued ex-ante regulations to ensure competition in the wholesale market, which includes reductions of the MTR. In this regard, the Plano Geral de Metas de Competição ("PGMC"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts without a definitive outcome). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. The mentioned public consultation is available for comments until March 22, 2017.

In Mexico, on September 23, 2016, the Instituto Federal de Telecomunicaciones ("IFT") announced that the MTRs applicable to operators different from the so-called Prevailing Economic Agent for 2017 will be 0.1906 pesos per minute, as long as the regulatory asymmetry of the Prevailing Economic Agent introduced by Mexico with the constitutional reform on 2014 and the new Federal Telecommunication Law on 2014 remains in effect.

In Colombia, the Comisión de Regulación de Comunicaciones ("CRC") published a regulatory project for public comments in November 2016. In the project the CRC proposes a symmetric termination rate of 11.17 COP per minute and 4.3 million COP per monthly capacity from 2017 for established operators and an asymmetric termination rate of 19.01 COP per minute and 7.6 million COP per monthly capacity for challenger operators in a five-year period. The CRC also proposes regulatory measures to promote the entry of mobile virtual network operators ("MVNOs"), including the regulation of prices for the access to the mobile networks. The project is still in debate.

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In Peru, the Organismo Supervisor de las Telecomunicaciones (“**OSIPTEL**”) started the process for the revision of the values on charges of interconnection for mobile termination of calls in telecommunication services networks in November 2016. The new values established by OSIPTEL will apply as of the fourth quarter of 2017.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and cash flows.

*Regulation of Universal Services*

The Universal Service (“**US**”) is an economic and legal term which refers to the obligation imposed to telecommunication operators to provide a basic service to all inhabitants of a country. In general, the goal is to promote quality services availability at affordable, reasonable and fair prices, to increase the access to advanced telecommunication services (such as broadband) and to move forward with the availability of such services to all customers. On its reform proposal for the regulatory framework issued on September 14, 2016, the EC seeks to modernize the Universal Services area in Europe, removing the mandatory inclusion of the traditional services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that the US must be funded from general budgets and not from sectorial budgets. However, if this funding method does not thrive, the affordable broadband inclusion could result more expensive for the sector. In any case, it is estimated that the new regulation will not be applicable before 2020.

In Spain, the licenses of Telefónica de España and Telefónica Telecomunicaciones Públicas for the provision of USs expired on December 31, 2016. Both companies have been designated for the provision of these services from January 1, 2017.

In Brazil, on December 15, 2016, a proposal of the General Plan for Universalisation of Fixed Switched Telephony Services (“**PGMU**”) was approved by ANATEL.

The imposition on the Telefónica Group of additional or more onerous obligations to provide US services in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and cash flows.

*Regulation of fiber networks*



On February 24, 2016, the Spanish CNMC adopted a final resolution on the wholesale broadband market regulation, which raises a geographical segmentation in competitive (66 cities, 34% of total population) and non-competitive areas. It is anticipated that this resolution will last for at least four years. Its implementation is expected to result in a moderate increase of the current regulatory obligations of Telefónica in Spain, in terms of its granting of access to other operators to its fiber network and with respect to certain aspects relating specifically to the business segment (high quality bitstream service for business customers with national coverage). This Resolution has been appealed by Telefónica España. Additionally, on January 18, 2016, the CNMC adopted a resolution which approves the reference offer of the new wholesale unbundled virtual access service to Telefónica's new broadband Ethernet service (local NEBA). The NEBA service should be operative in 12 months from the date of the resolution's adoption.

Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the mentioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulations on privacy*

An intense data protection and privacy regulation may result in limitations to offer innovative digital services such as Big Data services. In Europe the new General Data Protection Regulation ("**GDPR**") of April 27, 2016, will be directly applicable in all member States from May 25, 2018. The GDPR introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching the new data protection rules.

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On January 10, 2017, the EC presented its proposal for a regulation on ePrivacy, which will replace the current Directive 2002/58/EC on privacy in the electronic communications sector and will complement the recently approved GDPR. The proposal also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations.

In October 2015, the Court of Justice of the European Union declared invalid the decision of the EC as regards the "Safe Harbor Agreement" relating to the transfer of personal data from the EU to the United States. Subsequently, the EC adopted a new decision on Privacy Shield on July 12, 2016, which considers that there is an adequate level of protection of personal data transferred from the EU to US self-certified companies complying with the Privacy Shield principles. Telefónica USA, Inc. has self-certified itself as Privacy Shield compliant. The Privacy Shield has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending.

In Brazil, the adoption of a Personal Data Protection Act is still pending, this could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any of such obligations and restrictions could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

*Regulation of network neutrality*

Under the principle of network neutrality applicable to Internet access services area, network operators could not establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behaviour (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, the application of the so-called "net neutrality Regulation" (Regulation (EU) 2015/2120 of November 25, 2015) will be monitored by national regulatory authorities following guidance to be delivered by the European Regulatory Authority ("BEREC") on August 30, 2016. This guidance could directly impact internet access service commercial practices (for example, some zero rating offers) and it may limit network management practices or increase transparency requirements on the Internet Access Service.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico and Peru, where OSIPTEL adopted regulations aimed at providing clear guidelines on the implementation of the net neutrality regime adopted in 2012 and in force since January 1, 2017. In Brazil, the President approved a net neutrality decree (regulating Marco Civil) on May 11, 2016. In Mexico, the IFT scheduled a public consultation to be carried out in August 2016 in respect of the guidelines that will be issued regarding net neutrality, which was postponed to the first quarter 2017. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes are the establishment of rules more restricted to apply measures for traffic management and restrictive rules for “Zero Rating”. 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 various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government 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 government officials. 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 lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences that could have a material adverse effect on the Group's business, results of operations and financial condition.

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Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**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.

**Telefónica 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 effect 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, 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 906 million euros in 2016, representing a decrease of 14.1% from 1,055 million euros in 2015 (1,111 million euros in 2014). These expenses represented 1.7%, 1.9% and 2.2% of the Group's consolidated revenues in 2016, 2015 and 2014, 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 300MB 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 the 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 effect 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 to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by the Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and results of operations.

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**Telefónica 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 Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2016, the Telefónica Group depended on three handset suppliers and 12 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 effect 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.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, portable data devices and mobile phones and intelligence gathering on employees with access.

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 that 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 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 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 Telefónica 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 adversely affect the business, financial conditions, results of operations and cash flows of the Telefónica Group.

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**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 impairments 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. In 2016, impairment losses in goodwill were recognized amounting to 215 million euros for Telefónica operations in Venezuela (124 million euros) and Mexico (91 million euros).

**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 effect 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, antitrust 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, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of which a contentious-administrative appeal is currently pending and to certain tax proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and to the Corporate Tax. Further details on these matters are provided in Notes 17 and 21 of the Consolidated Financial Statements.

Item 4. Information on the Company

A. History and Development of the Company

Overview

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

· Are a diversified telecommunications group which provides a comprehensive range of services through one of the world's largest and most modern telecommunications networks;

· Are focused on providing telecommunications services; and

· operate principally in Europe and Latin America.

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The following significant events occurred in 2016:

On January 12, 2016, DTS and Mediaproducción, S.L.U. reached an agreement for the broadcasting of the thematic pay TV channel called "BeIN Sports LaLiga" with contents of the Spanish national league championship first and second division and the Copa del S.M. el Rey, corresponding to the three seasons 2016/17, 2017/18 and 2018/19. The total value of the agreements relating to those channels amounted to 2,400 million euros.

On January 28, 2016, Telefónica announced that its subsidiary Telefónica de España signed the first Collective Agreement of Related Companies, which was supported by the largest trade unions. Telefónica Móviles España and Telefónica Soluciones were also parties to this agreement. The agreement contemplates, among other elements, an "Individual Employment Suspension Plan" for their respective employees, the implementation of which is entirely voluntary in the period from 2016-2017. All employees who fulfil the following criteria are eligible to participate in the plan: (i) employees must have been employed as of January 1, 2015, (ii) as of the date of the agreement, such employees must have worked for the Group 15 years or more, and (iii) as of December 31, 2017, such employees must be at least 53 years old. In relation to the aforementioned plan, Telefónica has opened the registration period for employees to sign up to the plan and the value of the recognized expenses resulting from the plan was approximately 2,896 million euros (see "Item 6. – Directors, Senior Management and Employees").

On February 11, 2016, Telefónica announced the creation of Telxius Telecom, S.A., a company which brings together certain infrastructure assets of the Group, which is intended to enable the management of the Telefónica Group's infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telxius Telecom, S.A. to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.

· On April 8, 2016, the Board of Directors of Telefónica, S.A. resolved to adopt the following resolutions:

To propose to the next General Shareholders' Meeting the appointment of PricewaterhouseCoopers Auditores S.L. as statutory auditor for the annual accounts of Telefónica, S.A. and its consolidated group of companies for the years 2017, 2018 and 2019 (see "Item 16F – Change in Registrant's Certifying Accountant").

To appoint Mr. José María Álvarez-Pallete López as Chairman of the Board of Directors and of the Executive Commission, replacing Mr. César Alierta Izuel.

To take formal note of and record the voluntary resignation presented as members of the Board of Directors of Telefónica, S.A. by Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero, Mr. José Fernando de Almansa Moreno-Barreda and Mr. Santiago Fernández Valbuena.

Based on the proposal of the Nominating, Compensation and Corporate Governance Committee, to appoint Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher and Mr. Juan Ignacio Cirac -Sasturain as Independent Directors of Telefónica, S.A. The ratification of such resolutions was approved by the General Shareholders Meeting held on May 12, 2016.

- To appoint as Coordinating Independent Director, Mr. Francisco Javier de Paz Mancho.

To appoint: (i) the Independent Director Mr. José Javier Echenique Landiribar as a member of the Executive Commission; (ii) the Independent Director Mr. José Javier Echenique Landiribar as Chairman of the Audit and Control Committee; and (iii) the Independent Director Mr. Francisco Javier de Paz Mancho as a member and Chairman of the Nominating, Compensation and Corporate Governance Committee.

In addition, the Board of Directors agreed to call the Annual General Shareholders' Meeting which was held in Madrid, at the Recinto Ferial de la Casa de Campo, Pabellón de Cristal, Avenida de Portugal, sin número, at 1:00 p.m. on the second call on May 12, 2016.

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- On April 27, 2016, the Board of Directors of Telefónica, S.A. resolved to adopt the following resolutions:

To appoint Ms. Sabina Fluxà Thienemann (Independent Director) as a member of the Nomination, Compensation and Corporate Governance Committee, and Mr. Francisco Javier de Paz Mancho (Independent Director) as a member of the Audit and Control Committee.

- To cease Mr. Francisco Javier de Paz Mancho as member of Service Quality and Customer Service Committee.

To reorganize the current Regulation and Institutional Affairs Committees so as to become a single Committee, under the name "Regulation of Institutional Affairs Committee".

To reorganize the current Strategy and Innovation Committees so as to become a single Committee under the name "Strategy and Innovation Committee", and to appoint Mr. Juan Ignacio Cirac Sasturain (Independent Director) and Mr. Peter Löscher (Independent Director) as members of such committee.

On May 11, 2016, Telefónica, S.A. announced the decision of the EC to prohibit the potential acquisition by Hutchison Whampoa Group of the Telefónica subsidiary in the United Kingdom (O2 UK) under EU the Council Regulation (EC) No. 139/2004 of January 20, 2004 on the control of concentrations between undertakings (the “**EU Merger Regulation**”).

On May 12, 2016, Telefónica, S.A. announced the holding of the Annual General Shareholders’ Meeting of Telefónica S.A. at second call with the attendance, present or represented, of shareholders holding shares representing 56.13% of the share capital of the Company, which approved by a majority of votes all the resolutions submitted by the Board of Directors for deliberation and vote by the General Shareholders’ Meeting.

Furthermore, the Company announced that, according to the shareholder remuneration policy, a dividend distribution was agreed, charged to unrestricted reserves, of a fixed gross amount of 0.40 euro for each Company share issued, in circulation and carrying entitlement to such distribution. The payment of this dividend was executed on May 19, 2016.

On June 29, 2016, following the EC’s decision to prohibit the sale of O2 UK to the Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. agreed that Telefónica will continue to explore different strategic alternatives for O2 United Kingdom, to be implemented when market conditions are deemed appropriate. Given that the execution of a transaction for sale is now less certain, Telefónica’s operations in the United Kingdom have ceased to be presented as discontinued operations and the respective assets and liabilities are no longer classified as held for sale. Further details are provided in Note 2 of the Consolidated Financial Statements.

On July 10, 2016, Telefónica Internacional, S.A.U. (a 100% subsidiary of Telefónica, S.A.) sold 361,794,559 shares of China Unicom (Hong Kong) Limited ("**China Unicom HK**"), representing 1.51% of the share capital of the company, through a block trade process, at a price of 7.80 Hong Kong dollars per share, for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros. As of December 31, 2016, Telefónica maintained a stake of close to 1% in China Unicom HK.

On September 5, 2016, Telefónica, S.A. announced that it is considering various strategic options with respect to Telefónica's United Kingdom subsidiary (O2 UK) (all of which would involve Telefónica maintaining a majority shareholding), including, among others, a potential initial public offering.

On September 28, 2016, the Company announced its decision to proceed with the share capital reduction by means of a cancellation of 74,627,988 shares of the Company's own stock, representing 1.5% of the Company's current share capital. As a result, 74,627,988 shares of Telefónica were cancelled, reducing the company's share capital by the same amount. Telefónica's share capital after the reduction, at such date, stood at 4,900,571,209 euros made up of an equal number of ordinary shares, all of a single series and with a nominal value of one (1) euro per share. On October 11, 2016, the public deed of this share capital reduction was registered in the Madrid mercantile registry (Registro Mercantil).

On October 27, 2016, the Executive Commission of Telefónica's Board of Directors agreed that the corporate resolution required to carry out the free-of-charge capital increase related to the scrip dividend shareholder compensation scheme ("**Telefónica Flexible Dividend**") approved by the Annual General Shareholders' Meeting held on May 12, 2016, should be adopted at the Executive Commission meeting scheduled for November 11, 2016. On November 11, 2016, the Executive Commission agreed the implementation of the aforementioned capital increase.

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Furthermore, the Company announced the amendment of the dividend policy for the years 2016 and 2017. Telefónica would pay in 2016, 0.55 euros per share, of which 0.35 euros would be paid in November 2016 via a voluntary scrip dividend and 0.20 euros in cash in the second quarter of 2017. Relating to the 2017 dividend, it would amount to 0.40 euros per share in cash, of which 0.20 euros would be paid in the fourth quarter of 2017 and 0.20 euros in the second quarter of 2018. As a result, in the calendar year 2016 payments amounted to 0.75 euros per share while in the calendar year 2017 payments will amount 0.40 euros.

On November 7, 2016, Moody's Investors Service published its resolution to lower the long-term credit rating of Telefónica, S.A., from Baa2 to Baa3. At the same time, Moody's lowered the short-term rating to Prime-3 from Prime-2.

On November 15, 2016, Telefónica, S.A. announced that the entire share capital of Televisión Federal, S.A. ("**Telefé**") was sold to Viacom International Inc. in exchange for 345 million dollars (322 million euros).

On December 1, 2016, Telefónica announced that, on November 29, 2016, the free-of-charge allotment rights trading period for the free-of-charge capital increase related to Telefónica's Flexible Dividend had ended. The holders of 29.99% of the free-of-charge allotment rights accepted the purchase commitment assumed by Telefónica. The gross amount paid by Telefónica for these rights amounted to 499,707,062.36 euros. The Company waived the rights thus acquired, which were amortized.

The holders of 70.01% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica. Nevertheless, Telefónica waived the free-of-charge allotment rights that corresponded to its treasury shares at the record date (November 16, 2016). Therefore, the final number of ordinary shares with a nominal value of one (1) euro issued in the capital increase was 137,233,781 (2.8% of Telefónica's share capital as of that date), totaling 137,233,781 euros. As a result, the share capital of Telefónica after the capital increase, as registered on December 7, 2016, with the commercial registry of Madrid was 5,037,804,990 euros (5,037,804,990 shares).

The new shares were admitted to listing on the Madrid, Barcelona, Bilbao and Valencia stock exchanges (the "**Spanish Stock Exchanges**") on December 13, 2016, and the ordinary trading of the new shares in Spain begun on December 14, 2016.

Business areas

The organizational structure approved by the Board of Directors of Telefónica, S.A. on February 26, 2014 was made up of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (formed by the Group's operators in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay).

Following our signing of an agreement on March 24, 2015 with Hutchison for the sale and purchase of the entire issued share capital of Telefónica Europe plc, and the reclassification of the results attributable to our operations in the United Kingdom as discontinued operations, our segments were revised in 2015 as follows: Telefónica Spain, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica.

Following the EC's decision to prohibit the sale of O2 UK to Hutchison Whampoa Group, the Board of Directors of Telefónica, S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica's operations in United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, our segments were revised as follows: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay). As a result, the 2015 and 2014 financial information by operating segment presented in this report has been amended to reflect the inclusion of the Telefónica United Kingdom segment.

Our segments include the information relating to wireline, wireless, cable, data, internet and television businesses and other digital services in accordance with each location. The results, assets and liabilities of the segments include the new companies that operate the towers business. Consequently the impacts of the intercompany sales of towers have been eliminated. "Other companies and eliminations" includes the companies belonging to cross-segment areas as well as other Group companies and eliminations in the consolidation process.

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Segment reporting takes into account the impact of the purchase price allocation to assets acquired and the liabilities assumed from the companies included in each segment. The assets and liabilities presented in each segment are those managed by the heads of each segment, irrespective of their legal structure.

The Group manages borrowing activities and taxes centrally. Therefore, it does not disclose the related assets, liabilities, revenue and expenses by reportable segments. In addition, revenue and expenses arising from intra-group invoicing for the use of the trademark and management services have been eliminated from the operating results of each Group segment. These adjustments have no impact on the Group's consolidated results.



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The following chart shows the organizational structure of the principal subsidiaries of the Telefónica Group at December 31, 2016, including their jurisdictions of incorporation and our ownership interest. For further detail, see Exhibit 8.1 to this Annual Report.

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

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

Our principal executive offices are located at Distrito Telefónica, Ronda de la Comunicación, s/n, 28050 Madrid, Spain, and our registered offices are located at Gran Vía, 28, 28013 Madrid, Spain. Our telephone number is +34 900 111 004.

Capital Expenditures and Divestitures

Our principal capital expenditures during the three years ended December 31, 2016, consisted of additions to property, plant and equipment and additions to intangible assets, including spectrum. In 2016, 2015 and 2014, we made capital expenditures of 8,928 million euros, 10,461 million euros and 9,448 million euros, respectively.

**Year ended December 31, 2016**

Capital expenditures in 2016 decreased 14.7% compared to 2015. Capital expenditures in 2016 included the cost of spectrum mainly in Peru and Brazil, amounting to 345 million euros.

Investment by Telefónica Spain amounted to 1,847 million euros and was primarily focused on rapid fiber optic roll out, together with investments in the LTE network, reaching a 96% population coverage, and transport network modernization. Investment by Telefónica United Kingdom in 2016 amounted to 931 million euros and was mainly focused on increasing LTE coverage, achieving 95% population coverage by year-end 2016 and also, pursuing the improvement of network capacity. Investment by Telefónica Germany in 2016 amounted to 1,108 million euros, with LTE roll out the company's main focus, achieving a coverage of 79% by year-end 2016, and network consolidation activities, which are allowing to enhance customer experience and to capture integration synergies. Investment by Telefónica Brazil in 2016 amounted to 2,138 million euros and was mainly dedicated to extend the coverage and capacity of 4G and 3G mobile networks, as well as improving network quality, and the deployment and connection of fiber network in the fixed business. Investment by Telefónica Hispanoamérica in 2016 amounted to 2,613 million euros and was mainly focused on improving the coverage and capacity of 3G and 4G networks, the roll out of ultra-broadband fixed capabilities (fiber / HFC) and the quality enhancement in broadband and TV services.

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**Year ended December 31, 2015**

Capital expenditures in 2015 increased 10.7% compared to 2014. Capital expenditures in 2015 included the cost of spectrum mainly in Germany, Argentina, Ecuador and Spain, amounting to 1,585 million euros.

Investment by Telefónica Spain in 2015 amounted to 1,827 million euros and was primarily focused on fiber networks, 3G, 4G and fiber as well as improvement of the quality of broad-band services and Pay TV. Investments by Telefónica United Kingdom in 2015 amounted to 883 million euros and was mainly focused on increasing LTE coverage, achieving 79.6% population coverage by year-end 2015, seeking to achieve improvements of network capacity and quality in line with the operator's objectives. Investment by Telefónica Germany in 2015 amounted to 2,230 million euros, focusing on its LTE roll-out strategy. Investment by Telefónica Brazil in 2015 amounted to 2,105 million euros, and related mainly to the continuation of the 3G and LTE roll-outs and the expansion of the roll-out of fiber optic. Investment by Telefónica Hispanoamérica in 2015 amounted to 3,060 million euros and was mainly focused on LTE roll-outs, densification of the 3G network, the continuation of ultra-broad band (UBB) roll-out for fixed broadband by speed upgrades and network digitalization as well as improving the Pay TV network.

**Year ended December 31, 2014**

Capital expenditures in 2014 increased 0.6% compared to 2013. Capital expenditures in 2014 included the cost of spectrum mainly in Brazil, Argentina, Venezuela, Colombia and Panama, amounting to 1,294 million euros.

Investment by Telefónica Spain in 2014 amounted to 1,732 million euros. Fiber optic was rolled out rapidly, and by year-end 2014 Telefónica Spain had created more than 10 million "fiber-to-the-house" ("FTTH") facilities in Spain, increasing its investments in LTE networks. Investments by Telefónica United Kingdom in 2014 amounted to 755 million euros, mainly due to the greater LTE coverage, which extends outdoor to the areas where an estimated 58% of the population is concentrated, and a network capacity ramped up to cope with denser 3G and 4G traffic.

Investment by Telefónica Germany in 2014 amounted to 849 million euros, focusing on its LTE roll-out strategy, securing 61% coverage in 2014. Investment by Telefónica Brazil in 2014 amounted to 2,933 million euros, mainly due to the fact that the mobile segment featured a continuation of LTE roll-outs in 2014, improving network capacity, systems and applications. Investment in the fixed-line network was used to expand roll-out of fiber optic, larger volumes of IPTV customers and corporate projects. Investment by Telefónica Hispanoamérica in 2014 amounted to 2,842 million euros mainly focused on LTE roll-outs in practically all operations in the region. Investment was also allocated to the densification of the 3G network, optimization of fixed-mobile convergence systems, the continuation of ultra-broad band (UBB) roll-out for fixed broadband by speed upgrades and network digitalization, television and

digital initiatives.

#### Financial Investments and Divestitures

There were no significant financial investments in 2016. Our principal financial divestiture in 2016 was the sale of Telef , which was completed on November 11, 2016, for 345 million U.S. dollars (approximately 322 million euros) and the sale on July 10, 2016 of 361,794,559 shares of China Unicom (Hong Kong) Limited (“China Unicom”), representing 1.51% of the share capital of the company, at a price of 7.80 Hong Kong dollars per share for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros.

Our principal financial investment in 2015 was the acquisition of GVT, which was completed on May 28, 2015, through our subsidiary Telef nica Brasil for a total purchase price of 4,663 million euros (through payment in cash and debt assumption) as well as the delivery of shares representing 12% of the share capital of Telef nica Brasil (following its integration with GVT) and the acquisition on April 30, 2015 of 56% of DTS for an initial consideration of 707 million euros, subject to the finalization of the working capital and net debt adjustments. Our principal divestiture in 2015 was the sale of our stake in Telef nica Italia (we disposed of 872 million ordinary shares in Telecom Italia in exchange for approximately 1,025 million euros and 1,110 million ordinary shares in Telecom Italia in exchange for 4.5% of the share capital in Telef nica Brasil). In addition, we also exchanged 46 million treasury shares of Telef nica for approximately 3.5% of the Share Capital of Telef nica Brasil.

Our principal financial investment in 2014 was the acquisition of E-Plus, which was completed on October 1, 2014, through our subsidiary Telef nica Deutschland for a total purchase price of 7,463 million euros. Our principal divestitures in 2014 were the completion of the sales of Telef nica Czech Republic, a.s. on January 28, 2014, Telef nica Ireland, Ltd on July 2, 2014, and the sale of shares representing approximately 2.5% of the share capital of China Unicom (Hong Kong) Limited (“China Unicom”) for approximately 687 million euros.

Active portfolio management is part of Telef nica's strategy and therefore it may undertake transactions involving its or its subsidiaries' shares, including transactions similar to those undertaken in the 2014-2016 period or otherwise, at any time.

#### Public Takeover Offers

Not applicable

#### Recent Developments

The principal events that have occurred since December 31, 2016, are set forth below:

On February 10, 2017, Telefónica announced that it has received several offers for the acquisition of an equity stake in Telxius Telecom, S.A.U. Telefónica is in the process of negotiating and analyzing the diverse alternatives presented.

On February 20, 2017 Telefónica has reached an agreement for the sale of up to 40% of the total share capital of Telxius Telecom, S.A.U. to Taurus Bidco S.à.r.l. (hereafter, "KKR", entity managed by Kohlberg Kravis Roberts & Co. L.P.), for a total amount of 1,275 million euros (12.75 euros per share).

The aforementioned agreement includes a purchase agreement for the sale of 62 million shares (representing 24.8% of the share capital) of Telxius Telecom, S.A.U. for a price of 790.5 million euros, as well as stock options over 38 million shares (representing 15.2% of the share capital) for a price of at least 484.5 million euros.

These options correspond to a call option exercisable by KKR and to a put option exercisable by Telefónica upon maturity of the call option.

The closing is subject to obtaining the corresponding regulatory approvals. The exercise window of the options would take place during the fourth quarter of 2017, provided that regulatory approvals have been obtained on that date.

After the transaction Telefónica will maintain the control over Telxius.

For information related to our significant financing transactions completed in 2016 and through the date of this Annual Report, see "Item 5. Operating and Financial Review and Prospects—Liquidity and Capital Resources—Anticipated Sources of Liquidity".

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B. Business Overview

Telefónica is one of the world's leading communications services providers. Our objective is to create, protect and promote fixed and mobile connections for our customers helping them to take control of their digital lifestyle. Therefore, we offer our customers connectivity, simple products and services and also the security that we protect their data, managing it in a responsible way.

In order to develop its business model, Telefónica has an organizational structure completely focused on customers and incorporates the digital offering as the main focus for commercial policies. The structure gives greater visibility to local operations, bringing them closer to the corporate decision-making center, simplifying the global structure and strengthening the transverse areas to improve flexibility and agility in decision making. On top of the transverse areas, which are led by the Chief Commercial Digital Officer, who is responsible for fostering revenue growth, and the Chief Global Resources Officer who is in charge of the efficiency of the cost side, the organizational structure is composed of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay). These segments include the information related to wireline, wireless, DSL, TV, and other digital services provided in each country or countries.

The Telefónica Group's strategy aims to:

· Enhance value through:

○ Offering excellent connectivity, for which, our infrastructure management and our continuous investment in network are key. We aim to return the control over the data to our customers.

○ Providing a bundled offer with video and digital services. We offer our customers additional data in order to amplify their services, such as video or digital services, through unique, simple and clear offers.

○ Providing increased customer value and customer experience with digital access, aiming to offer the best products, solutions and contents.

· With the following enablers:

End-to-end Digitalization. We reduce our legacy investments to improve virtualization, reduce physical servers, data centers and applications, digitalization of IT systems and processes, digitalization of front-and back office, offering a true digital experience to our customers.

- o Big Data and Innovation to add value to our customers and return the control over data to our customers.

o Continued focus on capital allocation in our legacy investments and simplification processes in order to continue investing.

Moreover, Telefónica has increased its presence in key markets. In 2014 Telefónica acquired E-Plus (through Telefónica Germany) and in 2015 Telefónica acquired DTS (through Telefónica Spain) and GVT (through Telefónica Brazil).

On February 10, 2016, Telefónica announced the creation of “Telxius” a company which brings together certain infrastructure assets of the Group in several countries, which will enable the management of the Telefónica Group’s infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telefónica to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.



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## 2016 highlights

In 2016 Telefónica has taken further steps aimed at achieving profitable and sustainable long-term growth, and improving in efficiencies and synergies, which resulted in a higher OIBDA (+14.3% year-on-year in reported terms). Additionally, the investment levels over total revenues continued above 17% with a total amount of 8,928 million euros, with more than 2,000 million euros dedicated to LTE and ultra-broad band (“**UBB**”). The Company closed the year with a total of 350 million accesses, representing a stable growth level (0.7% versus 2015), where the downward growth trend in prepay and fixed voice was more than compensated by the growth in value customers. Post-pay customers, which grew by 6.3% year-on-year, reaching 111 million customers, while fiber customers amounted to 7.3 million customers at December 2016, representing a 18.9% increase year-on-year.

In 2016, **revenues** totaled 52,036 million euros, down 5.2% compared to 2015 in reported terms. **OIBDA** totaled 15,118 million euros in 2016, up 14.3% in reported terms. In organic terms (which term and calculation is explained further below), OIBDA was up 4.7%, due mainly to the positive evolution of all the regions mainly as a consequence of the integration synergies in Telefónica Brazil and Telefónica Germany, the positive evolution of service revenues and the continuous effort in efficiency and simplification.

Telefónica’s **total accesses** totaled 350.0 million as of December 31, 2016. Group accesses increased by 0.7% year-on-year, mainly as a result of the solid growth in accesses in Telefónica Germany, Telefónica United Kingdom and Telefónica Hispanoamérica. By service, it is worth highlighting the higher commercial activity based on high value customers, resulting in a sustained growth of the contract mobile segment (smartphones and LTE) and fiber. It is worth mentioning, the growth in accesses in Telefónica Hispanoamérica (representing 39% of the Group’s total accesses as of December 31, 2016) up by 0.9% year-on-year, the growth in accesses in Telefónica Germany (representing 14% of the Group’s total) up by 2.0% year-on-year and the growth in accesses in Telefónica United Kingdom (representing 7% of the Group’s total) up by 1.9% year-on-year.

The below table shows the evolution of accesses over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b> | <b>2015(*)</b> | <b>2016</b> | <b>% Reported YoY</b> |
|------------------------------|----------------|-------------|-----------------------|
| Fixed telephony accesses (1) | 39,734.9       | 38,280.1    | (3.7%)                |
| Internet and data accesses   | 21,365.3       | 21,652.1    | 1.3%                  |
| Broadband (2)                | 20,971.3       | 21,194.9    | 1.1%                  |

|                               |                  |                  |                |
|-------------------------------|------------------|------------------|----------------|
| Fiber                         | 7,393.1          | 9,162.9          | 23.9%          |
| Mobile accesses               | 272,103.9        | 276,450.0        | 1.6%           |
| Prepay                        | 167,845.1        | 165,663.2        | (1.3%)         |
| Contract                      | 104,258.8        | 110,786.8        | 6.3%           |
| M2M                           | 11,526.3         | 14,002.0         | 21.5%          |
| Pay TV                        | 8,271.6          | 8,289.0          | 0.2%           |
| <b>Final Clients Accesses</b> | <b>341,475.6</b> | <b>344,671.1</b> | <b>0.9%</b>    |
| <b>Wholesale Accesses</b>     | <b>6,062.8</b>   | <b>5,300.9</b>   | <b>(12.6%)</b> |
| <b>Total Accesses</b>         | <b>347,538.4</b> | <b>349,972.1</b> | <b>0.7%</b>    |

Notes:

(\*) Accesses include GVT and DTS customers since May 1, 2015. There were no variations in organic terms during the period.

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) Includes DSL, satellite, optic fiber, cable modem and broadband circuits.

The below table shows the evolution of accesses by segment:

| Accesses 2016  | YoY variation | % Over Total Accesses |       |
|----------------|---------------|-----------------------|-------|
|                |               | 2015                  | 2016  |
| Spain          | (1.8%)        | 12.1%                 | 11.8% |
| United Kingdom | 1.9%          | 7.3%                  | 7.4%  |
| Germany        | 2.0%          | 13.9%                 | 14.1% |
| Brazil         | 0.3%          | 27.9%                 | 27.8% |
| Hispanoamérica | 0.9%          | 38.7%                 | 38.8% |
| Others         | 40.7%         | 0.1%                  | 0.1%  |

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The Group's strategy is based on capturing growth in its markets, especially on attracting high-value customers.

**Mobile accesses** totaled 276.5 million at December 31, 2016, up 1.6% compared to December 31, 2015, affected mainly by the increase in the number of contract accesses, up 6.3% year-on-year, continuing to increase their weight over total mobile accesses reaching 40.1% (+1.8 p.p. year-on-year).

**Smartphone accesses** maintained a strong growth rate (up 16.6% year-on-year), totaling 147 million accesses and reaching a penetration rate over total accesses of 57.1% (+7.6 p.p. year-on-year), reflecting the Company's strategic focus on the growth of its data services.

**Fixed broadband accesses** stood at 21.2 million at December 31, 2016, up 1.1% year-on-year. UBB accesses stood at 9.2 million at December 31, 2016.

**TV accesses** totaled 8.3 million at December 31, 2016, remaining stable year-on-year (+0.2%) due to the effort in capturing high value customers in Telefónica Brazil and Telefónica Hispanoamérica.

The table below shows the evolution of our estimated access market share for mobile and DSL for the past two years.

## Competitive Position Evolution

|                | Mobile Market Share<br>(1) |       |
|----------------|----------------------------|-------|
| Telefónica     | 2015                       | 2016  |
| Spain          | 30.8%                      | 30.5% |
| United Kingdom | 27.2%                      | 26.8% |
| Germany        | 38.1%                      | 37.9% |
| Brazil         | 28.4%                      | 30.2% |
| Argentina      | 32.3%                      | 33.3% |
| Chile          | 36.7%                      | 33.4% |
| Peru           | 49.7%                      | 44.0% |
| Colombia       | 22.4%                      | 23.2% |

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|                 |       |       |
|-----------------|-------|-------|
| Venezuela       | 34.2% | 37.8% |
| Mexico          | 22.7% | 24.2% |
| Central America | 33.2% | 34.1% |
| Ecuador         | 29.7% | 31.0% |
| Uruguay         | 34.9% | 33.1% |

(1) Internal estimation in both years

|            | DSL Market<br>Share (1) |       |
|------------|-------------------------|-------|
| Telefónica | 2015                    | 2016  |
| Spain      | 43.5%                   | 42.5% |
| Brazil     | 28.1%                   | 28.0% |
| Argentina  | 29.4%                   | 28.6% |
| Chile      | 39.4%                   | 36.4% |
| Peru       | 80.5%                   | 78.7% |
| Colombia   | 18.1%                   | 16.6% |

(1) Internal estimation in both years

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In this section, we discuss changes in the Group's consolidated income statements for 2016 and 2015. Changes in the Group's consolidated income statements for 2015 and 2014 are discussed in a separate section further below.

| <b>Consolidated Results</b>  | <b>Year ended December 31</b> |                      |               |                      | <b>Variation</b>    |              |
|--|-------------------------------|----------------------|---------------|----------------------|---------------------|--------------|
|  | <b>2015(*)</b>                |                      | <b>2016</b>   |                      | <b>2016 vs 2015</b> |              |
| <b>Millions of euros</b>   | <b>Total</b>                  | <b>% of revenues</b> | <b>Total</b>  | <b>% of revenues</b> | <b>Total</b>        | <b>%</b>     |
| Revenues   | 54,916                        | 100.0%               | 52,036        | 100.0%               | (2,880)             | (5.2%)       |
| Other income   | 2,011                         | 3.7%                 | 1,763         | 3.4%                 | (248)               | (12.3%)      |
| Supplies   | (16,547)                      | (30.1%)              | (15,242)      | (29.3%)              | 1,305               | (7.9%)       |
| Personnel expenses   | (10,349)                      | (18.8%)              | (8,098)       | (15.6%)              | 2,251               | (21.8%)      |
| Other expenses   | (16,802)                      | (30.6%)              | (15,341)      | (29.5%)              | 1,461               | (8.7%)       |
| <b>OPERATING INCOME BEFORE DEPRECIATION AND AMORTIZATION (OIBDA)</b> | <b>13,229</b>                 | <b>24.1%</b>         | <b>15,118</b> | <b>29.1%</b>         | <b>1,889</b>        | <b>14.3%</b> |
| Depreciation and amortization  | (9,704)                       | (17.7%)              | (9,649)       | (18.5%)              | 55                  | (0.6%)       |
| <b>OPERATING INCOME</b>  | <b>3,525</b>                  | <b>6.4%</b>          | <b>5,469</b>  | <b>10.5%</b>         | <b>1,944</b>        | <b>55.2%</b> |
| Share of loss of investments accounted for by the equity method      | (10)                          | (0.0%)               | (5)           | (0.0%)               | 5                   | (54.3%)      |
| Net financial expense  | (2,609)                       | (4.8%)               | (2,219)       | (4.3%)               | 390                 | (14.9%)      |
| <b>PROFIT BEFORE TAX</b>   | <b>906</b>                    | <b>1.6%</b>          | <b>3,245</b>  | <b>6.2%</b>          | <b>2,339</b>        | <b>n.m.</b>  |
| Corporate income tax   | (155)                         | (0.3%)               | (846)         | (1.6%)               | (691)               | n.m.         |
| <b>PROFIT FOR THE YEAR</b>   | <b>751</b>                    | <b>1.4%</b>          | <b>2,399</b>  | <b>4.6%</b>          | <b>1,648</b>        | <b>n.m.</b>  |
| Attributable to equity holders of the Parent                         | 616                           | 1.1%                 | 2,369         | 4.6%                 | 1,753               | n.m.         |
| Attributable to non-controlling interests                            | 135                           | 0.2%                 | 30            | 0.1%                 | (105)               | (77.9%)      |

(\*)Amended data: comparative information was amended to cease to present the results of Telefónica United Kingdom as discontinued operations.

**Adjustments made to calculate organic variations**

Year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis, by considering a constant perimeter of consolidation and constant exchange rates and by making certain other adjustments which are described herein. “Organic variations” should not be viewed in isolation or as an alternative to reported variations.

For purposes of this report, 2016/2015 “organic” variation is defined as the reported variation as adjusted to exclude the impacts detailed below:

**Foreign exchange effects and hyperinflationary adjustments in Venezuela:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

Foreign exchange rates had a negative impact on our reported 2016 results, mainly due to the depreciation versus the euro of various Latin American currencies (in particular the Argentine peso, the Brazilian real and, to a lesser extent, the Venezuelan bolivar), and the pound sterling.

We have also excluded the impact of hyperinflationary adjustments in Venezuela by reversing such adjustments.

**Changes in the scope of consolidation:** we have excluded the impact of changes in our consolidation perimeter in 2016 and 2015. The main changes in our consolidation perimeter in such years related to the consolidation of GVT in Telefónica Brazil since May 2015 and the consolidation of DTS in Telefónica Spain since May 2015. In addition, Telefé was sold in November 2016.

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In order to exclude the impact of these changes in our perimeter for the calculation of organic variations, the 2015 comparative figures:

oinclude GVT's results from January 1 to April 30, 2015;

oinclude DTS's results from January 1 to April 30, 2015;

oexclude Telef e's results from November 1 to December 31, 2015.

**Restructuring costs:** we have excluded the impact in 2016 and 2015 of certain restructuring costs, mainly those related to the first Collective Agreement of Related Companies in Spain, restructuring processes relating to Germany and Brazil and the Group's simplification program in global areas.

The distribution by segment of the restructuring costs is as follows (impacts on OIBDA):

| Million euros                                 | 2015  | 2016  |
|---|-------|-------|
| Telef nica Spain (Individual Suspension Plan) | 2,896 | 789   |
| Telef nica Spain (other restructuring plans)  | -     | 48    |
| Telef nica Brazil                             | 7     | 40    |
| Telef nica Germany                            | 74    | 89    |
| Telef nica United Kingdom                     | 4     | 37    |
| Telef nica Hispanoam rica                     | 38    | 84    |
| Other companies                               | 198   | 293   |
| Total restructuring costs                     | 3,217 | 1,380 |

· **Results of tower sales:** the results attributable to the sale of towers in 2016 and 2015 have been excluded.

In 2016, the results from the sale of towers totaled 1 million euros, mainly in Telef nica Hispanoam rica. In 2015, the results from the sale of towers totaled 65 million euros, distributed as follows: Telef nica Spain (38 million euros), Telef nica Brazil (10 million euros) and Telef nica Hispanoam rica (18 million euros, mainly in Chile).

**Irrevocable commitment with Fundación Telefónica:** in 2015 we have excluded the expense (325 million euros) resulting from Telefónica, S.A.'s irrevocable commitment to make a donation to Fundación Telefónica in order to provide this entity with the financing required so that it can carry out its existing or new social programs and non-profit activities in the short and medium term.

**Adjustment to the final purchase price of E-Plus:** in 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

· **Spectrum acquisition:** we have excluded the impact of spectrum acquisitions in 2016 and 2015.

In 2016, these acquisitions totaled 345 million euros, 284 million euros corresponding to Telefónica Perú, 48 million euros corresponding to Telefónica Brasil, 7 million euros corresponding to Telefónica Spain and 6 million euros corresponding to Telefónica Germany.

In 2015 these acquisitions totaled 1,585 million euros, 1,198 million euros corresponding to Telefónica Germany, 49 million euros corresponding to Telefónica Spain and 338 million euros corresponding to Telefónica Hispanoamérica (mainly Argentina and Ecuador).

**Gains or losses on the sale of companies:** the gains obtained or losses incurred from the sale of companies have not been included in organic variations.

In 2016 the 199 million euros in profit obtained from the sale of Telefé and the 29 million euros obtained from the sale of Telecomunicaciones Personalizadas were not included. Similarly, the loss of 16 million euros incurred in the sale of Vocem was also not included.

· **Impairment of goodwill:** the impairment losses on goodwill have not been included in organic variations.



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In 2016, the impairment loss on the goodwill assigned to Telefónica Venezolana and Telefónica Móviles Mexico amounting to 124 and 91 million euros, respectively, has been excluded.

In 2015, the impairment loss on the goodwill generated by the acquisition of Telefónica Digital Inc. amounting to 104 million euros was excluded.

**Other adjustments:** we have excluded the impact of the impairment resulting from the deterioration in certain minority participations, totaling 23 million euros in 2015. We have also excluded the impact of the provisions recorded in Telefónica Spain to optimize the distribution network (18 and 30 million euros in 2016 and 2015, respectively).

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures:

|                           | <b>YoY variation</b> |                  |
|---------------------------|----------------------|------------------|
|                           | <b>% Reported</b>    | <b>% Organic</b> |
| <b>TELEFÓNICA 2016</b>    | <b>YoY</b>           | <b>YoY</b>       |
| Revenues                  | (5.2%)               | 1.3%             |
| Other income              | (12.3%)              | (13.9%)          |
| Supplies                  | (7.9%)               | (3.1%)           |
| Personnel expenses        | (21.8%)              | 1.9%             |
| Other expenses            | (8.7%)               | 0.2%             |
| <b>OIBDA</b>              | <b>14.3%</b>         | <b>4.7%</b>      |
| <b>Operating income</b>   | <b>55.2%</b>         | <b>8.3%</b>      |
| CapEx                     | (14.7%)              | 3.9%             |
| <b>OpCF (OIBDA-CapEx)</b> | <b>n.m.</b>          | <b>5.6%</b>      |

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The table below shows the contribution to reported growth of each item considered to calculate the organic variations, as explained above. For each line item, the contribution to reported growth, expressed in p.p., is the result of dividing the amount of each impact (on a net basis when the impact affects both years) by the consolidated reported figure for the previous year.

**Contribution to reported growth (percentage points)**

| <b>TELEFÓNICA<br/>2016</b>    | <b>Exchange rate<br/>effect and<br/>hyperinflation</b> | <b>Perimeter<br/>change</b> | <b>Restructuring<br/>costs</b> | <b>Towers<br/>sales</b> | <b>Commitment<br/>with<br/>Fundación</b> | <b>Adjustments<br/>to the final<br/>purchase<br/>price of<br/>E-Plus</b> | <b>Spectrum<br/>acquisition</b> | <b>Capita<br/>gains/<br/>on sale<br/>compa</b> |
|-------------------------------|--|-----------------------------|--------------------------------|-------------------------|--|--|---------------------------------|--|
| Revenues                      | (8.0)  | 1.4                         | --                             | --                      | --                                       | --   | --                              | --   |
| Other income                  | (3.9)  | 1.7                         | --                             | (3.2)                   | --                                       | (5.2)  | --                              | 11.3   |
| Supplies                      | (6.7)  | 1.9                         | --                             | --                      | --                                       | --   | --                              | --   |
| Personnel<br>expenses         | (7.0)  | 1.1                         | (17.2)                         | --                      | --                                       | --   | --                              | --   |
| Other expenses                | (8.7)  | 1.3                         | (0.1)                          | 0.0                     | (1.9)                                    | 0.0  | --                              | 0.1  |
| <b>OIBDA</b>                  | <b>(8.8)</b>   | <b>1.3</b>                  | <b>13.6</b>                    | <b>(0.5)</b>            | <b>2.5</b>                               | <b>(0.8)</b>   | --                              | <b>1.6</b>                                     |
| <b>Operating<br/>income</b>   | <b>(20.2)</b>  | <b>(0.9)</b>                | <b>51.1</b>                    | <b>(1.8)</b>            | <b>9.2</b>                               | <b>(2.9)</b>   | --                              | <b>6.0</b>                                     |
| Capex                         | (7.9)  | 1.5                         | --                             | --                      | --                                       | --   | (11.7)                          | --   |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>(12.4)</b>  | <b>0.2</b>                  | <b>65.1</b>                    | <b>(2.3)</b>            | <b>11.7</b>                              | <b>(3.7)</b>   | <b>44.1</b>                     | <b>7.6</b>                                     |

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**Results discussion**

**Revenues** totaled 52,036 million euros in 2016, decreasing 5.2% compared to 2015 in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.0 p.p.), which was partially offset by the changes in the consolidation perimeter, which contributed with 1.4 p.p. to the year-on-year growth. In organic terms, revenues increased 1.3% due to the increase in service revenues offset by the decrease in handset revenues affected by the extension of handset lifecycles.

The structure of revenues reflects Telefónica's business diversification, the segment with the largest contribution to our revenues in 2016 was Telefónica Spain, representing 24.4% (+1.8 p.p. compared to 2015), followed by Telefónica Hispanoamérica, representing 24.2% despite the adverse impact of exchange rates and hyperinflation in Venezuela, (-2.0 p.p. compared to 2015), and Telefónica Brazil, representing 21.3% (+1.2 p.p. compared to 2015).

**Mobile business revenues** totaled 32,401 million euros in 2016 (of which 28,030 million euros corresponded to service revenues and 4,032 million euros corresponded to handset revenues) down 8.8% year-on-year in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.7 p.p.). Excluding this impact, the year-on-year decrease was 0.1%, mainly due to the decrease of mobile revenues in Europe due to less handsets revenues that offset the increase of mobile revenues in Telefónica Hispanoamérica and in Telefónica Brazil as a result mainly of the increase in the customer base and data adoption.

**Mobile service revenues**, which is included in mobile business revenues, totaled 28,030 million euros in 2016, down 7.5% year-on-year in reported terms explained by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.9 p.p.). Excluding this impact, mobile service revenues increased year-on-year by 1.5% due mainly to the higher customer base and higher data consumption.

**Mobile data revenues**, which is included in mobile service revenues, totaled 14,663 million euros in 2016, up 2.1% in reported terms. This increase was mainly attributable to higher consumption of data by our customers, which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-10.2 p.p.). Excluding this impact, mobile data revenues increased by 12.3% due mainly to the increase of non-SMS data revenues (up 19.7%) and higher use of data per customer. Mobile data revenues accounted for 52% of mobile service revenues in 2016, up 4.9 p.p. compared to 2015 in reported terms.

**Fixed revenues** totaled 18,187 million euros in 2016, up 1.9% year-on-year in reported terms. This increase was mainly attributable to the full year of consolidation of GVT and DTS in 2015 (which accounted for +4.7 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and

hyperinflation in Venezuela (-6.9 p.p.). Excluding these impacts, fixed revenues increased 3.9%. This increase was mainly due to higher broad band connection revenues and Pay-TV revenues as a result of the commercial actions carried out by the Company in order to increase our value proposition and the higher customer base in Pay-TV.

**Other income** totaled 1,763 million euros in 2016, including the profit obtained from the sale of Telef  (199 million euros) and Telecomunicaciones Personalizadas (29 million euros). It also included income derived from the sale of towers totaling 1 million euros.

In 2015, other income included the positive result from the E-Plus price adjustment (104 million euros), the positive impact from the expired payment obligation (98 million euros) in Telef nica Brazil and the spectrum swap with AT&T in Telef nica Mexico carried out in December 2015 (79 million euros). Other income also included in 2015, income derived from the sale of real estate (78 million euros) and the sale of towers totaling 65 million euros in Telef nica Spain.

**Total expenses**, which include supply costs, personnel costs and other expenses (principally external services and taxes) but do not include amortization and depreciation expenses, were 38,681 million euros in 2016, down year-on-year 11.5% in reported terms. This decrease was mainly attributable to the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-7.5 p.p.). The costs are explained in detail below:

**Supplies** amounted to 15,242 million euros in 2016, down 7.9% year-on-year in reported terms mainly as a result of the impact of foreign exchange rates and hyperinflation in Venezuela (-6.7 p.p.). In organic terms, supplies expenses decreased by 3.1% year-on-year, mainly due to lower handset consumption associated with a longer handset lifecycle, and lower interconnection costs.

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**Personnel expenses** amounted to 8,098 million euros in 2016, down 21.8% in reported terms year-on-year compared to 2015. This decrease was mainly attributable to the restructuring provision of 1,336 million euros, principally in Telefónica Spain, accounting for 17.2 p.p. of the year-on-year decrease. In organic terms, personnel costs increased 1.9% year-on-year due to inflationary pressure in some Latin American countries and the internalization of services in Telefónica Brazil, which was partially offset by the savings generated from restructuring plans in recent years.

The average headcount was 132,120 employees in 2016, down 1.1% compared to 2015.

**Other expenses** amounted to 15,341 million euros in 2016, down 8.7% in reported terms. This decrease was mainly attributable to the impact of foreign exchange rates and hyperinflation in Venezuela (-8.7 p.p.) In organic terms, other expenses remained flat year-on-year (+0.2%), principally due to savings in commercial costs, benefitting from higher synergies in Telefónica Spain, Telefónica Brazil and Telefónica Germany, which offset in part the negative impact of the inflation rates in some Latin American countries resulting in higher network costs.

**OIBDA** was 15,118 million euros in 2016, up 14.3% in reported terms as a result of various factors that affect comparability, mainly the lower restructuring costs in 2016 (1,380 million euros) compared to 2015 (3,217 million euros), which accounted for 13.6 p.p. of the year-on-year increase, the provision related to the agreement between Telefónica, S.A. and Fundación Telefónica registered in 2015 (+2.5 p.p.), the impact of the consolidation of GVT, DTS and Telefé (+1.3 p.p.) and the capital gain from the sale of Telefé, Telecomunicaciones Personalizadas and Vocem (+1.6 p.p.). These factors more than offset the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-8.8 p.p.), the adjustments made to the final acquisition price of E-Plus in 2015 (-0.8 p.p.), the impairment loss on goodwill (-0,8 p.p.) and finally the lower sale of towers (-0.5 p.p.). In organic terms, OIBDA grew 4.7% due mainly to the positive evolution of all the regions as consequence of the positive evolution of service revenues, integration synergies captured in Telefónica Brazil and Telefónica Germany and the continuous effort to contain costs.

**OIBDA margin** stood at 29.1% in 2016, up 5 p.p. compared to 2015 in reported terms. In organic terms OIBDA margin was 31.5% and increased 1 p.p. compared to 2015 thanks to the increase in service revenues and higher content costs.

By segments, the main contributors to Group OIBDA were Telefónica Spain with 29.6% (+11.9 p.p. compared to 2015 due to lower restructuring cost provision in 2016), Telefónica Brazil with 24.6% (-2.4 p.p. compared to 2015) and Telefónica Hispanoamérica with 23% (reducing its contribution by 9.9 p.p. compared to 2015 due to the lower contribution of Argentina, Peru and Mexico).

**Depreciation and amortization** amounted to 9,649 million euros in 2016, down 0.6% year-on-year in reported terms, mainly due to the impact of foreign exchange rates and hyperinflation in Venezuela partially offset by the consolidation of GVT and DTS. The total depreciation and amortization charges arising from purchase price allocation processes amounted to 801 million euros in 2016, down 10% year-on-year.

**Operating income (OI)** in 2016 totaled 5,469 million euros, up 55.2% in reported terms compared to 2015 for the reasons set forth above. In organic terms, operating income grew 8.3% year-on-year mostly as a result of cost savings.

The **share of loss of investments accounted for by the equity method** for 2016 was a loss of 5 million euros (compared to a loss of 10 million euros in 2015).

**Net financial expense** amounted to 2,219 million euros in 2016, 14.9% lower than the previous year, due to savings from the management of debt (pound sterling hedges linked to Telefónica United Kingdom and the lower cost of debt in European currencies). On the other hand, the higher finance income resulting from the inflation in Venezuela was mainly offset by the income from the sale of equity investments, with the capital loss from the sale of the 1.5% stake in China Unicom (155 million euros) in 2016, and the positive impact from the divestment of the holding in Telecom Italia, S.p.A. (380 million euros) in 2015.

**Corporate income tax** amounted to 846 million euros in 2016. Considering a pre-tax profit of 3,245 million euros, the effective tax rate stood at 26.1%, 9.0 p.p. higher than the 2015 effective tax rate, due to lower tax credits recognition in 2016.

As a result of the foregoing, **profit for the year attributable to equity holders of the parent** for 2016 was 2,369 million euros (616 million euros in 2015).

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**Profit attributable to non-controlling interest** reached 30 million euros, 105 million euros less than in 2015, mainly due to the increase in losses attributable to minority interests at Telefónica Germany, offset by the lower profit attributable to minority interests in Telefónica Brazil.

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## TELEFÓNICA SPAIN

The below table shows the evolution of accesses in Telefónica Spain over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousand of accesses</b>   | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 10,005.6        | 9,720.2         | (2.9%)                |
| Internet and data accesses    | 6,000.0         | 6,094.5         | 1.6%                  |
| Broadband (2)                 | 5,962.0         | 6,067.3         | 1.8%                  |
| Fiber                         | 2,223.0         | 2,998.3         | 34.9%                 |
| Mobile accesses               | 17,258.5        | 17,237.7        | (0.1%)                |
| Prepay                        | 2,777.1         | 2,329.3         | (16.1%)               |
| Contract                      | 14,481.4        | 14,908.4        | 2.9%                  |
| M2M                           | 1,778.8         | 2,006.3         | 12.8%                 |
| Pay TV                        | 3,671.5         | 3,657.0         | (0.4%)                |
| <b>Final Clients Accesses</b> | <b>36,935.6</b> | <b>36,709.4</b> | <b>(0.6%)</b>         |
| <b>Wholesale Accesses</b>     | <b>5,037.7</b>  | <b>4,525.5</b>  | <b>(10.2%)</b>        |
| <b>Total Accesses</b>         | <b>41,973.3</b> | <b>41,234.9</b> | <b>(1.8%)</b>         |

Notes:

(\*) There were no variations in organic terms during the period.

(1) PSTN (including Public Use Telephony) x1; ISDN Basic access x1; ISDN Primary access; 2/6 Digital Access x30.

(1) Company's accesses for internal use included. Includes VoIP and Naked ADSL.

(2) Include ADSL, satellite, fiber optic and retail broadband circuit.

In 2016 the commercial activity was leveraged on the differentiated assets of the Company and, in the second half of 2015 was strengthened by the convergent offer "Movistar Fusión+" launched in July 2015. During the first semester of 2016 the tariffs of the consumer segment, fundamentally broadband, postpaid mobile and "Fusion" were revised and, on



July 3, 2016 a new "Movistar Fusión+" portfolio was launched, increasing the value offered to customers and tailoring it to their preferences. Basic bundles now include content from the Spanish "La Liga", to which "UEFA Champions and Europe League" are added in ultrafast packages; and the new "Movistar Fusión+" bundles include additional mobile lines and Premium TV content. It is important to highlight the good evolution of the second mobile line included in "Fusion+ Contigo" since its launching on June 1, 2016.

Churn evolution was positive in 2016, especially taking into account the elimination of "Fusión" long-term contracts on August 1, 2015, reflecting the higher loyalty of the customers with bundles services. This fact has resulted in a positive performance of commercial activity in 2016, broadband net adds grew by 39% year-on-year, there were more than 775 thousand new fiber accesses, and mobile contract net adds continued growth (+0.4 million customers). In fixed telephony the net loss of accesses decreased by 35.5% year-on-year.

Telefónica Spain had 41.2 million accesses at the end of December 2016, down 1.8% year-on-year, explained by the decrease in prepay mobile accesses and fixed telephony accesses. Retail accesses also declined by 0.6% year-on-year.

"**Movistar Fusión**", with a customer base of 4.3 million with 2.5 million additional wireless lines to the base offer as of December 31, 2016, maintained a solid year-on-year growth (+5% and +26% respectively compared to December 2015) and contributed 83% of the fixed retail broadband customer base (3.0% year-on-year) and 73% of the wireless contract customer base (6 p.p. year-on-year). There was significant growth in the penetration of the high value services of "Movistar Fusión", with 37% of the customer base already using 100 Mb or 300 Mb ultra-fast broadband (+8 p.p. year-on-year) and 68% of the customer base with Pay-TV as of December 31, 2016 (+5 p.p. year-on-year).

**Fixed accesses** decreased 2.9% year-on-year, with a net loss of 285 thousand accesses in the year 2016. This decrease was mainly due to a slower fixed access market evolution.

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**Retail broadband accesses** presented 105 thousand new accesses in 2016, totaling 6.1 million accesses (+1.8% year-on-year) due to a low churn (1.4% in 2016, +0.02 p.p. year-on-year).

**Fiber accesses** showed a good evolution in terms of net adds (0.8 million new accesses in 2016), reaching 3.0 million customers in 2016 (up 34.9% compared to 2015), 49% of which corresponded to broad band accesses (+12 p.p. year-on-year), and with more than 775 thousand new accesses in 2016. Ultra-speed fiber accesses, with 100 or 300 Mb (with additional ARPU of 10 euros, including VAT) reached 2.0 million accesses (68% of total fiber accesses). At December 31, 2016 the fiber deployment reached 17.1 million premises, 2.7million more than at December 31, 2015, and continues to be the largest in Europe.

Total **mobile accesses** stood at 17.2 million, down 0.1% compared with year-end 2015 as a result of the decrease in prepay accesses. The contract access base accelerated its growth during 2016, growing by 2.9% year-on-year. Smartphone penetration stood at 70.9% of the mobile voice base (+4.6 p.p. compared to year-end 2015) and significantly boosted data traffic growth to 62% year-on-year in 2016 due to the higher number of customers with the renewed portfolio containing superior data packages.

LTE network rollout continued to progress well and coverage reached (based on our estimates) approximately 91% of the population at the end of 2016, up 16 p.p. compared to 2015, due to the deployment of the 800 MHz. As a result, the LTE customer base reached 6.0 million customers in 2016, almost doubling the customer base in 2015, while penetration reached 40% (+19 p.p. year-on-year).

**Pay-TV accesses** reached 3.7 million, in line with the previous year, including 613 thousand satellite TV accesses from DTS.

Given the high penetration level of the convergent offer “Fusión”, the revenue breakdown by service is considered to be increasingly less relevant in 2016. For this reason, Telefónica Spain has disclosed a new revenue breakdown that management believes is more meaningful.

The table below shows the evolution of Telefónica Spain’s results over the past two years:

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Millions of euros

| TELEFÓNICA SPAIN              | 2015         | 2016         | % Reported YoY | % Organic YoY (3) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 12,402       | 12,713       | 2.5%           | (0.1%)            |
| <b>Consumer (1)</b>           | <b>6,129</b> | <b>6,536</b> | <b>6.6%</b>    | <b>1.8%</b>       |
| Fusion                        | 3,368        | 4,095        | 21.6%          | 21.6%             |
| Out of Fusion                 | 2,761        | 2,441        | (11.6%)        | (20.0%)           |
| <b>Corporate</b>              | <b>3,473</b> | <b>3,423</b> | <b>(1.4%)</b>  | <b>(1.4%)</b>     |
| Communications                | 2,799        | 2,708        | (3.3%)         | (3.3%)            |
| IT                            | 674          | 716          | 6.2%           | 6.2%              |
| <b>Others (2)</b>             | <b>2,152</b> | <b>2,257</b> | <b>4.8%</b>    | <b>3.2%</b>       |
| Other income                  | 516          | 476          | (7.6%)         | (6.4%)            |
| Supplies                      | (2,996)      | (3,375)      | 12.7%          | 4.4%              |
| Personnel expenses            | (5,173)      | (2,997)      | (42.1%)        | (6.2%)            |
| Other expenses                | (2,413)      | (2,350)      | (2.6%)         | (4.8%)            |
| <b>OIBDA</b>                  | <b>2,336</b> | <b>4,467</b> | <b>91.2%</b>   | <b>1.4%</b>       |
| OIBDA margin                  | 18.8%        | 35.1%        | 16.3 p.p.      | 0.6 p.p.          |
| Depreciation and amortization | (1,898)      | (1,830)      | (3.6%)         | (4.8%)            |
| <b>Operating income (OI)</b>  | <b>438</b>   | <b>2,637</b> | <b>n.m.</b>    | <b>5.1%</b>       |
| CapEx                         | 1,827        | 1,847        | 1.1%           | 3.0%              |
| OpCF (OIBDA-CapEx)            | 509          | 2,621        | n.m.           | 0.6%              |

Notes:

- (1) Consumer revenues also include freelance revenues.
- (2) Other revenues include wholesale, subsidiaries and other revenues.
- (3) See adjustments made to calculate organic variation below.

Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Spain, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Changes in the scope of consolidation:** DTS was included in Telefónica’s consolidation perimeter on May 1, 2015. In order to exclude the impact of this change in the perimeter for the calculation of organic variations, the 2015 comparative figures include DTS’s results from January 1 to April 30, 2015.

**Restructuring costs:** the impact of certain restructuring costs related to the Voluntary Suspension Plan in Spain and amounting to 837 million and 2,896 million euros in 2016 and 2015, respectively, has been excluded.

**Results of tower sales:** the result obtained by Telefónica Spain from the sale of towers in 2015 totaling 38 million euros, has been excluded. Telefónica Spain recognized no result from the sale of towers in 2016.

**Spectrum acquisition:** we have excluded the impact of spectrum acquisitions in 2016 and 2015, which totaled 7 and 49 million euros, respectively.

**Gains or losses on the sale of companies:** in 2016, the gain obtained from the sale of Telecomunicaciones Personalizadas for 29 million euros was excluded.

**Optimization of the distribution network:** the impact of the provisions recorded for 18 million and 30 million euros in 2016 and 2015, respectively, have been excluded.

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The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>SPAIN 2016      | YoY variation        |                     | Contribution to reported growth (percentage points) |                        |                 |                         |  |                                  |
|-------------------------------|----------------------|---------------------|---|------------------------|-----------------|-------------------------|--|----------------------------------|
|                               | %<br>Reported<br>YoY | %<br>Organic<br>YoY | Perimeter<br>change                                 | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition | Capital<br>Gains/losses<br>on sale of<br>companies | Spain<br>distribution<br>channel |
| Revenues                      | 2.5%                 | (0.1%)              | 2.6   | --                     | --              | --                      | --   | --                               |
| Other income                  | (7.6%)               | (6.4%)              | 0.1   | --                     | (7.4)           | --                      | 5.6  | --                               |
| Supplies                      | 12.7%                | 4.4%                | 7.9   | --                     | --              | --                      | --   | --                               |
| Personnel<br>expenses         | (42.1%)              | (6.2%)              | 0.5   | (39.8)                 | --              | --                      | --   | --                               |
| Other expenses                | (2.6%)               | (4.8%)              | 2.8   | --                     | --              | --                      | --   | (0.5)                            |
| <b>OIBDA</b>                  | <b>91.2%</b>         | <b>1.4%</b>         | <b>(0.2)</b>  | <b>88.1</b>            | <b>(1.6)</b>    | <b>--</b>               | <b>1.2</b>   | <b>0.5</b>                       |
| CapEx                         | 1.1%                 | 3.0%                | 0.4   | --                     | --              | (2.3)                   | --   | --                               |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>n.m.</b>          | <b>0.6%</b>         | <b>(2.2)</b>  | <b>n.m.</b>            | <b>(7.5)</b>    | <b>8.2</b>              | <b>5.6</b>   | <b>2.3</b>                       |

## Results discussion

**Revenues** in Telefónica Spain in 2016 were 12,713 million euros, up 2.5% year-on-year in reported terms mainly as a result of the consolidation of DTS since May 1, 2015 (which accounted for +2.6 p.p. of the year-on-year increase). In organic terms, revenues were flat year-on-year, as lower handset revenues were offset by higher service revenues.

Given the high penetration level of the convergent offer (which means the offer of more than a single service for a single price), the revenue breakdown by service is considered to be increasingly less relevant. For this reason, Telefónica Spain has established a new revenue breakdown that management believes is more meaningful.

**Consumer revenues** (6,536 million euros in 2016) grew by 6.6% year-on-year in reported terms, as a result of the consolidation of DTS since May 1, 2015 (+4.8 p.p. of the year-on-year increase). In organic terms, these revenues increased 1.8% year-on-year, mainly driven by the growth in ARPU and in the number of customers. It is worth highlighting the strong growth in "Fusión" revenues during 2016 (4,095 million euros, +21.6% year-on-year) which more than offset the drop in "non-Fusión" revenues.

**Business revenues** (3,423 million euros in 2016) decreased by 1.4% year-on-year in reported terms, improving the year-on-year trend, mainly due to a better evolution in communications revenues evolution and higher IT revenues. During 2016, business revenues showed a path of stabilization, supported by the commercial offer renovation, with integrated connectivity solutions, IT and digital services, all of them key for the digitalization of the businesses.

**Other revenues**, which include wholesale, subsidiaries and other revenues (2,257 million euros in 2016) grew by 4.8% year-on-year in reported terms, due to the growth in wholesale TV revenues and fixed ingoing voice revenues.

**Fusión ARPU** was 80.4 euros in 2016, up 12.0% year-on-year in reported terms, boosted by the demand of higher value packages and the tariff revisions, as well as the improvement in the customers' mix stimulated by the renovation of the portfolio that took place in August, 2016 including mobile additional lines and additional contents in the convergent offers.

**OIBDA** amounted to 4,467 million euros in 2016, up 91.2% year-on-year in reported terms, as a consequence of the provisions recorded in 2015 totaling 2,896 million euros relating to restructuring cost by the "Employment Suspension Plan" and 30 million euros relating to restructuring of the distribution channel. The OIBDA reported in 2016 also included 837 million euros of provisions due to the Individual Suspension Plan and other restructuring plans, and 18 million euros of provision due to the restructuring of the distribution channel.

In organic terms OIBDA increased 1.4% year-on-year, mainly due to the higher service revenues, lower personnel costs (down by 6.2% year-on-year in organic terms which is mainly explained by the savings generated by the "employment suspension plan" (207 million euros) since April 2016) and lower other expenses, which dropped 2.6% in reported terms and down 4.8% in organic terms excluding changes in the perimeter of consolidation, principally due to lower commercial costs, which in total offset the increase of supplies (+12.7% in reported terms, +4.4% in organic terms) impacted by higher content costs and IT equipment purchases.

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**OIBDA margin** was 35.1% in 2016 in reported terms and 41.6% in organic terms, up 16.3 p.p. year-on-year in reported terms.

**TELEFÓNICA UNITED KINGDOM**

As explained above, the consolidated income statement for 2015 appearing in the Consolidated Financial Statements has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuous operations. Therefore, these results do not match the results published for such period. Consequently, segmented information has been modified for 2015.

The table below shows the evolution of accesses in Telefónica United Kingdom over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 247.1           | 272.6           | 10.3%                 |
| Internet and data accesses    | 21.0            | 23.7            | 12.8%                 |
| Broadband                     | 21.0            | 23.7            | 12.8%                 |
| Mobile accesses               | 25,018.8        | 25,462.7        | 1.8%                  |
| Prepay                        | 10,561.4        | 9,701.4         | (8.1%)                |
| Contract                      | 14,457.4        | 15,761.3        | 9.0%                  |
| M2M (2)                       | 2,383.9         | 3,266.9         | 37.0%                 |
| <b>Final Clients Accesses</b> | <b>25,286.9</b> | <b>25,759.0</b> | <b>1.9%</b>           |
| <b>Total Accesses</b>         | <b>25,286.9</b> | <b>25,759.0</b> | <b>1.9%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) Includes 720 thousand M2M accesses on the global platform since the first quarter 2016.

In 2016, Telefónica United Kingdom maintained market momentum, as a result of the O2 brand recognition, the commercial proposal success and the customer loyalty. These factors have allowed the company to keep growing in a competitive market.

The **total access** base grew 1.9% year-on-year and stood at 25.8 million at December 31, 2016, mainly driven by a 1.8% increase in the mobile customer base.

The contract **mobile customer** base grew 9.0% year-on-year and reached 15.8 million accesses, with a broadly stable 61.9% share over the total mobile base driven by the incorporation of 720 thousand M2M accesses on the global platform, not accounted before. Net adds reached 444 thousand accesses due to the solid contribution of postpay accesses. Smartphone penetration reached 68.4% of the total mobile accesses base, up 8.0 p.p. year-on-year, driven by the continued growth of LTE customers (+36.1% year-on-year reaching 10.4 million at December 31, 2016). LTE penetration reached 47% of the total mobile access base.

The prepay access base decreased 8.1% year-on-year to 9.7 million at December 31, 2016.

The table below shows the evolution of Telefónica United Kingdom's results over the past two years:

Millions of euros

| TELEFÓNICA UNITED KINGDOM     | 2015         | 2016         | % Reported YoY | % Organic YoY (1) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 7,837        | 6,861        | (12.5%)        | (1.5%)            |
| Mobile service revenues       | 5,778        | 5,121        | (11.4%)        | (0.3%)            |
| Other income                  | 170          | 148          | (12.7%)        | (1.8%)            |
| Supplies                      | (3,769)      | (3,226)      | (14.4%)        | (3.7%)            |
| Personnel expenses            | (549)        | (528)        | (3.9%)         | 1.2%              |
| Other expenses                | (1,760)      | (1,546)      | (12.1%)        | (1.1%)            |
| <b>OIBDA</b>                  | <b>1,929</b> | <b>1,709</b> | <b>(11.4%)</b> | <b>1.7%</b>       |
| OIBDA margin                  | 24.6%        | 24.9%        | 0.3 p.p.       | 0.8 p.p.          |
| Depreciation and amortization | (1,196)      | (1,090)      | (8.9%)         | 2.6%              |
| <b>Operating income (OI)</b>  | <b>733</b>   | <b>619</b>   | <b>(15.5%)</b> | <b>0.2%</b>       |
| CapEx                         | 883          | 931          | 5.5%           | 18.7%             |
| OpCF (OIBDA-CapEx)            | 1,046        | 778          | (25.6%)        | (12.7%)           |

(1) See adjustments made to calculate organic variation below.





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Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica United Kingdom, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

**Restructuring costs:** we have excluded the impact in 2016 and 2015 of restructuring costs, amounting to 37 and 4 million euros, respectively.

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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| <b>TELEFÓNICA UNITED<br/>KINGDOM 2016</b> | <b>YoY variation</b>      |                          | <b>Contribution to reported growth<br/>(percentage points)</b> |                                |
|---|---------------------------|--------------------------|--|--------------------------------|
|   | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY</b> | <b>Exchange rate<br/>effect</b>                                | <b>Restructuring<br/>costs</b> |
| Revenues                                  | (12.5%)                   | (1.5%)                   | (11.0)   | --                             |
| Other income                              | (12.7%)                   | (1.8%)                   | (10.9)   | --                             |
| Supplies                                  | (14.4%)                   | (3.7%)                   | (10.7)   | --                             |
| Personnel expenses                        | (3.9%)                    | 1.2%                     | (12.0)   | 6.9                            |
| Other expenses                            | (12.1%)                   | (1.1%)                   | (11.0)   | --                             |
| <b>OIBDA</b>                              | <b>(11.4%)</b>            | <b>1.7%</b>              | <b>(11.1)</b>  | <b>(2.0)</b>                   |
| CapEx                                     | 5.5%                      | 18.7%                    | (13.2)   | --                             |
| <b>OpCF (OIBDA-CapEx)</b>                 | <b>(25.6%)</b>            | <b>(12.7%)</b>           | <b>(9.3)</b>   | <b>(3.6)</b>                   |

**Results discussion**

Total **revenues** were 6,861 million euros in 2016, down by 12.5% year-on-year in reported terms mainly due to the depreciation of the pound sterling (which accounted for -11 p.p. of the year-on-year decrease). In organic terms, revenues decreased by 1.5% year-on-year due mainly to lower handset sales, which declined by 8.0% year-on-year.

**Mobile service revenues** totaled 5,121 million euros in 2016, down by 11.4% year-on-year in reported terms due mainly to the depreciation of the pound sterling (which accounted for -11.1 p.p. of the year-on-year decrease). Excluding this impact, mobile service revenues decreased by 0.3% due to the “Refresh” commercial model as well as the low interconnection fares. Under the Refresh commercial model, certain revenues related to handset are not considered as mobile service revenues, but as handset revenues.

Mobile **ARPU** decreased by 12.1% year-on-year in reported terms due mainly to the depreciation of the pound sterling. In organic terms, **ARPU** went down by 1.1% adversely affected by the “Refresh” model, while data ARPU increased by 2.3%. In the “Refresh” model handset revenues are not considered as mobile service revenues, but as handset revenues and ARPU does not reflect the handset revenues.

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| TELEFÓNICA UNITED KINGDOM           | 2015        | 2016        | %YoY           | %Organic YoY  |
|-------------------------------------|-------------|-------------|----------------|---------------|
| Voice Traffic (millions of minutes) | 90,527      | 93,306      | 3.1%           | 3.1%          |
| <b>ARPU (EUR)</b>                   | <b>19.4</b> | <b>17.0</b> | <b>(12.1%)</b> | <b>(1.1%)</b> |
| Prepay                              | 7.7         | 7.5         | (3.1%)         | 9.7%          |
| Contract (1)                        | 33.5        | 28.8        | (14.1%)        | (3.5%)        |
| <b>Data ARPU (EUR)</b>              | <b>11.3</b> | <b>10.3</b> | <b>(9.0%)</b>  | <b>2.3%</b>   |
| % non-SMS over data revenues        | 59.4%       | 61.4%       | 2.0 p.p.       | 2.0 p.p.      |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,709 million euros in 2016, down 11.4% year-on-year in reported terms, as a result mainly of the depreciation of the sterling pound. In organic terms, OIBDA increased by 1.7% year-on-year due to the reduction of costs offset by lower service revenues.

The **OIBDA margin** stood at 24.9% in 2016, with an increase of 0.3 p.p. in reported terms compared to 2015. In organic terms, OIBDA margin stood at 25.5%.

Table of Contents**TELEFÓNICA GERMANY**

The below table shows the evolution of accesses in Telefónica Germany over the past two years as of December 31 of such years:

**ACCESSES**

| Thousands of accesses         | 2015            | 2016            | %Reported<br>YoY |
|-------------------------------|-----------------|-----------------|------------------|
| Fixed telephony accesses (1)  | 1,997.8         | 2,010.3         | 0.6%             |
| Internet and data accesses    | 2,330.6         | 2,324.5         | (0.3%)           |
| Broadband                     | 2,098.0         | 2,104.0         | 0.3%             |
| VDSL                          | 516.8           | 805.5           | 55.9%            |
| Mobile accesses               | 43,062.8        | 44,320.7        | 2.9%             |
| Prepay                        | 23,979.4        | 23,784.0        | (0.8%)           |
| Contract                      | 19,083.4        | 20,536.6        | 7.6%             |
| M2M                           | 632.0           | 787.8           | 24.6%            |
| <b>Final Clients Accesses</b> | <b>47,391.2</b> | <b>48,655.5</b> | <b>2.7%</b>      |
| <b>Wholesale Accesses</b>     | <b>972.0</b>    | <b>691.0</b>    | <b>(28.9%)</b>   |
| <b>Total Accesses</b>         | <b>48,363.2</b> | <b>49,346.4</b> | <b>2.0%</b>      |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

During 2016 Telefónica Germany maintained market momentum with the launch of a new Premium portfolio called "O2 Free" on October 5, 2016, which underpins the company's data monetization strategy, offering more content at a higher price with a clear focus on retaining and developing the premium customer base. Competitive pressure in the non-premium segment is showing some signs of improvement. At the same time, Telefónica Germany delivered on its integration milestones, generating additional savings in line with its synergy targets.

The **total access** base grew 2.0% year-on-year and stood at 49.3 million at December 31, 2016, mainly driven by a 2.9% increase in the mobile base (which reached 44.3 million).

The contract **mobile customer** base grew 8% year-on-year and reached 20.5 million accesses, with a broadly stable 46.3% share over the total mobile base. Net adds reached 1.5 million accesses due to the solid contribution of partners (second brands). Smartphone penetration reached 59% of the total mobile access base, up 5.2 p.p. year-on-year driven by the continued growth of LTE customers (+53% year-on-year reaching 12.1 million at December 31, 2016) which reflects the continuous demand by customers for high speed mobile data access. LTE penetration reached 27% of the total mobile access base.

The prepay access base remained broadly stable year-on-year (-0.8%) at 23.8 million. The prepay segment lost 195 thousand accesses in 2016 due to the partner segment.

The retail broadband access loss trend continued to improve, with 6 thousand net additions in 2016. VDSL registered 289 thousand net additions (+60% year-on-year) in 2016 and continued to benefit from the continued strong demand, while the wholesale DSL customer base continued to fall due to the planned dismantling of the legacy infrastructure.

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The table below shows the evolution of Telefónica Germany's results over the past two years:

Millions of euros

| TELEFÓNICA GERMANY            | 2015         | 2016         | % Reported YoY | % Organic YoY (1) |
|-------------------------------|--------------|--------------|----------------|-------------------|
| Revenues                      | 7,888        | 7,503        | (4.9%)         | (4.9%)            |
| <b>Mobile Business</b>        | <b>6,832</b> | <b>6,498</b> | <b>(4.9%)</b>  | <b>(4.9%)</b>     |
| Mobile service revenues       | 5,532        | 5,437        | (1.7%)         | (1.7%)            |
| <b>Fixed Business</b>         | <b>1,043</b> | <b>981</b>   | <b>(5.9%)</b>  | <b>(5.9%)</b>     |
| Other income                  | 265          | 146          | (45.0%)        | (9.3%)            |
| Supplies                      | (2,712)      | (2,452)      | (9.6%)         | (9.6%)            |
| Personnel expenses            | (655)        | (646)        | (1.4%)         | (7.9%)            |
| Other expenses                | (2,928)      | (2,757)      | (5.8%)         | (5.0%)            |
| <b>OIBDA</b>                  | <b>1,858</b> | <b>1,794</b> | <b>(3.4%)</b>  | <b>2.9%</b>       |
| OIBDA margin                  | 23.6%        | 23.9%        | 0.4 p.p.       | 1.9 p.p.          |
| Depreciation and amortization | (2,128)      | (2,211)      | 3.9%           | 3.9%              |
| <b>Operating income (OI)</b>  | <b>(270)</b> | <b>(417)</b> | <b>54.2%</b>   | <b>9.8%</b>       |
| CapEx                         | 2,230        | 1,108        | (50.3%)        | 6.8%              |
| OpCF (OIBDA-CapEx)            | (372)        | 686          | c.s.           | (2.1%)            |

(1) See adjustments made to calculate organic variation below.

#### Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Germany, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Restructuring costs:** we have excluded the impact of restructuring costs associated with simplification processes implemented in Germany. In 2016, restructuring costs had an 89 million euros impact on OIBDA. In 2015, restructuring costs had a 74 million euros impact on OIBDA.

**Adjustments to the final purchase price of E-Plus:** in 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

**Spectrum acquisition:** the CapEx organic variation exclude spectrum acquisition, which in 2015 amounted to 1.198 million euros (6 million euros in 2016).



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The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement measures and CapEX and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>GERMANY 2016    | YoY variation     |                  | Contribution to reported growth (percentage points) |  |                         |
|-------------------------------|-------------------|------------------|---|--|-------------------------|
|                               | % Reported<br>YoY | % Organic<br>YoY | Restructuring<br>costs                              | Adjustments to the final<br>purchase price of E-Plus | Spectrum<br>acquisition |
| Revenues                      | (4.9%)            | (4.9%)           | --  | --   | --                      |
| Other income                  | (45.0%)           | (9.3%)           | --  | (39.4)   | --                      |
| Supplies                      | (9.6%)            | (9.6%)           | --  | --   | --                      |
| Personnel expenses            | (1.4%)            | (7.9%)           | 6.4   | --   | --                      |
| Other expenses                | (5.8%)            | (5.0%)           | (0.9)   | (0.1)  | --                      |
| <b>OIBDA</b>                  | <b>(3.4%)</b>     | <b>2.9%</b>      | <b>(0.8)</b>  | <b>(5.5)</b>   | <b>--</b>               |
| CapEx                         | (50.3%)           | 6.8%             | --  | --   | (53.5)                  |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>c.s.</b>       | <b>(2.1%)</b>    | <b>4.1</b>  | <b>27.4</b>  | <b>n.m.</b>             |

## Results discussion

Total **revenues** were 7,503 million euros in 2016, down 4.9% year-on-year in reported terms due mainly to the lower service revenues and handset sales.

**Mobile service revenues** totaled 5,437 million euros in 2016, decreasing 1.7% year-on-year in reported terms due mainly to the impact of termination and roaming tariffs, the increasing share of partner segment (second brands) within the customer base and the competitive pressure. Telefónica Germany continued to focus on data revenues, which increased by 5.3% and accounted for 55% of mobile service revenues in 2016. Non-P2P SMS data revenues amounted to 2,300 million euros (increasing +13.1% year-on-year) and non-P2P SMS data revenues accounted for 76.9% of the total data revenues (+5.3 p.p. year-on-year).

**Fixed revenues** were 981million euros in 2016 (down 5.9% year-on-year), due to lower wholesale revenues driven by the planned decommissioning of the legacy ULL platform.

**Mobile ARPU** was 10.3 euros in 2015 (down 3.7% year-on-year), while contract ARPU stood at 16.5 euros (down 4.1% year-on-year), as a result of the high pricing pressure in a competitive market, higher share of wholesale customers in the customer base and the consequent change in the weight of retail to wholesale. Data ARPU was 5.7 euros (+3.4% year-on-year).

| <b>TELEFÓNICA GERMANY</b>           | <b>2015</b> | <b>2016</b> | <b>%YoY</b>   |
|-------------------------------------|-------------|-------------|---------------|
| Voice Traffic (millions of minutes) | 117,877     | 113,896     | (3.4%)        |
| <b>ARPU (EUR)</b>                   | <b>10.7</b> | <b>10.3</b> | <b>(3.7%)</b> |
| Prepay                              | 5.8         | 5.7         | (1.6%)        |
| Contract (1)                        | 17.2        | 16.5        | (4.1%)        |
| <b>Data ARPU (EUR)</b>              | <b>5.5</b>  | <b>5.7</b>  | <b>3.4%</b>   |
| % non-SMS over data revenues        | 71.6%       | 76.9%       | 5.3 p.p.      |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,794 million euros in 2016, decreasing 3.4% year-on-year in reported terms as a result mainly of the previously mentioned positive impact of the final purchase price of E-Plus in 2015 (-5.5 p.p.) and the lower restructuring costs recorded in 2016 (-0.8 p.p.). In organic terms, OIBDA grew by 2.9% year-on-year, driven by the synergies captured in integration (approximately 150 million euros in 2016) mainly by employees restructuring and infrastructure dismantling.

The **OIBDA margin** stood at 23.9% in reported terms for 2016, up 0.4 p.p. compared to 2015 (+1.9 p.p. in organic terms).

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## TELEFÓNICA BRAZIL

The below table shows the evolution of accesses in Telefónica Brazil over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2015</b>     | <b>2016</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 14,654.5        | 14,338.4        | (2.2%)                |
| Internet and data accesses    | 7,195.5         | 7,383.2         | 2.6%                  |
| Broadband                     | 7,129.5         | 7,311.0         | 2.5%                  |
| Fiber and VDSL                | 3,779.9         | 4,171.0         | 10.3%                 |
| Mobile accesses               | 73,261.3        | 73,769.8        | 0.7%                  |
| Prepay                        | 42,194.4        | 40,387.2        | (4.3%)                |
| Contract                      | 31,066.9        | 33,382.6        | 7.5%                  |
| M2M                           | 4,234.7         | 5,005.1         | 18.2%                 |
| Pay TV                        | 1,787.9         | 1,712.7         | (4.2%)                |
| <b>Final Clients Accesses</b> | <b>96,899.3</b> | <b>97,204.2</b> | <b>0.3%</b>           |
| <b>Wholesale Accesses</b>     | <b>22.3</b>     | <b>17.9</b>     | <b>(19.5%)</b>        |
| <b>Total Accesses</b>         | <b>96,921.5</b> | <b>97,222.2</b> | <b>0.3%</b>           |

Notes:

(\*) There were no variations in organic terms during the period.

(1) Includes "fixed wireless" and Voice over IP accesses.

Telefónica Brazil closed the year 2016 improving its competitive position in the mobile as well as in the fixed market. In the mobile business, leadership has been maintained in the higher value segments, which permitted the operator to capture mobile market revenue growth in 2016. In the fixed business, the transformation towards fiber and Pay-TV was strengthened after the integration of GVT in May 2015.

Revenues and OIBDA evolution was positively supported by the acceleration of mobile data and the good evolution of fiber and Pay-TV. Additionally, Telefónica Brazil carried out costs control measures and generated benefits from the synergies with GVT that offset the adverse macroeconomic situation in Brazil.

However, results in 2016 were adversely affected by the interconnection tariff reduction in the mobile business (-33.8%) and in the retail fixed-mobile tariff (-20.6%), fixed-local (-65.9%) and fixed-interurban (-21.3%) since February 25, 2016.

Telefónica Brazil reached 97.2 million **accesses** at December 31, 2016, up 0.3% compared with December 2015.

In the **mobile business**, the strategic focus remained on gaining and retaining high value customers, reaching a market share of 42.1% in the contract segment as of December 31, 2016 (Source: Anatel), preserving the leadership. Telefónica Brazil maintained its market leadership in terms of total accesses with a market share of 30.2% as of December 2016 (source: Anatel), driven by the contract clients growth (7.5% year-on-year), and offset the fall in prepaid clients (-4.3% year-on-year). An improvement has been experienced on the “familiar plans”, giving the chance to proceed to data sharing among the same family, as well as progress in online client assistance through “meu vivo”, acclaiming one of Vivo’s strengths and continuing with constant upgrades.

In its **fixed business**, Telefónica Brazil maintained its strategic focus on fiber deployment, with 17 million premises passed with fiber at December 31, 2016 and 4.3 million homes connected. Traditional accesses decreased 2.2% due to the fixed-mobile substitution. Retail broadband accesses totaled 7.3 million accesses at the end of 2016, increasing 2.5% year-on-year. Among them, 59% accesses were connected with FTCC. Pay TV customers reached 1.7 million as of December 31, 2016, down 4.2% in reported terms due mainly to the macroeconomic situation and a commercial strategy based in value clients gaining. IPTV accesses increased in relevance representing 13% of total Pay TV accesses.

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The table below shows the evolution of Telefónica Brazil's results over the past two years:

**Millions of Euros**

| <b>TELEFÓNICA BRAZIL</b>      | <b>2015</b>  | <b>2016</b>  | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|-------------------------------|--------------|--------------|-----------------------|--------------------------|
| Revenues                      | 11,060       | 11,097       | 0.3%                  | 0.9%                     |
| <b>Mobile Business</b>        | <b>6,906</b> | <b>6,669</b> | <b>(3.4%)</b>         | <b>1.7%</b>              |
| Mobile service revenues       | 6,495        | 6,357        | (2.1%)                | 3.1%                     |
| <b>Fixed Business</b>         | <b>4,154</b> | <b>4,428</b> | <b>6.6%</b>           | <b>(0.2%)</b>            |
| Other income                  | 416          | 348          | (16.3%)               | (16.6%)                  |
| Supplies                      | (2,568)      | (2,249)      | (12.4%)               | (10.9%)                  |
| Personnel expenses            | (1,042)      | (1,167)      | 11.9%                 | 3.1%                     |
| Other expenses                | (4,293)      | (4,315)      | 0.5%                  | 2.0%                     |
| <b>OIBDA</b>                  | <b>3,573</b> | <b>3,714</b> | <b>3.9%</b>           | <b>5.3%</b>              |
| OIBDA margin                  | 32.3%        | 33.5%        | 1.2 p.p.              | 1.4 p.p.                 |
| Depreciation and amortization | (1,916)      | (2,038)      | 6.4%                  | 2.5%                     |
| <b>Operating income (OI)</b>  | <b>1,657</b> | <b>1,676</b> | <b>1.1%</b>           | <b>8.8%</b>              |
| CapEx                         | 2,105        | 2,138        | 1.6%                  | (2.9%)                   |
| OpCF (OIBDA-CapEx)            | 1,468        | 1,576        | 7.3%                  | 17.8%                    |

(1) See adjustments made to calculate organic variation below.

## Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Brazil, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years.

**Changes in the scope of consolidation:** GVT was included in Telefónica's consolidation perimeter in May 2015. In order to exclude the impact of this change in the perimeter for the calculation of organic variations, the 2015 comparative figures include GVT's results from January 1 to April 30, 2015.

**Restructuring costs:** we have excluded the impact of restructuring costs associated with the simplification processes implemented in Telefónica Brazil. In 2016, these restructuring costs totaled 40 million euros. In 2015, these restructuring costs totaled 7 million euros

**Results of tower sales:** the results attributable to the sale of towers have been excluded (10 million euros in 2015).

**Spectrum acquisition:** the impact of spectrum acquisitions has been excluded (48 million euros in 2016).

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

|                               | YoY variation  |               | Contribution to reported growth (percentage points) |                  |                     |              |                      |
|-------------------------------|----------------|---------------|---|------------------|---------------------|--------------|----------------------|
|                               | % Reported YoY | % Organic YoY | Exchange rate effect                                | Perimeter change | Restructuring costs | Towers sales | Spectrum acquisition |
| <b>TELEFÓNICA BRAZIL 2016</b> |                |               |   |                  |                     |              |                      |
| Revenues                      | 0.3%           | 0.9%          | (5.2)   | 4.6              | --                  | --           | --                   |
| Other income                  | (16.3%)        | (16.6%)       | 4.4   | (7.9)            | --                  | 2.3          | --                   |
| Supplies                      | (12.4%)        | (10.9%)       | (4.6)   | 3.4              | --                  | --           | --                   |
| Personnel expenses            | 11.9%          | 3.1%          | (5.8)   | 11.0             | 3.3                 | --           | --                   |
| Other expenses                | 0.5%           | 2.0%          | (5.2)   | 3.7              | --                  | --           | --                   |
| <b>OIBDA</b>                  | <b>3.9%</b>    | <b>5.3%</b>   | <b>(5.4)</b>  | <b>5.1</b>       | <b>(1.0)</b>        | <b>(0.3)</b> | --                   |
| CapEx                         | 1.6%           | (2.9%)        | (5.3)   | 7.6              | --                  | --           | 2.4                  |
| <b>OpCF (OIBDA-CapEx)</b>     | <b>7.3%</b>    | <b>17.8%</b>  | <b>(5.6)</b>  | <b>1.4</b>       | <b>(2.4)</b>        | <b>(0.7)</b> | <b>(3.5)</b>         |

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## Results discussion

**Revenues** totaled 11,097 million euros in 2016, up 0.3% in reported terms and 0.9% year-on-year in organic terms, due mainly to the depreciation of the Brazilian real (which accounted for -5.2 p.p. of the evolution) and the consolidation of GVT (+4.6 p.p.). In organic terms, the year-on-year variation of 0.9% was principally due to the good evolution in the mobile business (+1.7% year-on-year), which was partially offset by the impact of the regulatory interconnection tariff reduction, impacting resulting in a reduction in fixed revenues, that decreased by 0.2%.

**Revenues from the mobile business** totaled 6,669 million euros in 2016, down 3.4% in reported terms due mainly to the depreciation of the Brazilian real (which accounted for -5.0 p.p. of the evolution). In organic terms, revenues from the mobile business increased by 1.7% due to the positive evolution of service revenues (+3.1% year-on-year) as a result of the good performance of outbound revenues, which in turn increased as a result of an increase in the customer base and the increased proportion of data revenues. This offsets the decrease in inbound revenues because of the fall in interconnection, due to the decrease of tariffs, and prepaid revenues associated with the customer base fall. Additionally, handsets revenues slow down 23.9% in reported terms due to a lower commercial activity.

**Fixed telephony revenues** totaled 4,428 million euros, up by 6.6% in reported terms due mainly to the impact of the consolidation of GVT (+12.3 p.p.) and partially offset by depreciation of the Brazilian real (which accounted for -5.6 p.p. of the evolution). In organic terms, revenues were down by 0.2%, mainly due to the regulatory impact of the decrease of the fixed-mobile and fixed-fixed tariffs that compensate the increase in broadband and new services revenues, which were up by 6.5% year-on-year in organic terms supported by the increase in fiber and Pay TV revenues.

The mobile **ARPU** increased 13.3% year-on-year in reported terms due mainly to the better quality of the customer base and the expansion of data revenues that compensate the depreciation of the Brazilian real. In organic terms, it increased 19.3% year-on-year as a consequence of the higher data ARPU which more than offset the negative impact of the reduction in the mobile termination rates. We believe the high quality of the client base is reflected in an increase in the outbound ARPU and the 25.3% growth in the data ARPU.

| <b>TELEFÓNICA BRAZIL</b>            | <b>2015</b> | <b>2016</b> | <b>% YoY</b> | <b>% Local Currency YoY</b> |
|-------------------------------------|-------------|-------------|--------------|-----------------------------|
| Voice Traffic (millions of minutes) | 379,430     | 373,074     | (1.7%)       | (1.7%)                      |
| <b>ARPU (EUR)</b>                   | <b>6.3</b>  | <b>7.1</b>  | <b>13.3%</b> | <b>19.3%</b>                |
| Prepay                              | 3.2         | 3.4         | 5.4%         | 11.2%                       |
| Contract (1)                        | 13.3        | 12.9        | (2.9%)       | 2.4%                        |
| <b>Data ARPU (EUR)</b>              | <b>2.9</b>  | <b>3.5</b>  | <b>19.1%</b> | <b>25.3%</b>                |

|                              |       |       |          |          |
|------------------------------|-------|-------|----------|----------|
| % non-SMS over data revenues | 82.9% | 88.4% | 5.5 p.p. | 5.5 p.p. |
|------------------------------|-------|-------|----------|----------|

Notes:

(1) Excludes M2M.

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**OIBDA** stood at 3,714 million euros in 2016, up 3.9% in reported terms. This evolution was affected by the recognition of a 40 million euros related to a restructuring personnel plan in 2016 compared with the 7 million euros provision registered in 2015, the positive impact from the expired payment obligation (98 million euros) in 2015, the negative impact of the depreciation of the Brazilian real (-5.4 p.p.) and the consolidation of GVT (+5.1 p.p.). In organic terms, the year-on-year increase was 5.3% due to revenue improvement and cost efficiency compensating a worse macro scenario with higher inflation, more devaluation and greater insolvencies provision rates. Personnel expenses totaled 1,167 million euros in 2016, up 11.9% in reported terms as result mainly of the consolidation of GVT, which was partially offset by the depreciation of the Brazilian real. In organic terms, personnel expenses increased by 3.1% year-on-year due to higher social benefits and the internalization of network contractors that compensates benefits from restructuring plans and voluntary redundancy programs in 2016. In addition, supplies costs fell (-10.9% in organic terms) thanks to the positive impact of the interconnection tariff reduction and lesser devices consumption (commercial activity focused on profitable clients).

**The OIBDA margin** stood at 33.5% in reported terms for 2016, up 1.2 p.p. compared to 2015.

Table of Contents**TELEFÓNICA HISPANOAMÉRICA**

The below table shows the evolution of accesses in Telefónica Hispanoamérica over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>            | <b>2015</b>      | <b>2016</b>      | <b>% Reported YoY</b> |
|---|------------------|------------------|-----------------------|
| Fixed telephony accesses (1)            | 12,829.8         | 11,938.6         | (6.9%)                |
| Internet and data accesses              | 5,667.8          | 5,707.9          | 0.7%                  |
| Broadband                               | 5,610.4          | 5,570.7          | (0.7%)                |
| Mobile accesses                         | 113,302.7        | 115,284.5        | 1.7%                  |
| Prepay                                  | 88,332.8         | 89,461.2         | 1.3%                  |
| Contract                                | 24,969.8         | 25,823.3         | 3.4%                  |
| M2M                                     | 2,296.9          | 2,561.3          | 11.5%                 |
| Pay TV                                  | 2,812.2          | 2,919.2          | 3.8%                  |
| <b>Final Clients Accesses</b>           | <b>134,612.4</b> | <b>135,850.3</b> | <b>0.9%</b>           |
| <b>Wholesale Accesses</b>               | <b>30.9</b>      | <b>66.5</b>      | <b>115.6%</b>         |
| <b>Total Accesses T. Hispanoamérica</b> | <b>134,643.3</b> | <b>135,916.8</b> | <b>0.9%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

**Total accesses** reached 135.9 million at December 31, 2016 (+ 0.9% year-on-year).

**Mobile accesses** totaled 115.3 million customers and grew 1.7% year-on-year, highlighting the higher quality of the customer base.

In the contract segment, accesses grew 3.4% year-on-year. Growth was particularly strong in Argentina (+3.3%), Chile (+7.5%) and Colombia (+6.0%). Annual net adds reached 854 thousand customers, mainly due to the contribution of Argentina (+231 thousand accesses), Chile (+218 thousand accesses) and Colombia (+203 thousand

accesses), benefitting from a successful strategy of migrations (from prepay to contract), as well as a higher amount of gross adds.

In the prepay segment, accesses grew 1.3% year-on-year, with net adds of 1,1 million customers. Growth was driven mainly by Mexico (+1.5 million accesses), Colombia (+0.6 million accesses) and Central America (+0.8 million accesses), compensating the negative net adds in other markets like Peru (-1.2 million accesses) and Chile (-1.0 million accesses). Such increases were explained by strong price competition in the prepay segment, not followed by Movistar to avoid harming the quality levels of the network (avoiding reduced price offers), along with the focus on attracting high value customers that allowed the acceleration of migration processes from prepay to contract.

The smartphone customer base grew 14.7% year-on-year to 46.1 million accesses, with a penetration over mobile accesses of 41.3% (+4.7 p.p. year-on-year), mainly due to the growth in all countries of the region. At the same time, 4G accesses continued growing, reaching 15.5 million accesses at the end of the year.

**Traditional fixed business accesses** stood at 11.9 million at December 31, 2016 (-6.9% year-on-year) with negative net adds of 0.9 million customers, affected by the erosion of traditional fixed business in the region, including Argentina (-4.0% year-on-year), Peru (-5.8% year-on-year), Chile (-5.4% year-on-year) and Colombia (-5.4% year-on-year).

**Broadband accesses** totaled 5.6 million at December 31, 2016 (-0.7% year-on-year), due to negative net adds in Colombia (-3.6%) and Argentina (-1.6%), which were not enough to offset the positive performance of Peru (+2.4%). The penetration of fixed broadband accesses over traditional fixed business accesses was 46.7% at December 31, 2016 (+2.9 p.p. year-on-year). There was progressive migration towards data plans with higher speeds, with 62.1% of broadband accesses having a speed over 4Mb at December 31, 2016 (+9 p.p. year-on-year).

**TV accesses** totaled 2.9 million (+3.8% year-on-year), with net adds of 107 thousand customers as a result of an improvement in all the countries in the region that offer the service. Growth was particularly positive in Peru (+6.2%), Colombia (+5.9%) and Chile (+2.5%).

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The table below shows the evolution of Telefónica Hispanoamérica's results over the past two years:

**Millions of euros**

| <b>TELEFÓNICA HISPANOAMÉRICA</b> | <b>2015</b>   | <b>2016</b>  | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|----------------------------------|---------------|--------------|-----------------------|--------------------------|
| Revenues                         | 14,387        | 12,579       | (12.6%)               | 7.5%                     |
| <b>Mobile Business</b>           | <b>10,347</b> | <b>8,882</b> | <b>(14.2%)</b>        | <b>6.3%</b>              |
| Mobile service revenues          | 9,160         | 7,918        | (13.6%)               | 7.0%                     |
| <b>Fixed Business</b>            | <b>4,070</b>  | <b>3,732</b> | <b>(8.3%)</b>         | <b>12.2%</b>             |
| Other income                     | 347           | 274          | (21.3%)               | (10.4%)                  |
| Supplies                         | (4,176)       | (3,704)      | (11.3%)               | 4.4%                     |
| Personnel expenses               | (1,686)       | (1,584)      | (6.1%)                | 22.8%                    |
| Other expenses                   | (4,516)       | (4,088)      | (9.5%)                | 7.0%                     |
| <b>OIBDA</b>                     | <b>4,356</b>  | <b>3,477</b> | <b>(20.2%)</b>        | <b>3.9%</b>              |
| OIBDA margin                     | 30.3%         | 27.6%        | (2.6 p.p.)            | (1.0 p.p.)               |
| Depreciation and amortization    | (2,241)       | (2,190)      | (2.3%)                | 7.5%                     |
| <b>Operating income (OI)</b>     | <b>2,115</b>  | <b>1,287</b> | <b>(39.1%)</b>        | <b>0.5%</b>              |
| CapEx                            | 3,060         | 2,613        | (14.6%)               | 6.5%                     |
| OpCF (OIBDA-CapEx)               | 1,296         | 864          | (33.3%)               | (0.3%)                   |

(1) See adjustments made to calculate organic variation below.

**Adjustments made to calculate organic variations**

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Hispanoamérica, we have made the following adjustments in order to calculate 2016/2015 variations in organic terms:

**Exchange rate effects and hyperinflationary adjustments in Venezuela:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates year on year. In particular, we have used the average foreign exchange rates of 2015 for both years. We have also excluded the impact of hyperinflationary adjustments in Venezuela, by reversing such adjustments.

**Restructuring costs:** we have excluded the impact of restructuring costs in 2016 and 2015, amounting to 84 and 38 million euros, respectively.

**Results of tower sales:** the results attributable to the sale of towers have been excluded (1 million euros in 2016 and 18 million euros in 2015).

**Spectrum acquisition:** the impact of spectrum acquisitions has been excluded in 2016 (284 million euros, corresponding to Peru) and 2015 (338 million euros, mainly corresponding to Argentina and Ecuador).

**Capital gains and losses on sales of companies:** gains and losses obtained from the sale of companies are excluded to calculate organic variations. In 2016, the profit from the sale of Telef  for 15 million euros was excluded.

**Goodwill impairments:** Impairment losses from goodwill in consolidation are excluded to calculate organic variations. In 2016, the impairment loss on the goodwill assigned to Telef nica Venezolana and Telef nica M viles Mexico amounting to 124 and 91 million euros, respectively.

The table below shows 2016/2015 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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| TELEFÓNICA<br>HISPANOAMÉRICA<br>2016 | YoY variation        |                     | Contribution to reported growth (percentage points) |                        |                 |                         |            | Capital<br>Gains/losses<br>on sale of<br>companies | Impa |
|--------------------------------------|----------------------|---------------------|---|------------------------|-----------------|-------------------------|------------|--|------|
|                                      | %<br>Reported<br>YoY | %<br>Organic<br>YoY | Exchange rate<br>effect and<br>hyperinflation       | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition |            |  |      |
| Revenues                             | (12.6%)              | 7.5%                | (20.0)  | --                     | --              | --                      | --         | --   |      |
| Other income                         | (21.3%)              | (10.4%)             | (10.7)  | --                     | (5.0)           | --                      | 4.2        | --   |      |
| Supplies                             | (11.3%)              | 4.4%                | (15.6)  | --                     | --              | --                      | --         | --   |      |
| Personnel expenses                   | (6.1%)               | 22.8%               | (32.4)  | 4.2                    | --              | --                      | --         | --   |      |
| Other expenses                       | (9.5%)               | 7.0%                | (21.2)  | --                     | --              | --                      | --         | 4.8  |      |
| <b>OIBDA</b>                         | <b>(20.2%)</b>       | <b>3.9%</b>         | <b>(17.5)</b>                                       | <b>(1.6)</b>           | <b>(0.4)</b>    | --                      | <b>0.3</b> | <b>(4.9)</b>                                       |      |
| CapEx                                | (14.6%)              | 6.5%                | (19.1)  | --                     | --              | (1.2)                   | --         | --   |      |
| <b>OpCF<br/>(OIBDA-CapEx)</b>        | <b>(33.3%)</b>       | <b>(0.3%)</b>       | <b>(13.6)</b>                                       | <b>(5.5)</b>           | <b>(1.3)</b>    | <b>2.9</b>              | <b>1.1</b> | <b>(16.6)</b>                                      |      |

## Results discussion

**Revenues** amounted to 12,579 million euros in 2016, decreasing 12.6% year-on-year in reported terms due to the foreign exchange effects and the hyperinflation in Venezuela (-20.0 p.p.). Revenues increased 7.5 % year-on-year in organic terms mainly due to the growth in data revenues (mobile and fixed) and the growth of the customer base, higher data usage per customer and higher data penetration.

**Mobile service revenues** reached 7,918 million euros in 2016 and decreased by 13.6% year-on-year in reported terms. This decrease was mainly driven by the foreign exchange effects and the hyperinflation in Venezuela (which decreased growth by 20.6 p.p. of the year-on-year variation). Excluding these effects, these revenues grew by 7.0% principally as a result of the increase of service revenues in Argentina (18.4%). Mobile service revenues performance by country was as follows:

In Argentina: mobile service revenues amounted to 1,628 million euros in 2016, decreasing 25.8% year-on-year in reported terms. This decrease was mainly due to the exchange rate effect, reducing growth by 44.2 p.p. Excluding this effect, revenues increased by 18.4% due to the data revenues growth leveraged on the higher 4G customer base, permitting data consumption acceleration and commercial offers adapted to the inflationary environment.

In Mexico: mobile service revenues reached 1,246 million euros in 2016, decreasing 19% year-on-year in reported terms. In local currency, these revenues decreased 4.9%, mainly due to lower prepaid revenues as a result of strong competition and due to the regulatory impact, which was partially offset by a satisfactory performance in wholesale service.

In Chile: service revenues reached 1,103 million euros in 2016, decreasing 6.3% year-on-year in reported terms mainly due to the foreign exchange effect (-3.1 p.p.). In local currency, these revenues decreased by 3.2% affected by lower prepaid revenues as well as lower interconnection rates.

In Peru: mobile service revenues reached 1,206 million euros in 2016, decreasing 13.2% year-on-year in reported terms mainly due to the foreign exchange effect (-5 p.p.). In local currency these revenues decreased by 8.2%, affected by the reduction of prepaid and contract revenues due to higher aggressiveness in the market, resulting in lower ARPUs.

**Data revenues** in the segment reached 3,511 million euros in 2016 and decreased 4.8% year-on-year in reported terms mainly due to foreign exchange effects and the hyperinflation in Venezuela (-24.4 p.p.). Excluding these effects, these revenues grew 19.6 % year-on-year mainly due to the increase in data revenues in most of the countries of the region and by the higher data penetration which grew from 41.3% in 2015 to 46.1 % during 2016.

**Fixed business revenues** reached 3,732 million euros in 2016, and decreased 8.3% in reported terms. Excluding the foreign exchange effects and the hyperinflation in Venezuela (which decreased growth by 20.5p.p.) these revenues grew by 12.2% due to the increase in broadband and new services revenues (+21.6%). Revenues from broadband and new services, accounted for 53.7% of fixed revenues (+3.0 p.p. year-on-year). The growth was particularly notable in Argentina (44.7%), Colombia (17.4%) and Chile (11.7%) with a strong growth in broadband revenues due to the higher quality of the customer base as well as the tariff adjustment.

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**OIBDA** reached 3,477 million euros in 2016, decreasing 20.2% in reported terms, negatively affected by the goodwill impairment in Mexico and Venezuela and restructuring costs in 2016 and 2015, previously mentioned, and offset by the generated capital gain from the Telef  sale. Excluding these adjustments, exchange rate effects and hyperinflation in Venezuela, OIBDA increased 3.9% in organic terms. This growth is mainly due to the good evolution in revenues and higher commercial efficiencies that offset higher interconnection, content and network costs, up principally due to the devaluation in certain countries in the region. Energy, electricity and call center costs also increased during 2016.

Below additional information by country.

Argentina: OIBDA reached 797 million euros in December 2016, decreasing 20.7% in reported terms. In local currency, OIBDA increased by 26.6%, mainly due to the revenue growth as well as to lower commercial costs recorded in 2016, as a result of lower commercial activity and greater commercial efficiency.

Chile: OIBDA reached 704 million euros in December 2016, decreasing 7.4% in reported terms mainly due to the exchange rate evolution (-3 p.p.). In local currency, OIBDA decreased by 4.4%, explained by the decrease in mobile service revenues.

Peru: OIBDA reached 782 million euros in December 2016, decreasing 17.1% in reported terms mainly due to the exchange rate evolution. In local currency, OIBDA decreased by 12.3%, as the efforts in costs savings were insufficient to compensate higher interconnection costs associated with higher traffic, and more than offset the revenue increase.

Colombia: OIBDA reached 464 million euros in December 2016, decreasing 15% in reported terms mainly due to the exchange rate evolution. In local currency, OIBDA decreases 5.1% year-on-year due to higher interconnection costs associated to the successful offer "Todo Destino".

The **OIBDA margin** was 27.6% in 2016, decreasing 2.6 p.p. in reported terms. This decrease is affected by the margin reduction in Chile (-1.7 p.p.), Peru (-2.8 p.p.), Colombia (-3.3 p.p.) and Mexico (-5.0 p.p.), reflecting a higher commercial effort focused on higher value segments.

**2015/2014 Consolidated results**

In this section, we discuss changes in the Group's consolidated income statements for 2015 and 2014. The consolidated income statement data for the years ended December 31, 2015 and 2014 set forth below has been retrospectively amended, in order to cease to present our operations in the United Kingdom as a discontinued operation.



As explained above, the consolidated income statement for the year ended December 31, 2015 has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuing operations. Therefore, the results below differ from the results previously published for such period. The segmented financial information shown below has been amended for 2015 as discussed above.

Telefónica's **total accesses** totaled 347.5 million as of December 31, 2015. Telefónica United Kingdom customers have been included in the 2014 and 2015 customer base, since we have classified Telefónica United Kingdom and its operations as continuing operations. Group accesses increased 1.9% year-on-year, as a result mainly of the additional accesses gained following the purchase of GVT by Telefónica Brazil and DTS in Telefónica Spain and the growth in accesses in Telefónica Hispanoamérica, Telefónica Germany and Telefónica United Kingdom. If we consider the accesses from GVT and DTS as of December 31, 2014 to make both years comparable, accesses would have decreased by 0.8% affected, in part, by prepaid disconnections in Telefónica Brazil (which resulted in the disconnection of 11.5 million accesses in 2015 and 1.6 million accesses in 2014). In 2015, commercial activity increased based on high value customers, resulting in growth of the contract mobile segment (smartphones and LTE), fiber and Pay TV. Accesses in Telefónica Hispanoamérica (38.7% of the Group's total as of December 31, 2015) increased by 2.3% year-on-year, Telefónica United Kingdom (7.3% of the Group's total as of December 31, 2015) increased by 2.3% year-on-year, while accesses in Telefónica Germany (13.9% of the Group's total) increased by 1.5% year-on-year.

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The below table shows the evolution of accesses 2014 and 2015:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2014</b>      | <b>2015</b>      | <b>% Reported YoY</b> | <b>% Organic YoY (1)</b> |
|-------------------------------|------------------|------------------|-----------------------|--------------------------|
| Fixed telephony accesses (2)  | 36,830.0         | 39,734.9         | 7.9%                  | (3.0%)                   |
| Internet and data accesses    | 18,151.7         | 21,365.3         | 17.7%                 | 1.3%                     |
| Broadband (3)                 | 17,668.5         | 20,971.3         | 18.7%                 | 1.8%                     |
| Fiber (4)                     | 1,755.0          | 6,100.3          | 247.6%                | 29.9%                    |
| Mobile accesses               | 274,458.0        | 272,103.9        | (0.9%)                | (0.9%)                   |
| Prepay                        | 175,720.4        | 167,845.1        | (4.5%)                | (4.5%)                   |
| Contract                      | 98,737.6         | 104,258.8        | 5.6%                  | 5.6%                     |
| M2M                           | 9,787.4          | 11,526.3         | 17.8%                 | 17.8%                    |
| Pay TV (5)                    | 5,087.2          | 8,271.6          | 62.6%                 | 12.0%                    |
| <b>Final Clients Accesses</b> | <b>334,526.9</b> | <b>341,475.6</b> | <b>2.1%</b>           | <b>(0.7%)</b>            |
| <b>Wholesale Accesses</b>     | <b>6,521.6</b>   | <b>6,062.8</b>   | <b>(7.0%)</b>         | <b>(7.0%)</b>            |
| <b>Total Accesses</b>         | <b>341,048.5</b> | <b>347,538.4</b> | <b>1.9%</b>           | <b>(0.8%)</b>            |

Notes:

- T. Ireland customers are excluded since the third quarter 2014. Accesses include E-Plus customers since the fourth quarter 2014 and GVT and DTS customers since May 1 2015.

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

(2) Includes "fixed wireless" and Voice over IP accesses.

(3) Includes DSL, satellite, optic fiber, cable modem and broadband circuits.

(4) Includes 3.25 million GVT fiber (FTTx) customers since second quarter 2015.

(5) Includes 1.1 million DTS customers.

The below table shows the contribution of each item for which we have adjusted our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the

impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year.

| <b>TELEFÓNICA<br/>2015</b> | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> | <b>DTS</b> | <b>GVT</b> |
|----------------------------|---------------------------|------------------------------|------------|------------|
| Fixed telephony accesses   | 7.9%                      | (3.0%)                       | 0.0 p.p.   | 11.2 p.p.  |
| Internet and data accesses | 17.7%                     | 1.3%                         | 0.0 p.p.   | 16.2 p.p.  |
| Broadband                  | 18.7%                     | 1.8%                         | 0.0 p.p.   | 16.6 p.p.  |
| Fiber                      | n.m.                      | 29.9%                        | 0.0 p.p.   | n.m.       |
| Pay TV                     | 62.6%                     | 12.0%                        | 28.3 p.p.  | 16.9 p.p.  |
| Final Clients Accesses     | 2.1%                      | (0.7%)                       | 0.4 p.p.   | 2.4 p.p.   |
| Total Accesses             | 1.9%                      | (0.8%)                       | 0.4 p.p.   | 2.3 p.p.   |

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

The table below shows the evolution of accesses by segment:

| <b>Accesses 2015</b> | <b>YoY variation</b>      |                              | <b>% Over<br/>Total<br/>Accesses</b> |             |
|----------------------|---------------------------|------------------------------|--------------------------------------|-------------|
|                      | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> | <b>2014</b>                          | <b>2015</b> |
| Spain                | 1.9%                      | (1.6%)                       | 12.1%                                | 12.1%       |
| United Kingdom       | 2.3%                      | --                           | 7.3%                                 | 7.3%        |
| Germany              | 1.5%                      | --                           | 14.0%                                | 13.9%       |
| Brazil               | 1.4%                      | (6.4%)                       | 28.0%                                | 27.9%       |
| Hispanoamérica       | 2.3%                      | --                           | 38.6%                                | 38.7%       |
| Others               | 16.6%                     | --                           | 0.1%                                 | 0.1%        |

(1) In order to calculate organic changes, we have added the accesses of DTS and GVT as of December 31, 2014 to our accesses as of such date.

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The Group's strategy is based on capturing growth in its markets, especially on attracting high-value customers.

**Mobile accesses** totaled 272.1 million at December 31, 2015, down 0.9% compared to December 31, 2014, affected mainly by the decrease in prepay accesses (due to the disconnection of prepay accesses in Brazil (11.5 million accesses in 2015 and 1.6 million accesses in 2014)). Contract accesses, however, were up 5.6% year-on-year, continuing to increase their weight over total mobile accesses up to 38.3% (+2.3 p.p. year-on-year).

**Smartphone accesses** maintained a strong growth rate (up 48.3% year-on-year), totaling 126.2 million accesses as of December 31, 2015 and reaching a penetration rate over total accesses of 49.5% (+14.3 p.p. year-on-year), reflecting the Company's strategic focus on the growth of its data services.

**Fixed broadband accesses** stood at 21.0 million at December 31, 2015, up 18.7% year-on-year (of which 16.6 p.p. was due to the inclusion of accesses from GVT in the 2015). Fiber accesses stood at 6.1 million at December 31, 2015.

**TV accesses** totaled 8.3 million up 63% year-on-year (of which 28 p.p. was due to the inclusion of accesses from DTS and 17 p.p. was due to the inclusion of accesses from GVT in the 2015 access base).

Telefónica's customer base includes the consumer and business segments, and therefore is not affected by customer concentration risk.

| Consolidated Results | Year ended December, 31 |               |          |               | Percent Change |       |
|----------------------|-------------------------|---------------|----------|---------------|----------------|-------|
|                      | 2014 (*)                |               | 2015 (*) |               | 2015 vs 2014   |       |
| Millions of euros    | Total                   | % of revenues | Total    | % of revenues | Total          | %     |
| Revenues             | 50,377                  | 100.0%        | 54,916   | 100.0%        | 4,539          | 9.0%  |
| Other income         | 1,707                   | 3.4%          | 2,011    | 3.7%          | 304            | 17.8% |
| Supplies             | (15,182)                | (30.1%)       | (16,547) | (30.1%)       | (1,365)        | 9.0%  |
| Personnel expenses   | (7,098)                 | (14.1%)       | (10,349) | (18.9%)       | (3,251)        | 45.8% |

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|  |               |              |               |              |                |                |
|--|---------------|--------------|---------------|--------------|----------------|----------------|
| Other expenses   | (14,289)      | (28.4%)      | (16,802)      | (30.6%)      | (2,513)        | 17.6%          |
| <b>OPERATING INCOME BEFORE DEPRECIATION AND AMORTIZATION (OIBDA)</b> | <b>15,515</b> | <b>30.8%</b> | <b>13,229</b> | <b>24.1%</b> | <b>(2,286)</b> | <b>(14.7%)</b> |
| Depreciation and amortization  | (8,548)       | (17.0%)      | (9,704)       | (17.7%)      | (1,156)        | 13.5%          |
| <b>OPERATING INCOME</b>  | <b>6,967</b>  | <b>13.8%</b> | <b>3,525</b>  | <b>6.4%</b>  | <b>(3,442)</b> | <b>(49.4%)</b> |
| Share of loss of investments accounted for by the equity method      | (510)         | (1.0%)       | (10)          | (0.0%)       | 500            | (97.9%)        |
| Net financial expense  | (2,822)       | (5.6%)       | (2,609)       | (4.8%)       | 213            | (7.5%)         |
| <b>PROFIT BEFORE TAX</b>   | <b>3,635</b>  | <b>7.2%</b>  | <b>906</b>    | <b>1.7%</b>  | <b>(2,729)</b> | <b>(75.1%)</b> |
| Corporate income tax   | (383)         | (0.8%)       | (155)         | (0.3%)       | 228            | (59.6%)        |
| <b>PROFIT FOR THE YEAR</b>   | <b>3,252</b>  | <b>6.5%</b>  | <b>751</b>    | <b>1.4%</b>  | <b>(2,501)</b> | <b>(76.9%)</b> |
| Attributable to equity holders of the Parent                         | 3,001         | 6.0%         | 616           | 1.1%         | (2,385)        | (79.5%)        |
| Attributable to non- controlling interests                           | 251           | 0.5%         | 135           | 0.3%         | (116)          | 46.2%          |

(\* Amended data

#### Adjustments made to calculate organic variations

As previously mentioned, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis (see Consolidated Results 2016/2015- Adjustments for the calculation of organic variations)

The adjustments made to calculate 2015/2014 organic variations are the following:

**Foreign exchange effects and the impact of hyperinflationary adjustments in Venezuela:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rates of 2014 for both years.

Foreign exchange rates had a negative impact on our reported 2015 results, mainly due to the depreciation of various Latin American currencies versus the euro, in particular the Brazilian real and, to a lesser extent, the Venezuelan bolívar.

We have also excluded the impact of hyperinflationary adjustments in Venezuela by reversing such adjustments.



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**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The main changes in our consolidation perimeter in such years related to the consolidation of GVT in Telefónica Brazil since May 2015, the consolidation of DTS in Telefónica Spain since May 2015, the consolidation of E-Plus in Telefónica Germany since October 2014 and the sale of Telefónica Ireland in July 2014.

In order to exclude the impact of these changes in our perimeter, we have:

- o consolidated GVT's results from May 1 to December 31, 2014 in our 2014 results;
- o consolidated DTS's results from May 1 to December 31, 2014 in our 2014 results;
- o consolidated E-Plus's results from January 1 to September 30, 2014 in our 2014 results; and
- o excluded Telefónica Ireland's results from January 1 to June 30, 2014 from our 2014 results.

**Restructuring costs:** We have excluded the impact of certain restructuring costs, mainly those related to the 1st Collective Agreement of Related Companies in Telefónica Spain, restructuring processes relating to Telefónica Germany, Telefónica United Kingdom and Telefónica Brazil and the Group's simplification program.

In 2015, these restructuring costs totaled 3,217 million euros and were aimed at increasing future efficiency, representing a further step towards the transformation and simplification initiatives carried out by Telefónica. These costs were distributed by segment as follows (impacts on OIBDA): Telefónica Spain (2,896 million euros), Telefónica Germany (74 million euros), Telefónica Hispanoamérica (38 million euros), Telefónica Brazil (7 million euros), Telefónica United Kingdom (4 million euros) and other companies (197 million euros).

In 2014, these restructuring costs totaled 658 million euros and were attributable to the simplification initiatives that the Group has implemented to meet its targets. These costs were mainly distributed by segment as follows (impacts on OIBDA): Telefónica Germany (414 million euros), Telefónica Brazil (68 million euros), Telefónica Hispanoamérica (99 million euros, mainly in Peru) and other companies (77 million euros).

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years.

In 2015 the results from the sale of towers totaled 65 million euros, distributed as follows: Telefónica Spain (38 million euros), Telefónica Brazil (10 million euros) and Telefónica Hispanoamérica (18 million euros, mainly in Chile). In 2014 the results from the sale of towers totaled 196 million euros in OIBDA, mainly in Telefónica Spain (191 million euros).

**Irrevocable commitment with Fundación Telefónica:** In 2015 we have excluded the expense (325 million euros) resulting from Telefónica, S.A.'s irrevocable commitment to make a donation to Fundación Telefónica in order to provide this entity with the financing required so that it can carry out its existing or new social programs and non-profit activities in the short and medium term.

**Adjustments to the final purchase price of E-Plus:** In 2015 we have excluded the positive result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA, net of costs related to the acquisition).

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015 and 2014.

In 2015, these acquisitions totaled 1,585 million euros, 1,198 million euros corresponding to Telefónica Germany, 49 million euros corresponding to Telefónica Spain and 338 million euros corresponding to Telefónica Hispanoamérica (mainly Argentina and Ecuador).



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In 2014 these acquisitions totaled 1,294 million euros, 889 million euros corresponding to Telefónica Brazil and 405 million euros corresponding to Telefónica Hispanoamérica with the following distribution by country or region:

- o Telefónica Argentina (168 million euros);
- o Telefónica Colombia (111 million euros); and
- o Telefónica Venezuela and Central America (126 million euros).

**Real Estate Efficiency Plan:** In 2014 we have excluded the impact of certain urban assets qualification changes in Telefónica Spain and also the investment in Telefónica's Barcelona head office, which had an impact on capital expenditures (Capex) of 78 million euros.

**Other adjustments:** We have excluded the partial adjustment of the goodwill generated in the acquisition of Telefónica Digital Inc. amounting to 104 million euros y the impact of the impairment resulting from the deterioration in certain minority participations, totaling 23 million euros in 2015. We have also excluded the impact of the 30 million euros provision recorded in 2015 in Telefónica Spain to optimize the distribution channel.

The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures:

| TELEFÓNICA<br>2015           | YoY variation  |                  |
|------------------------------|----------------|------------------|
|                              | % Reported YoY | % Organic<br>YoY |
| Revenues                     | 9.0%           | 3.5%             |
| Other income                 | 17.8%          | 15.3%            |
| Supplies                     | 9.0%           | 0.3%             |
| Personnel expenses           | 45.8%          | 4.0%             |
| Other expenses               | 17.6%          | 8.1%             |
| <b>OIBDA</b>                 | <b>(14.7%)</b> | <b>3.2%</b>      |
| <b>Operating income (OI)</b> | <b>(49.4%)</b> | <b>4.0%</b>      |
| CapEx                        | 10.7%          | 4.9%             |

**OpCF (OIBDA-CapEx) (54.4%) 1.3%**

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year.

Table of Contents**Contribution to reported growth (percentage points)**

| TELEFÓNICA<br>2015               | Exchange rate<br>effect and<br>hyperinflation | Perimeter<br>change | Restructuring<br>costs | Towers<br>sales | Commitment<br>with<br>Fundación | Adjustments<br>to the final<br>purchase<br>price of<br>E-Plus | Spectrum<br>acquisition | Real<br>Estate<br>Efficiency<br>Plan |
|----------------------------------|---|---------------------|------------------------|-----------------|---------------------------------|---|-------------------------|--------------------------------------|
| Revenues                         | (2.3)   | 7.6                 | -                      | -               | -                               | -   | -                       | -                                    |
| Other income                     | (2.7)   | 7.5                 | -                      | (7.7)           | -                               | 6.1   | -                       | -                                    |
| Supplies                         | 0.3   | 8.4                 | -                      | -               | -                               | -   | -                       | -                                    |
| Personnel<br>expenses            | (1.5)   | 7.1                 | 36.3                   | -               | -                               | -   | -                       | -                                    |
| Other expenses                   | (4.4)   | 9.9                 | (0.1)                  | -               | 2.3                             | -   | -                       | -                                    |
| <b>OIBDA</b>                     | <b>(3.2)</b>                                  | <b>4.8</b>          | <b>(16.5)</b>          | <b>(0.8)</b>    | <b>(2.1)</b>                    | <b>0.7</b>  | -                       | -                                    |
| <b>Operating<br/>Income (OI)</b> | <b>(5.3)</b>                                  | <b>(4.2)</b>        | <b>(36.7)</b>          | <b>(1.9)</b>    | <b>(4.7)</b>                    | <b>1.5</b>  | -                       | -                                    |
| CapEx                            | (3.7)   | 7.9                 | -                      | -               | -                               | -   | 2.8                     | (0.8)                                |
| <b>OpCF<br/>(OIBDA-CapEx)</b>    | <b>(2.4)</b>                                  | -                   | <b>(42.2)</b>          | <b>(2.1)</b>    | <b>(5.4)</b>                    | <b>1.7</b>  | <b>(4.4)</b>            | <b>1.3</b>                           |

## Results Discussion

**Revenues** totaled 54,916 million euros in 2015, increasing 9.0% compared to 2014 in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 7.6 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.3 p.p.). In organic terms, revenues increased 3.5% due to higher connectivity revenues, mainly in the mobile business as a consequence of the strong data revenue growth. The growing focus on our key markets was reflected in the revenue mix with Telefónica Spain, Telefónica Brazil and Telefónica Germany accounting for 57.1% of the revenues, increasing local scale and keeping at the same time the Group's differential diversification and global scale.

The **structure of revenues** reflects Telefónica's business diversification. Despite the adverse impact of exchange rates and hyperinflation in Venezuela, the segment with the largest contribution to our revenues in 2015 was Telefónica Hispanoamérica, representing 26.2% (+0.1 p.p. compared to 2014), followed by Telefónica Spain, representing 22.6% (-1.3 p.p. compared to 2014), Telefónica Brazil, representing 20.1% (-2.2 p.p. compared to 2014), Telefónica Germany, which increased its contribution with respect to 2014 to 14.4% (+3.4 p.p. year-on-year), and Telefónica

United Kingdom representing 14.3% (+0.3 p.p. compared to 2014).

**Mobile business revenues** totaled 35,540 million euros in 2015 (of which 30,289 million euros corresponded to service revenues and 4,984 million euros corresponded to handset revenues) up 8.2% year-on-year in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 6.1 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.6 p.p.). Excluding these impacts, year-on-year growth was 3.5% due to higher mobile revenues in Telefónica Hispanoamérica and Telefónica Brazil as a result mainly of the increase in the customer base and data adoption.

**Mobile service revenues** totaled 30,289 million euros in 2015, up 6.6% year-on-year in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 6.0 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.2 p.p.). Excluding these impacts, year-on-year growth was 2.6% due mainly to the higher customer base and higher data consumption.

**Mobile data revenues** totaled 13,869 million euros in 2015, up 18.9% in reported terms. This increase was mainly attributable to the consolidation of E-Plus (which accounted for 7.9 p.p. of the year-on-year increase) and the higher consumption of data of our customers, which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-2.2 p.p.). Excluding these impacts, mobile data revenues increased by 12.2% due mainly to the increased revenues of non-SMS data (up 20.4%) and higher use of data per customer. Mobile data revenues accounted for 45.5% of mobile service revenues in 2015, up 4.8 p.p. compared to 2014 in reported terms.

**Fixed revenues** totaled 17,854 million euros in 2015, up 9.5% year-on-year in reported terms. This increase was mainly attributable to the consolidation of GVT and DTS (which accounted for +10.9 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-3.9 p.p.). Excluding these impacts, fixed revenues increased 2.2%. This increase was mainly due to higher broad band connection revenues and Pay-TV revenues as a result of the commercial actions carried out by the Company in order to increase our value proposition and the higher customer base in Pay-TV.

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**Other income** in 2015 mainly included own work capitalized in our fixed assets, profit from the sale of other assets, and the sale of towers by Telefónica Spain, Telefónica Brazil and Telefónica Hispanoamérica.

In 2015, other income totaled 2,011 million euros, up 17.8% year-on-year in reported terms. In 2015, other income was positively affected by the consolidation of E-Plus, GVT and DTS, the positive result from the E-Plus price adjustment (104 million euros), the positive impact from the expired payment obligation (98 million euros) in Telefónica Brazil, the spectrum swap with AT&T in Telefónica Mexico carried out in December 2015 (79 million euros), the sale of real estate in Telefónica Spain (78 million euros) and the result from the sale of towers amounting to 65 million euros.

In 2014, the sale of towers had a positive impact of 196 million euros. Other income also included an extraordinary sale of real estate in Telefónica Spain (63 million euros).

**Total expenses** (which include supply costs, personnel costs and other expenses (principally external services and taxes) but do not include amortization and depreciation expenses), were 43,698 million euros in 2015, up year-on-year 19.5% in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 8.7 p.p. of the year-on-year increase) and higher restructuring costs amounting to 3,217 million euros (which accounted for 7.0 p.p. of the year-on-year increase), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.9 p.p.). The costs are explained in detail below:

**Supplies** amounted to 16,547 million euros in 2015, up 9.0% year-on-year in reported terms mainly as a result of the consolidation of E-Plus, GVT and DTS (which accounted for 8.4 p.p. of the year-on-year increase). In organic terms, supplies expenses grew by 0.3% year-on-year, due to increased commercial activity in high-end devices and higher TV content costs, which more than offset the decrease in mobile interconnection costs.

**Personnel expenses** amounted to 10,349 million euros in 2015, up 45.8% in reported terms year-on-year compared to 2014. This increase was mainly attributable to higher restructuring costs of 3,146 million euros (which accounted for +36.3 p.p. of the year-on-year increase), the consolidation of E-Plus, GVT and DTS (which accounted for 7.1 p.p. of the year-on-year increase), and was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-1.5 p.p.). In organic terms, personnel costs increased 4.0% year-on-year mainly affected by inflationary pressures in some Latin American countries.

The average headcount was 133,569 employees in 2015, up 10.8% compared to 2014 (-2.1% excluding the impact of changes in the scope of consolidation).

**Other expenses** amounted to 16,802 million euros in 2015, up 17.6% in reported terms. This increase was mainly attributable to the consolidation of E-Plus, GVT and DTS (which accounted for 9.9 p.p. of the year-on-year increase), the provision of 325 million euros related to the irrevocable agreement between Telefónica, S.A. and Fundación Telefónica for its short-and mid-term financing (+2.3 p.p.) and to a lesser extent, the impairment resulting from the deterioration in certain minority participations, the goodwill value adjustment in Telefónica Digital Inc. (+1.1 p.p.) and the decrease in other expenses related to restructuring processes (-0.1 p.p.), which was partially offset by the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-4.4 p.p.). In organic terms, other expenses increased by 8.1% compared to 2014, mainly as a result of increased network costs, higher IT costs and a higher commercial activity. Increased inflation in some Latin American countries offset in part the savings resulting from the simplification measures carried out by the Company.

**OIBDA** was 13,229 million euros in 2015, down 14.7% in reported terms. This decrease was mainly attributable to the higher restructuring costs (which accounted for 16.5 p.p. of the year-on-year decrease and included a restructuring costs provision of 3,217 million euros), the impact of changes in foreign exchange rates and hyperinflation in Venezuela (-3.2 p.p.), the provision of 325 million euros related to the agreement between Telefónica S.A. and Fundación Telefónica for its short and mid-term financing (-2.1 p.p.) and, to a lesser extent, the decreased results from the sale of towers (-0.8 p.p.), the provision recorded in connection with the optimization of the distribution channel in Spain of 30 million euros (-0.2 p.p.) and the impairment resulting from the deterioration in certain minority participations (-0.8 p.p.), which was partially offset by the impact of the consolidation of E-Plus, GVT and DTS (+4.8 p.p.) and the adjustments made to the final acquisition price of E-Plus (+0.7 p.p.).

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In organic terms, OIBDA grew 3.2% due to the positive evolution of Telefónica Germany (+20.9% year-on-year), reflecting increased synergies, the better performance of Telefónica Brazil (+2.9% year-on-year) and the results from Telefónica Hispanoamérica (+7.2% year-on-year).

**OIBDA margin** stood at 24.1% in 2015, down 6.7 p.p. compared to 2014 in reported terms due mainly to the restructuring costs provision of 3,217 million euros in 2015.

By segments, Telefónica Hispanoamérica was the main contributor to Group OIBDA with 32.9% (+6.7 p.p. compared to 2014), Telefónica Brazil contributed 27.0% (+4.2 p.p. compared to 2014), Telefónica Germany contributed 14.0% (+9.3 p.p. compared to 2014) and Telefónica United kingdom contributed 14.6% (+3.3 p.p. compared to 2014). Telefónica Spain contributed 17.7% to Group OIBDA, down 18.9 p.p. compared to 2014, mainly as a result of the restructuring cost provision of 2,896 million euros in 2015.

**Depreciation and amortization** amounted to 9,704 million euros in 2015, up 13.5% year-on-year in reported terms, mainly due to the consolidation of E-Plus, GVT and DTS. The total depreciation and amortization charges arising from purchase price allocation processes amounted to 894 million euros in 2015, up 26.3% year-on-year.

**Operating income (OI)** in 2015 totaled 3,525 million euros, down 49.4% compared to 2014 for the reasons set forth above for OIBDA. In organic terms, operating income grew 4.0% year-on-year as a result of higher revenues and costs savings.

The **share of loss of investments accounted for by the equity method** for 2015 was a loss of 10 million euros (compared to a loss of 510 million euros in 2014). The loss recorded in 2014 was mainly due to the valuation adjustment of Telco, S.p.A. at Telecom Italia, S.p.A. amounting to 464 million euros.

**Net financial expense** amounted to 2,609 million euros in 2015, 7.5% lower than the previous year. Excluding exchange rate differences, costs improved by 21.2% (536 million euros) to 1,993 million euros. Negative foreign exchange differences amounted to 616 million euros (excluding monetary correction), primarily due to adoption of the SIMADI exchange rate for the Venezuelan bolivar. The lower cost of debt in euros explains 146 million euros of this improvement, due to lower fixed rate debt and capture of the reduction in short-term rates. The divestment of the entire holding in Telecom Italia, S.p.A. generated a positive variation of 404 million euros. Other effects resulted in losses of 13 million euros. These included the monetary correction for inflation in Venezuela, net of higher expenses in Latin America currencies, costs for updating contingencies, and other gains and losses on equities. The effective cost of debt over 2015, excluding exchange rate differences and the positive impact of the divestment of Telecom Italia, S.p.A., stood at 4.82%, down 52 basis points year-on-year.

**Corporate income tax** totaled 155 million euros in 2015, compared to 383 million euros in 2014, mainly due to the temporary difference recorded related to a restructuring provision the activation of tax credit in Spain. Considering a pre-tax income of 906 million euros, the effective tax rate was 17.1% in 2015, 6.5 p.p. higher than in 2014.

**Profit attributable to non-controlling interest** reduced the profit for the year attributable to equity holder of the parent by 135 million euros, 116 million euros less than in 2014, mainly due to the lower profit attributable to minority interests in Telefónica Brazil and Colombia Telecomunicaciones.

As a result of the foregoing, profit for the year attributable to equity holders of the parent for 2015 was 616 million euros, down by 79.5% year on year compared to 2014.



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## TELEFÓNICA SPAIN

The below table shows the evolution of accesses in Telefónica Spain over the past two years as of December 31 of such years:

## ACCESSES

| Thousands of accesses        | 2014     | 2015     | %Reported<br>YoY | %Organic<br>YoY (1) |
|------------------------------|----------|----------|------------------|---------------------|
| Fixed telephony accesses (2) | 10,447.8 | 10,005.6 | (4.2%)           | (4.2%)              |
| Internet and data accesses   | 5,928.7  | 6,000.0  | 1.2%             | 1.2%                |
| Broadband (3)                | 5,885.9  | 5,962.0  | 1.3%             | 1.3%                |
| Fiber                        | 1,316.8  | 2,223.0  | 68.8%            | 68.8%               |
| Mobile accesses              | 17,575.4 | 17,258.5 | (1.8%)           | (1.8%)              |
| Prepay                       | 3,328.1  | 2,777.1  | (16.6%)          | (16.6%)             |
| Contract                     | 14,247.3 | 14,481.4 | 1.6%             | 1.6%                |
| M2M                          | 1,612.4  | 1,778.8  | 10.3%            | 10.3%               |
| Pay TV                       | 1,884.7  | 3,671.5  | 94.8%            | 10.5%               |
| Final Clients Accesses       | 35,836.7 | 36,935.6 | 3.1%             | (0.9%)              |
| Wholesale Accesses           | 5,366.0  | 5,037.7  | (6.1%)           | (6.1%)              |
| Total Accesses               | 41,202.7 | 41,973.3 | 1.9%             | (1.6%)              |

## Notes:

(1) In order to calculate organic changes, we have added the accesses of DTS as of December 31, 2014 to our accesses as of such date.

(2) PSTN (including Public Use Telephony) x1; ISDN Basic access x1; ISDN Primary access; 2/6 Digital Access x30. Company's accesses for internal use included. Includes VoIP and Naked ADSL.

(3) Includes ADSL, satellite, optical fiber, cable modem and broadband circuits.

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year:

| TELEFÓNICA<br>SPAIN<br>2015 | %Reported<br>YoY | %Organic<br>YoY (1) | DTS       |
|-----------------------------|------------------|---------------------|-----------|
| Pay TV                      | 94.8%            | 10.5%               | 76.3 p.p. |
| Final Clients Accesses      | 3.1%             | (0.9%)              | 4.0 p.p.  |
| Total Accesses              | 1.9%             | (1.6%)              | 3.5 p.p.  |

(1) In order to calculate organic changes, we have added the accesses of DTS as of December 31, 2014 to our accesses as of such date.

In 2015 the commercial activity was leveraged on the differentiated assets of the Company and, in the second half of 2015 was strengthened by the convergent offer “Movistar Fusión+” launched in July 2015 as well as the promotion that included all “TV Premium Extra” content from 9.90 euros/month, launched in August 2015. This promotion was subscribed by almost 700 thousand customers, reflecting the attractiveness of the offer (new TV contents and ultra-speed fiber in an economic environment where private consumption continues to improve).

Churn evolution has been positive in 2015, especially taking into account the elimination of “Fusión” long-term contracts on August 1, 2015. This fact, together with the good evolution in adds since the launching of “Movistar Fusión+” has resulted in a positive performance of commercial activity. In 2015, broadband net adds duplicated year-on-year, fiber net adds grew by 25.3%, mobile contract net adds resumed growth (+0.2 million customers) and in fixed telephony the net loss of accesses decreased by 31.1% year-on-year.

The results of Telefónica Spain in 2015 showed a lower decrease in revenues compared to the year-on-year results of 2014-2013, as a result of the transformation strategy implemented in recent years which relies on a high value offer based on the differentiated assets of Telefónica Spain, a more rational market in competition terms and a more favorable macroeconomic context, with improvement in private consumption.

Telefónica Spain had 42.0 million accesses at the end of December 2015, up 1.9% year-on-year, after the consolidation of the DTS satellite TV accesses (0.9 million accesses at December 2015). The organic variation was down by 1.6%, explained by the decrease in mobile accesses and fixed telephony accesses, although it is important to highlight that retail accesses grew by 3.1% year-on-year.

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“Movistar Fusión”, with a customer base of 4.2 million with 1.5 million additional wireless lines to the base offer as of December 31, 2015, maintained a solid year-on-year growth (+13% and +8% respectively compared to December 2014) and contributed 81% of the fixed retail broadband customer base and 63% of the wireless contract customer base. There was significant growth in the penetration of the high value services of “Movistar Fusión”, with 31.8% of the customer base already using 100 Mb or 300 Mb ultra-fast broadband (+10.9 p.p. year-on-year) and 62.4% of the customer base with Pay-TV as of December 31, 2015 (+17.7 p.p. year-on-year).

**Fixed accesses** decreased 4.2% year-on-year, with a net loss of 442 thousand accesses in the year 2015. This decrease was mainly due to a lower fixed access market growth.

**Retail broadband accesses** totaled 6.0 million and grew 1.3% year-on-year, with net adds of 76 thousand accesses, due to the good evolution of fiber adds (+37.1% year-on-year) and lower churn (1.4% in 2015, -0.1 p.p. year-on-year).

**Fiber accesses** posted a new record in terms of net adds (0.9 million new accesses in 2015), reaching 2.2 million customers (1.7 times compared to December 31, 2014), representing 37.3% of total broadband customers (+14.9 p.p. year-on-year). Two thirds of fiber accesses are benefiting from the new speeds (30 and 300 Mb) launched in May 2015.

Ultra-speed fiber accesses, with 100 or 300 Mb (with additional ARPU of 12 euros, including VAT) reached 1.5 million accesses (68.6% of total fiber accesses), after the new record of 0.5 million accesses in 2015, triggered by the higher level of adds (+25.9% year-on-year) and contained churn (0.9%, +0.1 p.p. year-on-year).

At December 31, 2015 our fiber deployment reached 14.3 million premises, 4 million more than at December 31, 2014.

Total **mobile accesses** stood at 17.3 million, down 1.8% compared with year-end 2014 as a result of the decrease in prepay accesses. The contract access base accelerated its growth during 2015, growing by 1.6% year-on-year. The positive evolution of contract portability (-162 thousand customers at December 31, 2015, compared to -508 thousand customers at December 31, 2014), resulted in a positive contract net adds base (excluding M2M) (+68 thousand customers at December 31, 2015, compared to -113 thousand customers at December 31, 2014). Smartphone penetration stood at 66.3% of the mobile voice base (+5.7 p.p. compared to year-end 2014) and significantly boosted data traffic growth to 86.8% year-on-year in 2015 due to the higher number of customers with the renewed portfolio containing superior data packages.

LTE network rollout continued to progress well and coverage reached (based on our estimates) approximately 75% of the population at the end of 2015, up 17 p.p. compared to December 31, 2014, due to the deployment of the 800 MHz. As a result, the LTE customer base reached 3.3 million customers at December 31, 2015, doubling the customer base at December 31, 2014, while the penetration reached 21% (+10 p.p. year-on-year).

**Pay-TV accesses** reached 3.7 million, up by 94.8% in reported terms compared to December 31, 2014 as a result of the acquisition of DTS (+10.5% in organic terms), including 926 thousand satellite TV accesses from DTS.

The table below shows the evolution of Telefónica Spain's results over the past two years:

Millions of euros

| TELEFÓNICA SPAIN              | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 12,023       | 12,402       | 3.2%             | (2.1%)              |
| Mobile Business               | 4,556        | 4,337        | (4.8%)           | (4.8%)              |
| Mobile service revenues       | 3,888        | 3,677        | (5.4%)           | (5.4%)              |
| Fixed Business                | 8,543        | 9,359        | 9.6%             | 1.9%                |
| Other income                  | 635          | 516          | (18.7%)          | 7.0%                |
| Supplies                      | (2,592)      | (2,996)      | 15.6%            | (2.7%)              |
| Personnel expenses            | (2,139)      | (5,173)      | 141.8%           | 4.0%                |
| Other expenses                | (2,256)      | (2,413)      | 7.0%             | (0.2%)              |
| <b>OIBDA</b>                  | <b>5,671</b> | <b>2,336</b> | <b>(58.8%)</b>   | <b>(4.3%)</b>       |
| OIBDA Margin                  | 47.2%        | 18.8%        | (28.3 p.p.)      | (1.0 p.p.)          |
| Depreciation and amortization | (1,805)      | (1,898)      | 5.2%             | 2.4%                |
| <b>Operating Income (OI)</b>  | <b>3,866</b> | <b>438</b>   | <b>(88.7%)</b>   | <b>(7.8%)</b>       |
| CapEx                         | 1,732        | 1,827        | 5.5%             | 4.5%                |
| OpCF (OIBDA-CapEx)            | 3,939        | 509          | (87.1%)          | (8.3%)              |

(1) See adjustments made to calculate organic variation below.

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Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Spain, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Spain consolidation perimeter in such years is related to the consolidation of DTS in Telefónica Spain since May 1, 2015. In order to exclude the impact of such change in our perimeter, we have consolidated DTS’s results from May 1 to December 31, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of the 2,896 million euros of restructuring costs in 2015, mainly those related to the Voluntary Suspension Plan in Spain. The restructuring process is aimed at increasing future efficiency, representing a further step towards the transformation and simplification initiatives carried out by Telefónica.

No restructuring costs were excluded from our 2014 results to calculate organic variations.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years. In 2015, the results from the sale of towers totaled 38 million euros. In 2014, the results from the sale of towers totaled 191 million euros.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015, which totaled 49 million euros.

**Real Estate Efficiency Plan:** We have excluded the impact of certain urban assets qualification changes in Telefónica Spain in 2014, totaling 49 million euros.

**Spain distribution channel:** We have excluded the impact of the 30 million euros provision recorded in 2015 in Telefónica Spain to optimize the distribution network.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>SPAIN<br>2015   | YoY variation    |                 | Contribution to reported growth (percentage points) |                        |                 |                         |                                      |                                  |
|-------------------------------|------------------|-----------------|---|------------------------|-----------------|-------------------------|--------------------------------------|----------------------------------|
|                               | %Reported<br>YoY | %Organic<br>YoY | Perimeter<br>change<br>(DTS)                        | Restructuring<br>costs | Towers<br>sales | Spectrum<br>acquisition | Real<br>Estate<br>Efficiency<br>Plan | Spain<br>distribution<br>channel |
| Revenues                      | 3.2%             | (2.1%)          | 5.4   | --                     | --              | --                      | --                                   | --                               |
| Other income                  | (18.7%)          | 7.0%            | 0.9   | --                     | (24.5)          | --                      | --                                   | --                               |
| Supplies                      | 15.6%            | (2.7%)          | 18.7  | --                     | --              | --                      | --                                   | --                               |
| Personnel<br>expenses         | 141.8%           | 4.0%            | 2.4   | 135.4                  | --              | --                      | --                                   | --                               |
| Other expenses                | 7.0%             | (0.2%)          | 5.9   | --                     | (0.1)           | --                      | --                                   | 1,3                              |
| <b>OIBDA</b>                  | <b>(58.8%)</b>   | <b>(4.3%)</b>   | <b>(0.4)</b>  | <b>(51.1)</b>          | <b>(2.7)</b>    | --                      | --                                   | <b>(0.5)</b>                     |
| CapEx                         | 5.5%             | 4.5%            | 1.1   | --                     | --              | 2.8                     | (2.8)                                | --                               |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>(87.1%)</b>   | <b>(8.3%)</b>   | <b>(1.0)</b>  | <b>(73.5)</b>          | <b>(3.9)</b>    | <b>(1.2)</b>            | <b>1.3</b>                           | <b>(0.8)</b>                     |

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## Results Discussion

**Revenues** in Telefónica Spain in 2015 were 12,402 million euros, up 3.2% year-on-year in reported terms mainly as a result of the consolidation of DTS since May 1, 2015 (which accounted for +5.4 p.p. of the year-on-year increase). In organic terms, revenues were down by 2.1% due to lower mobile service revenues in the mobile business and lower access and voice revenues in the fixed business.

We consider revenue breakdown to be increasingly less relevant given the high penetration level of our convergent offer, by which we mean the offer of more than a single service for a single price. However, we continue to report revenue separately for information purposes. Fixed business revenues were up by 9.6% year-on-year in 2015, due to the consolidation of DTS, the repositioning of tariffs, higher retail broadband revenues and new services, mainly related to TV and IT services. Excluding the impact of DTS, fixed revenues increased by 1.9%. Mobile business revenues fell 4.8% year-on-year in 2015 due to the decline in mobile accesses and the 3.6% drop in ARPU.

**Mobile ARPU** was 15.3 euros in 2015, down by 3.6% year-on-year. Mobile ARPU is becoming less representative of the Group's business performance, owing to its high dependence on the allocation of revenue in convergent offers.

| TELEFÓNICA SPAIN                    | 2014   | 2015   | %YoY     |
|-------------------------------------|--------|--------|----------|
| Voice Traffic (millions of minutes) | 35,600 | 36,368 | 2.2%     |
| ARPU (EUR)                          | 15.9   | 15.3   | (3.6%)   |
| Prepay                              | 6.2    | 5.7    | (8.2%)   |
| Contract (1)                        | 20.6   | 19.5   | (5.3%)   |
| Data ARPU (EUR)                     | 7.0    | 7.8    | 11.0%    |
| % non-SMS over data revenues        | 95.0%  | 95.5%  | 0.5 p.p. |

Notes:

(1) Excludes M2M.

**OIBDA** amounted to 2,336 million euros in 2015, down 58.8% year-on-year in reported terms, mainly due to provisions recorded in 2015 totaling 2,926 million euros (relating to restructuring cost accounted for 51.1 p.p. of the year-on-year decrease and 0.5 p.p. of the year-on-year decrease in distribution channel restructuring) and, to a lesser extent, the lower proceeds (38 million euros in 2015 compared to 191 million euros in 2014) from the sale of towers (-2.7 p.p.). This decrease was partially offset by the sale of real estate assets amounting to 73 million euros (net of costs).

In organic terms OIBDA decreased 4.3% year-on-year, mainly due to the lower revenues, higher personnel costs and higher content costs. The higher personnel costs, up by 4.0% year-on-year in organic terms, were primarily due to the resumption of the Company's contribution to its pension plan in July 2014, and to a lesser extent, the acquisition of DTS. Telefónica Spain had 32,171 employees at the end of December 2015, up 7.2% year-on-year, due mainly to the acquisition of DTS.

**OIBDA margin** was 18.8% in 2015, down 28.3 p.p. year-on-year.



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As explained above, the consolidated income statement for the year ended December 31, 2015 has been amended to retroactively show the reclassification of Telefónica United Kingdom's results as continuing operations. Therefore, the results below differ from the results previously published for such period. The segmented financial information shown below has been amended for 2015 as discussed above.

The table below shows the evolution of accesses in Telefónica United Kingdom over the past two years as of December 31 of such years:

**ACCESSES**

| <b>Thousands of accesses</b>  | <b>2014</b>     | <b>2015</b>     | <b>% Reported YoY</b> |
|-------------------------------|-----------------|-----------------|-----------------------|
| Fixed telephony accesses (1)  | 228.0           | 247.1           | 8.4%                  |
| Internet and data accesses    | 19.2            | 21.0            | 9.4%                  |
| Broadband                     | 19.2            | 21.0            | 9.4%                  |
| Mobile accesses               | 24,479.1        | 25,018.8        | 2.2%                  |
| Prepay                        | 10,761.2        | 10,561.4        | (1.9%)                |
| Contract                      | 13,717.9        | 14,457.4        | 5.4%                  |
| M2M                           | 2,192.0         | 2,383.9         | 8.8%                  |
| <b>Final Clients Accesses</b> | <b>24,726.4</b> | <b>25,286.9</b> | <b>2.3%</b>           |
| <b>Total Accesses</b>         | <b>24,726.4</b> | <b>25,286.9</b> | <b>2.3%</b>           |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses

In 2015, Telefónica United Kingdom maintained market momentum, as a result of O2's brand recognition, the success of commercial proposal success and customer loyalty. These factors have allowed the company to keep growing in a competitive market.

The **total access** base grew 2.3% year-on-year and stood at 25.3 million at December 31, 2015, mainly driven by a 2.2% increase in the mobile base.

The contract **mobile customer base** grew 5.4% year-on-year and reached 14.5 million accesses, with a broadly stable 57.8% share over the total mobile base. Net adds reached 539 thousand accesses due to the solid contribution of postpay accesses. Smartphone penetration reached 60% of the total mobile accesses base, up 15.4 p.p. year-on-year, driven by the continued growth of LTE customers (+85.8% year-on-year reaching 7.6 million at December 31, 2015). LTE penetration reached 35% of the total mobile access base.

The prepay access base decreased 1.9% year-on-year to 10.6 million at December 31, 2015.

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The table below shows the evolution of Telefónica United Kingdom's results over the past two years:

**Millions of euros**

| <b>TELEFÓNICA UNITED KINGDOM</b> | <b>2014</b>  | <b>2015</b>  | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY (1)</b> |
|----------------------------------|--------------|--------------|---------------------------|------------------------------|
| Revenues                         | <b>7,062</b> | <b>7,837</b> | <b>11.0%</b>              | <b>(0.1%)</b>                |
| <b>Mobile service revenues</b>   | 5,397        | 5,778        | 7.1%                      | (3.6%)                       |
| Other income                     | 184          | 170          | (7.5%)                    | (16.7%)                      |
| Supplies                         | (3,520)      | (3,769)      | 7.1%                      | (3.6%)                       |
| Personnel expenses               | (460)        | (549)        | 19.5%                     | 6.8%                         |
| Other expenses                   | (1,522)      | (1,760)      | 15.7%                     | 4.1%                         |
| <b>OIBDA</b>                     | <b>1,744</b> | <b>1,929</b> | <b>10.6%</b>              | <b>(0.2%)</b>                |
| OIBDA Margin                     | 24.7%        | 24.6%        | (0.1 p.p.)                | (0.0 p.p.)                   |
| Depreciation and amortization    | (1,121)      | (1,196)      | 6.7%                      | (3.9%)                       |
| <b>Operating Income (OI)</b>     | <b>623</b>   | <b>733</b>   | <b>17.6%</b>              | <b>6.5%</b>                  |
| CapEx                            | 755          | 883          | 17.0%                     | 5.3%                         |
| OpCF (OIBDA-CapEx)               | 989          | 1,046        | 5.7%                      | (4.4%)                       |

(1) See adjustments made to calculate organic variation below.

## Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

To calculate the organic growth for 2015 of Telefónica United Kingdom, we have made the following adjustments:

**Exchange rate effect:** we have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates for 2014 and 2015. In particular, we have used the average foreign exchange rates of 2014 for both years.

**Restructuring costs:** we have excluded the impact from 2015 of restructuring costs, associated with certain simplification processes implemented in Telefónica United Kingdom amounting to 4 million euros. There were not restructuring costs in Telefónica United Kingdom in 2014.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement measures, and the contribution of each item for which we have adjusted to our reported growth:

| <b>TELEFÓNICA UNITED<br/>KINGDOM 2015</b> | <b>YoY variation</b>      |                          | <b>Contribution to reported growth<br/>(percentage points)</b> |                                |
|---|---------------------------|--------------------------|--|--------------------------------|
|   | <b>% Reported<br/>YoY</b> | <b>% Organic<br/>YoY</b> | <b>Exchange rate<br/>effect</b>                                | <b>Restructuring<br/>costs</b> |
| Revenues                                  | <b>11.0%</b>              | <b>(0.1%)</b>            | <b>11.0</b>  | -                              |
| Other income                              | (7.5%)                    | (16.7%)                  | 9.2  | -                              |
| Supplies                                  | 7.1%                      | (3.6%)                   | 10.7   | -                              |
| Personnel expenses                        | 19.5%                     | 6.8%                     | 11.8   | 0.8                            |
| Other expenses                            | 15.7%                     | 4.1%                     | 11.5   | -                              |
| <b>OIBDA</b>                              | <b>10.6%</b>              | <b>(0.2%)</b>            | <b>11</b>  | <b>(0.2)</b>                   |
| CapEx                                     | 17.0%                     | 5.3%                     | 11.6   | -                              |
| <b>OpCF (OIBDA-CapEx)</b>                 | <b>5.7%</b>               | <b>(4.4%)</b>            | <b>10.5</b>  | <b>(0.4)</b>                   |

## Results Discussion

Total **revenues** were 7,837 million euros in 2015, up 11.0% year-on-year in reported terms due mainly to the appreciation of the pound sterling (which accounted for 11 p.p. of the year-on-year increase). In organic terms, revenues decreased by 0.1% year-on-year due mainly to lower handset sales, down by 13.9%.

**Mobile service revenues** totaled 5,778 million euros in 2015, up 7.1% year-on-year in reported terms due mainly to the appreciation of the pound sterling (which accounted for 10.7 p.p. of the year-on-year increase). Excluding this impact, mobile service revenues decreased by 3.6% due to the “Refresh” commercial model as well as the low interconnection fares. Under the Refresh commercial model, certain revenues related to handset are not considered as mobile service revenues, but as handset revenues.

Mobile **ARPU** increased by 2.9% year-on-year in reported terms due mainly to the appreciation of the pound sterling. In organic terms, ARPU went down by 7.3% adversely affected by the “Refresh” commercial model, as well as a

decrease in data ARPU of 5.7%. Revenues under the “Refresh” commercial model, are not considered as service revenues but as handset revenues, therefore, smartphone sales are not reflected in ARPU.

| TELEFÓNICA UNITED KINGDOM           | 2014        | 2015        | %YoY        | %Organic YoY  |
|-------------------------------------|-------------|-------------|-------------|---------------|
| Voice Traffic (millions of minutes) | 49,096      | 50,231      | 2.3%        | 2.3%          |
| <b>ARPU (EUR)</b>                   | <b>18.8</b> | <b>19.4</b> | <b>2.9%</b> | <b>(7.3%)</b> |
| Prepay                              | 7.3         | 7.7         | 4.4%        | (6.0%)        |
| Contract (1)                        | 33.1        | 33.5        | 1.4%        | (8.7%)        |
| <b>Data ARPU (EUR)</b>              | <b>10.8</b> | <b>11.3</b> | <b>4.7%</b> | <b>(5.7%)</b> |
| % non-SMS over data revenues        | 57.9%       | 59.4%       | 1.5 p.p.    | (1.5 p.p.)    |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,929 million euros in 2015, up 10.6% year-on-year in reported terms, as a result mainly of the appreciation of the pound sterling. In organic terms, **OIBDA** decreased by 0.2% year-on-year due to lower service revenues, which was partially offset by expense restraint.

The **OIBDA margin** stood at 24.6% in reported terms for 2015, down 0.1 p.p. compared to 2014.

Table of Contents**TELEFÓNICA GERMANY**

The below table shows the evolution of accesses in Telefónica Germany over the past two years as of December 31 of such years:

| Thousands of accesses         | 2014            | 2015            | %              |
|-------------------------------|-----------------|-----------------|----------------|
|                               |                 |                 | Reported YoY   |
| Fixed telephony accesses (1)  | 2,036.4         | 1,997.8         | (1.9%)         |
| Internet and data accesses    | 2,387.0         | 2,330.6         | (2.4%)         |
| Broadband                     | 2,143.8         | 2,098.0         | (2.1%)         |
| VDSL                          | 256.5           | 516.8           | 101.5%         |
| Mobile accesses               | 42,124.9        | 43,062.8        | 2.2%           |
| Prepay                        | 23,350.7        | 23,979.4        | 2.7%           |
| Contract (2)                  | 18,774.1        | 19,083.4        | 1.6%           |
| M2M                           | 414.0           | 632.0           | 52.7%          |
| <b>Final Clients Accesses</b> | <b>46,548.3</b> | <b>47,391.2</b> | <b>1.8%</b>    |
| <b>Wholesale Accesses</b>     | <b>1,113.3</b>  | <b>972.0</b>    | <b>(12.7%)</b> |
| <b>Total Accesses</b>         | <b>47,661.5</b> | <b>48,363.2</b> | <b>1.5%</b>    |

Notes:

(1) Includes "fixed wireless" and Voice over IP accesses.

(2) In the fourth quarter of 2014, 428 thousand E-Plus accesses were excluded before integration, due to the criteria harmonization.

In 2015, Telefónica Germany maintained market momentum, increasing slightly its estimated mobile service revenue market share.

The **total access** base grew 1.5% year-on-year and stood at 48.4 million at December 31, 2015, mainly driven by a 2.2% increase in the mobile base (which reached 43.1 million).

The contract mobile customer base grew 1.6% year-on-year and reached 19.1 million accesses, with a broadly stable 44.3% share over the total mobile base. Net adds reached 309 thousand accesses due to the solid contribution of partners (second brands). Smartphone penetration reached 54.2% of the total mobile access base, up 5.5 p.p. year-on-year driven by the continued growth of LTE customers (+154.5% year-on-year reaching 7.9 million at December 31, 2015). LTE penetration reached 18.6% of the total mobile access base.

The prepay access base increased 2.7% year-on-year to 24.0 million. Prepay posted 629 thousand net additions in 2015, 32.5% more than in 2014 due to the strong contribution from wholesale agreements (second brands). The retail broadband access loss trend continued to improve, with 46 thousand net loss in 2015, more than halving the number of 2014. VDSL was once again the main growth engine of fixed performance with 260 thousand net additions (+55% year-on-year) in 2015.



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The table below shows the evolution of Telefónica Germany's results over the past two years:

Millions of euros

| TELEFÓNICA GERMANY            | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 5,522        | 7,888        | 42.9%            | 1.2%                |
| Mobile Business               | 4,375        | 6,832        | 56.2%            | 2.8%                |
| Mobile service revenues       | 3,580        | 5,532        | 54.5%            | 0.1%                |
| Fixed Business                | 1,138        | 1,043        | (8.3%)           | (8.3%)              |
| Other income                  | 106          | 265          | 150.4%           | 14.7%               |
| Supplies                      | (2,144)      | (2,712)      | 26.5%            | (3.4%)              |
| Personnel expenses            | (828)        | (655)        | (20.9%)          | (10.1%)             |
| Other expenses                | (1,923)      | (2,928)      | 52.2%            | (1.1%)              |
| <b>OIBDA</b>                  | <b>733</b>   | <b>1,858</b> | <b>153.7%</b>    | <b>20.9%</b>        |
| OIBDA Margin                  | 13.3%        | 23.6%        | 10.3 p.p.        | 3.8 p.p.            |
| Depreciation and amortization | (1,426)      | (2,128)      | 49.3%            | (3.8%)              |
| <b>Operating Income (OI)</b>  | <b>(693)</b> | <b>(270)</b> | <b>(61.0%)</b>   | <b>(57.2%)</b>      |
| CapEx                         | 849          | 2,230        | 162.8%           | (11.1%)             |
| OpCF (OIBDA-CapEx)            | (116)        | (372)        | n.m.             | 126.2%              |

(1) See adjustments made to calculate organic variation below.

#### Adjustments made to calculate organic variations

With respect to Telefónica Germany, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Germany consolidation perimeter in such years related to the consolidation of E-Plus in Telefónica Germany since October 1, 2014. In order to exclude the impact of this change in our perimeter, we have consolidated E-Plus's results from January 1 to September 30, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of restructuring costs associated with certain simplification processes implemented in Germany. In 2015, restructuring costs had a 74 million euros impact on OIBDA. In 2014, restructuring costs had a 414 million euros impact on OIBDA.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015, amounting to 1,198 million euros. There were no spectrum acquisitions in 2014.

**Adjustments to the final purchase price of E-Plus:** In 2015 we have excluded the result from the difference between the preliminary purchase price of E-Plus (as estimated at the end of the valuation period) and the final purchase price agreed with KPN, totaling 104 million euros (which had a 102 million euros positive impact on OIBDA net of costs related to the acquisition).

The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

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| TELEFÓNICA<br>GERMANY 2015    | YoY variation     |                  | Contribution to reported growth (percentage points) |                        |                         |   |
|-------------------------------|-------------------|------------------|---|------------------------|-------------------------|---|
|                               | % Reported<br>YoY | % Organic<br>YoY | Perimeter<br>change<br>(E-Plus)                     | Restructuring<br>Costs | Spectrum<br>acquisition | Adjustments to<br>the final purchase<br>Price of E-Plus |
| Revenues                      | 42.9%             | 1.2%             | 41.1  | --                     | --                      | --  |
| Other income                  | 150.4%            | 14.7%            | 32.3  | --                     | --                      | 98.6  |
| Supplies                      | 26.5%             | (3.4%)           | 30.9  | --                     | --                      | --  |
| Personnel expenses            | (20.9%)           | (10.1%)          | 26.9  | (39.0)                 | --                      | --  |
| Other expenses                | 52.2%             | (1.1%)           | 54.7  | (0.9)                  | --                      | 0.1   |
| <b>OIBDA</b>                  | <b>153.7%</b>     | <b>20.9%</b>     | <b>50.2</b>   | <b>46.5</b>            | <b>--</b>               | <b>13.9</b>   |
| CapEx                         | 162.8%            | (11.1%)          | 36.8  | --                     | 141.2                   | --  |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>n.m.</b>       | <b>126.2%</b>    | <b>(47.1)</b>                                       | <b>(293.2)</b>         | <b>1,031.3</b>          | <b>(87.7)</b>   |

## Results Discussion

Total **revenues** were 7,888 million euros in 2015, up 42.9% year-on-year in reported terms due mainly to the consolidation of E-Plus since October 1, 2014 (which accounted for 41.1 p.p. of the year-on-year increase). In organic terms, revenues increased by 1.2% due mainly to higher handset sales arising from Christmas campaigns.

**Mobile service revenues** totaled 5,532 million euros in 2015, up 54.5% year-on-year in reported terms, due mainly to the consolidation of E-Plus since October 1, 2014 and to a lesser extent, the increasing share of the partner segment (second brands) within the customer base. Telefónica Germany continued to focus on data revenues, which increased by 58.4% and accounted for 51.3% of mobile service revenues in 2015. Non-P2P SMS data revenues amounted to 2,034 million euros (increasing 4.9% year-on-year), accounting for 71.6% of the total data revenues (+0.4 p.p. year-on-year).

**Fixed revenues** were 1,043 million euros in 2015, down 8.3% year-on-year, due to continued decrease in accesses.

**Mobile ARPU** was 10.7 euros in 2015, down 8.9% year-on-year, while contract ARPU stood at 17.2 euros down 6.5% year-on-year, as a result of the higher share of wholesale customers in the customer base. Data ARPU was 5.5 euros, down 6.8% year-on-year, mainly as a result of the continued decline of SMS volumes.

| TELEFÓNICA GERMANY                  | 2014   | 2015   | %YoY     |
|-------------------------------------|--------|--------|----------|
| Voice Traffic (millions of minutes) | 41,186 | 62,696 | 52.2%    |
| ARPU (EUR)                          | 11.8   | 10.7   | (8.9%)   |
| Prepay                              | 5.4    | 5.8    | 8.2%     |
| Contract (1)                        | 18.4   | 17.2   | (6.5%)   |
| Data ARPU (EUR)                     | 5.9    | 5.5    | (6.8%)   |
| % non-SMS over data revenues        | 71.2%  | 71.6%  | 0.4 p.p. |

Notes:

(1) Excludes M2M.

**OIBDA** totaled 1,858 million euros in 2015, up 153.7% year-on-year in reported terms, as a result mainly of the consolidation of E-Plus (which accounted for 50.2 p.p. of the increase), the lower restructuring costs recorded in 2015 (+46.5 p.p.) and the positive result from the E-Plus preliminary acquisition price and the final acquisition price agreed on with KPN (+13.9 p.p.). In organic terms, OIBDA increased by 20.9% year-on-year, driven by the increased synergies, which mainly affected personnel expenses and supplies.

The **OIBDA margin** stood at 23.6% in reported terms for 2015, up 10.3 p.p. compared to 2014.

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## TELEFÓNICA BRAZIL

The below table shows the evolution of accesses in Telefónica Brazil over the past two years as of December 31 of such years:

| ACCESSES                      |                 |                 |                |                  |
|-------------------------------|-----------------|-----------------|----------------|------------------|
| Thousands of accesses         | 2014            | 2015            | %Reported YoY  | %Organic YoY (1) |
| Fixed telephony accesses (2)  | 10,743.4        | 14,654.5        | 36.4%          | (1.6%)           |
| Internet and data accesses    | 4,082.6         | 7,195.5         | 76.2%          | 2.5%             |
| Broadband                     | 3,939.8         | 7,129.5         | 81.0%          | 3.6%             |
| Fiber                         | 374.6           | 3,779.9         | n.m.           | 14.0%            |
| Mobile accesses               | 79,932.1        | 73,261.3        | (8.3%)         | (8.3%)           |
| Prepay                        | 51,582.4        | 42,194.4        | (18.2%)        | (18.2%)          |
| Contract                      | 28,349.7        | 31,066.9        | 9.6%           | 9.6%             |
| M2M                           | 3,506.9         | 4,234.7         | 20.8%          | 20.8%            |
| Pay TV                        | 770.6           | 1,787.9         | 132.0%         | 9.7%             |
| <b>Final Clients Accesses</b> | <b>95,528.6</b> | <b>96,899.3</b> | <b>1.4%</b>    | <b>(6.4%)</b>    |
| <b>Wholesale Accesses</b>     | <b>25.9</b>     | <b>22.3</b>     | <b>(14.0%)</b> | <b>(14.0%)</b>   |
| <b>Total Accesses</b>         | <b>95,554.5</b> | <b>96,921.5</b> | <b>1.4%</b>    | <b>(6.4%)</b>    |

Notes:

(1) In order to calculate organic changes, we have added the accesses of GVT as of December 31, 2014 to our accesses as of such date.

(2) Includes "fixed wireless" and Voice over IP accesses.

The below table shows the contribution of each item for which we have adjusted to our reported growth. With respect to each line item, the contribution to reported growth of such line item, expressed in p.p., is the result of dividing the impact of each item for which we have adjusted by the amount of such line item, on a reported basis, for the prior year:

| TELEFÓNICA<br>BRAZIL<br>2015  | %Reported<br>YoY | %Organic<br>YoY (1) | GVT             |
|-------------------------------|------------------|---------------------|-----------------|
| Fixed telephony accesses      | 36.4%            | (1.6%)              | 38.6 p.p.       |
| Internet and data accesses    | 76.2%            | 2.5%                | 72.0 p.p.       |
| Broadband                     | 81.0%            | 3.6%                | 74.6 p.p.       |
| Fiber                         | n.m.             | 14.0%               | 785.0 p.p.      |
| Pay TV                        | 132.0%           | 9.7%                | 111.5 p.p.      |
| <b>Final Clients Accesses</b> | <b>1.4%</b>      | <b>(6.4%)</b>       | <b>8.3 p.p.</b> |
| <b>Total Accesses</b>         | <b>1.4%</b>      | <b>(6.4%)</b>       | <b>8.3 p.p.</b> |

Notes:

(1) In order to calculate organic changes, we have added the accesses of GVT as of December 31, 2014 to our accesses as of such date.

Telefónica Brazil closed the year 2015 improving its competitive position in the mobile as well as in the fixed market. In the mobile business, Telefónica Brazil kept its leadership in the higher value segments, which permitted the operator to capture mobile market revenue growth in 2015. In the fixed business, the transformation towards fiber and Pay-TV was strengthened by the GVT consolidation in May 2015, adding as of December 31, 2015, 8.5 million customers to the Group.

Revenues and OIBDA evolution were positively supported by the acceleration of mobile data and the good evolution of fixed broadband and Pay-TV. Additionally, Telefónica Brazil carried out costs control measures aimed at offsetting the adverse macroeconomic situation.

However, results in 2015 were adversely affected by the interconnection tariff reduction in the mobile business (-33.0%) and in the retail fixed-mobile tariff (-23.3%) since February 24, 2015.

Telefónica Brazil reached 96.9 million **accesses** at December 31, 2015, up 1.4% due mainly to the consolidation of GVT. Excluding the impact of such consolidation, accesses were down 6.4%, due to the disconnection of prepay accesses.

In the **mobile business**, the strategic focus remained on gaining and retaining high value customers, reaching a market share of 42.4% in the contract segment as of December 31, 2015 (Source: ANATEL). Telefónica Brazil maintained its market leadership in terms of total accesses with a market share of 29.5% as of December 2015 (source: ANATEL). The commercial offer in the contract segment included a higher data volume, more minutes of voice traffic and

innovative products such as “Vivo Bis” (pursuant to which the data not consumed in a month is automatically added to data available for the following month). The contract growth was partially offset by the disconnection of 11.5 million prepay accesses.

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In the **fixed business**, Telefónica Brazil maintained its strategic focus on fiber deployment, with 16.6 million premises passed with FTTx at December 31, 2015 and 3.8 million homes connected, and also on increasing Pay-TV accesses (up 10% year-on-year). Fixed telephony accesses stood at 14.7 million in 2015, up 36.4% in reported terms due mainly to the consolidation of GVT. In organic terms, these accesses were down by 1.6% year-on-year. Retail broadband customers totaled 7.1 million customers as of December 31, 2015, up 81.0% year-on-year due mainly to the consolidation of GVT (up 3.6% year-on-year in organic terms due to the increase of fiber accesses). Of the 7.1 million customers at the end of 2015, 53.0% were connected with FTTC. Pay TV customers stood at 1.8 million as of December 31, 2015, up 132.0% in reported terms due mainly to the consolidation of GVT, increasing by 9.7% year-on-year in organic terms due to a higher penetration of high value and IPTV clients. IPTV accesses increased their relevance, representing 9.6% of total Pay-TV accesses.

The table below shows the evolution of Telefónica Brazil's results over the past two years:

Millions of euros

| TELEFÓNICA BRAZIL             | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 11,231       | 11,060       | (1.5%)           | 4.5%                |
| <b>Mobile Business</b>        | 7,618        | 6,906        | (9.3%)           | 6.2%                |
| Mobile service revenues       | 7,228        | 6,495        | (10.1%)          | 5.3%                |
| <b>Fixed Business</b>         | 3,613        | 4,154        | 15.0%            | 1.9%                |
| Other income                  | 261          | 416          | 59.3%            | 35.4%               |
| Supplies                      | (2,680)      | (2,568)      | (4.2%)           | 4.4%                |
| Personnel expenses            | (976)        | (1,042)      | 6.8%             | 3.5%                |
| Other expenses                | (4,293)      | (4,293)      | (0.0%)           | 8.6%                |
| <b>OIBDA</b>                  | <b>3,543</b> | <b>3,573</b> | <b>0.9%</b>      | <b>2.9%</b>         |
| OIBDA Margin                  | 31.5%        | 32.3%        | 0.8 p.p.         | (0.5 p.p.)          |
| Depreciation and amortization | (1,762)      | (1,916)      | 8.7%             | 12.9%               |
| <b>Operating Income (OI)</b>  | <b>1,781</b> | <b>1,657</b> | <b>(6.9%)</b>    | <b>(6.7%)</b>       |
| CapEx                         | 2,933        | 2,105        | (28.2%)          | (1.1%)              |
| OpCF (OIBDA-CapEx)            | 610          | 1,468        | 140.8%           | 9.3%                |

(1) See adjustments made to calculate organic variation below.

Adjustments made to calculate organic variations



As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis. With respect to Telefónica Brazil, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Foreign exchange effects:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rate of 2014 for both years. Foreign exchange rates had a negative impact on our reported 2015 Telefónica Brazil results as a result of the depreciation of the Brazilian real.

**Changes in the scope of consolidation:** We have excluded the impact of changes in our consolidation perimeter in 2015 and 2014. The only change to our Telefónica Brazil consolidation perimeter in such years related to the consolidation of GVT since May 1, 2015. In order to exclude the impact of this change in our perimeter, we have consolidated GVT's results from May 1 to December 31, 2014 in our 2014 results.

**Restructuring costs:** We have excluded the impact of certain restructuring costs associated with certain simplification processes implemented in Telefónica Brazil. In 2015, these restructuring costs totaled 7 million euros. In 2014, these restructuring costs totaled 68 million euros.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2014 amounting to 889 million euros (related to a LTE block in the 700 MHz band) while there were no spectrum acquisitions in 2015.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded in both years. The results from the sale of towers totaled 10 million euros and 1 million euros in 2015 and 2014, respectively.

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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>BRAZIL<br>2015  | YoY variation    |                 | Contribution to reported growth (percentage points) |                              |                        |                         |                 |
|-------------------------------|------------------|-----------------|---|------------------------------|------------------------|-------------------------|-----------------|
|                               | %Reported<br>YoY | %Organic<br>YoY | Exchange<br>rate effect                             | Perimeter<br>change<br>(GVT) | Restructuring<br>Costs | Spectrum<br>acquisition | Towers<br>sales |
| Revenues                      | (1.5%)           | 4.5%            | (16.6)  | 10.1                         | --                     | --                      | --              |
| Other income                  | 59.3%            | 35.4%           | (26.9)  | 34.5                         | --                     | --                      | 4.1             |
| Supplies                      | (4.2%)           | 4.4%            | (16.2)  | 7.2                          | --                     | --                      | --              |
| Personnel expenses            | 6.8%             | 3.5%            | (18.1)  | 26.8                         | (6.2)                  | --                      | --              |
| Other expenses                | (0.0%)           | 8.6%            | (16.9)  | 7.6                          | --                     | --                      | --              |
| <b>OIBDA</b>                  | <b>0.9%</b>      | <b>2.9%</b>     | <b>(17.0)</b>                                       | <b>12.5</b>                  | <b>1.7</b>             | <b>--</b>               | <b>0.3</b>      |
| CapEx                         | (28.2%)          | (1.1%)          | (12.1)  | 15.1                         | --                     | (30.3)                  | --              |
| <b>OpCF<br/>(OIBDA-CapEx)</b> | <b>140.8%</b>    | <b>9.3%</b>     | <b>40.7</b>   | <b>0.2</b>                   | <b>9.9</b>             | <b>145.8</b>            | <b>1.7</b>      |

## Results Discussion

**Revenues** totaled 11,060 million euros in 2015, down 1.5% in reported terms, mainly due to the depreciation of the Brazilian real (which accounted for -16.6 p.p. of the evolution) and partially offset by the impact of the consolidation of GVT (+10.1 p.p.). In organic terms, the year-on-year variation was 4.5%, principally due to the good evolution in the mobile business (+6.2% year-on-year) as well as the fixed business (+1.9% year-on-year), which was partially offset by the impact of the regulatory interconnection tariff reduction (-2.7 p.p. of the year-on-year variation).

**Revenues from the mobile business** totaled 6,906 million euros in 2015, down 9.3% in reported terms due mainly to the depreciation of the Brazilian real (which accounted for -15.3 p.p. of the evolution). Excluding this impact, revenues from the mobile business increased by 6.2% due to the positive evolution of service revenues (+5.3% year-on-year) as a result of the good performance of outbound revenues, which increased as a result of an increase in the contract customer base and the higher data penetration. This trend was partially offset by lower inbound revenues affected by lower interconnection tariffs. Handset revenues were up by 5.1% in reported terms, due to higher proportion of contract add and higher smartphones and LTE handset sales.

**Fixed telephony revenues** totaled 4,154 million euros, up by 15.0% in reported terms due mainly to the consolidation of GVT (+31.9 p.p.) and were partially offset by the impact of depreciation of the Brazilian real (which accounted for -19.4 p.p. of the evolution). Excluding these effects, revenues were up by 1.9%, mainly due to the increase in fixed broadband revenues, which were up by 9.3% supported by the increase of fiber and the growth of Pay TV accesses with higher ARPU, in spite of the lower retail fixed-mobile tariff (-2.5 p.p.).

The **mobile ARPU** decreased 13.2% year-on-year in reported terms due mainly to depreciation of the Brazilian real. In organic terms, it increased 1.6% year-on-year as a consequence of the higher data ARPU which more than offset the negative impact of the reduction in the mobile termination rates. We believe the high quality of the customer base is reflected in an increase in the outbound ARPU and the 31.5% growth in the data ARPU.

| TELEFÓNICA BRAZIL                   | 2014    | 2015    | %YoY     | %Local Currency YoY |
|-------------------------------------|---------|---------|----------|---------------------|
| Voice Traffic (millions of minutes) | 127,412 | 131,029 | 2.8%     | 2.8%                |
| ARPU (EUR)                          | 7.3     | 6.3     | (13.2%)  | 1.6%                |
| Prepay                              | 3.9     | 3.2     | (18.5%)  | (4.7%)              |
| Contract (1)                        | 15.7    | 13.3    | (15.0%)  | (0.7%)              |
| Data ARPU (EUR)                     | 2.6     | 2.9     | 12.5%    | 31.5%               |
| % non-SMS over data revenues        | 77.4%   | 82.9%   | 5.5 p.p. | 5.5 p.p.            |

Notes:

(1) Excludes M2M.

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**OIBDA** stood at 3,573 million euros in 2015, up 0.9% in reported terms due mainly to the consolidation of GVT (which accounted for +12.5 p.p. of the evolution) and, to a lesser extent, the lower restructuring costs incurred in 2015 compared to 2014 (+1.7 p.p.), and the higher results from the sale of towers compared to 2014 (+0.3 p.p.), all of which was partially offset by the negative impact of the depreciation of the Brazilian real (-17.0 p.p.). In organic terms, the year-on-year increase was 2.9% due to revenue growth and cost efficiency offsetting a worse macro scenario with higher inflation, high devaluation and a higher rate of bad debt. Personnel expenses totaled 1,042 million euros in 2015, up 6.8% in reported terms as result mainly of the consolidation of GVT, which was partially offset by the depreciation of the Brazilian real. In organic terms, personnel expenses increased by 3.5% year-on-year due to higher social benefits and the internalization of the work of certain network contractors which more than offset the savings resulting from restructuring plans in 2014. In addition, network costs grew due to higher energy costs and the deployment and improvement of fixed- and mobile networks, legal contingencies and higher content costs. OIBDA was also positively impacted by the expiration of a payment obligation (98 million euros).

**The OIBDA margin** stood at 32.3% in reported terms for 2015, up 0.8 p.p. compared to 2014.

Table of Contents**TELEFÓNICA HISPANOAMÉRICA**

The below table shows the evolution of accesses in Telefónica Hispanoamérica over the past two years as of December 31 of such years:

| ACCESSES                         |           |           |                |
|----------------------------------|-----------|-----------|----------------|
| Thousands of accesses            | 2014      | 2015      | % Reported YoY |
| Fixed telephony accesses (1) (2) | 13,374.4  | 12,829.8  | (4.1%)         |
| Internet and data accesses       | 5,433.8   | 5,667.8   | 4.3%           |
| Broadband                        | 5,379.4   | 5,610.4   | 4.3%           |
| Mobile accesses                  | 110,346.5 | 113,302.7 | 2.7%           |
| Prepay (3)                       | 86,698.0  | 88,332.8  | 1.9%           |
| Contract                         | 23,648.5  | 24,969.8  | 5.6%           |
| M2M                              | 2,062.2   | 2,296.9   | 11.4%          |
| Pay TV                           | 2,431.9   | 2,812.2   | 15.6%          |
| Final Clients Accesses           | 131,586.6 | 134,612.4 | 2.3%           |
| Wholesale Accesses               | 16.4      | 30.9      | 87.8%          |
| Total Accesses T. Hispanoamérica | 131,603.0 | 134,643.3 | 2.3%           |

Notes:

- (1) Includes "fixed wireless" and Voice over IP accesses.
- (2) Includes 50 thousand "fixed wireless" additional customers in Peru, in the second quarter of 2014.
- (3) In the fourth quarter of 2014, 1.8 millions of inactive customers were disconnected in Central America.

Total accesses in Telefónica Hispanoamérica reached 134.6 million accesses at December 31, 2015 (+2.3% year-on-year).

**Mobile accesses** totaled 113.3 million (+2.7% year-on-year) due to positive net adds of 3.0 million accesses.

There was strong contract segment growth, which expanded by 5.6% year-on-year. Growth was particularly strong in Peru (+12.9% year-on-year), Mexico (+22.3% year-on-year) and Chile (+4.2% year-on-year). Annual net adds reached 1.3 million accesses, primarily due to Peru (+659 thousand net adds) which benefitted from a successful migration strategy (from prepay to contract). Mexico also showed positive net adds (+327 thousand accesses) due to higher commercial activity.

In the prepay segment (+1.9% year-on-year), with net adds of 1.6 million customers, growth was driven mainly by Mexico (+2.9 million customers) while Venezuela and Central America closed with 1.2 million net adds, partially compensating the net loss in Chile (-0.9 million customers) and Peru (-0.7 million customers) where we have faced a fierce competition and we have concentrated on high value customers migrating the best prepaid customers to contract and not following competition offers that would damage the quality of our networks due to intense traffic.

There was growth in smartphones (+43.7% year-on-year) to 40.2 million accesses as of December 31, 2015, with a penetration over mobile accesses of 36.7% (+10.4 p.p. year-on-year), related mainly to Mexico, Argentina, Peru and Colombia. 4G handsets also continued to grow, reaching 8.3 million accesses as of December 31, 2015 (corresponding to a penetration of 7.4%).

Traditional **fixed business accesses** stood at 12.8 million at December 31, 2015 (-4.1% year-on-year), with negative net adds of 545 thousand customers, affected by the erosion of traditional fixed business in the region, including Chile (-5.9% year-on-year), Peru (-4.4% year-on-year), Colombia (-2.1% year-on-year) and Argentina (-1.9% year-on-year).

**Broadband accesses** totaled 5.6 million at December 31, 2015 (+4.3% year-on-year), after reaching net adds of 0.2 million accesses during 2015 due mainly to access growth in Peru (+8.0%), Chile (+5.8%) and Colombia (+4.0%). The penetration of fixed broadband accesses over traditional fixed business accesses was 43.7% at December 31, 2015 (+3.5 p.p. year-on-year). There was progressive migration towards data plans with higher speeds, with 53.4% of broadband accesses having a speed over 4Mb at December 31, 2015 (+4 p.p. year-on-year).

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Pay TV accesses totaled 2.8 million (+15.6% year-on-year), with net adds of 0.4 million accesses as a result of an improvement in all countries in the region that offer the service. Growth was particularly positive in Peru (+26.7% year-on-year), Colombia (+17.5%) and Chile (+7.2%).

The table below shows the evolution of Telefónica Hispanoamérica's results over the past two years:

Millions of euros

| TELEFÓNICA HISPANOAMÉRICA     | 2014         | 2015         | %Reported<br>YoY | %Organic<br>YoY (1) |
|-------------------------------|--------------|--------------|------------------|---------------------|
| Revenues                      | 13,155       | 14,387       | 9.4%             | 10.1%               |
| Mobile Business               | 9,578        | 10,347       | 8.0%             | 10.2%               |
| Mobile service revenues       | 8,454        | 9,160        | 8.4%             | 10.6%               |
| Fixed Business                | 3,604        | 4,070        | 12.9%            | 10.0%               |
| Other income                  | 254          | 347          | 36.5%            | 29.6%               |
| Supplies                      | (3,841)      | (4,176)      | 8.7%             | 7.2%                |
| Personnel expenses            | (1,525)      | (1,686)      | 10.6%            | 16.0%               |
| Other expenses                | (3,975)      | (4,516)      | 13.6%            | 15.1%               |
| <b>OIBDA</b>                  | <b>4,068</b> | <b>4,356</b> | <b>7.1%</b>      | <b>7.2%</b>         |
| OIBDA Margin                  | 30.9%        | 30.3%        | (0.6 p.p.)       | (0.8 p.p.)          |
| Depreciation and amortization | (2,034)      | (2,241)      | 10.2%            | 7.8%                |
| <b>Operating Income (OI)</b>  | <b>2,034</b> | <b>2,115</b> | <b>4.0%</b>      | <b>6.7%</b>         |
| CapEx                         | 2,842        | 3,060        | 7.7%             | 17.2%               |
| OpCF (OIBDA-CapEx)            | 1,226        | 1,296        | 5.7%             | (7.0%)              |

(1) See adjustments made to calculate organic variation below.

### Adjustments made to calculate organic variations

As explained above, year-on-year changes referred to in this document as “organic” or presented in “organic terms” intend to present year-on-year variations on a comparable basis.

With respect to Telefónica Hispanoamérica, we have made the following adjustments in order to calculate 2015/2014 variations in organic terms:

**Foreign exchange effects and the impact of hyperinflationary adjustments in Venezuela:** We have excluded the impact of changes in exchange rates by assuming constant average foreign exchange rates in 2015 and 2014. In particular, we have used the average foreign exchange rates of 2014 for both years.

We have also excluded the impact of hyperinflationary adjustments in Venezuela.

**Restructuring costs:** We have excluded the impact of certain restructuring costs associated with certain simplification processes implemented in Telefónica Hispanoamérica. In 2015, restructuring costs totaled 38 million euros. In 2014, restructuring costs totaled 99 million euros.

**Results of tower sales:** The results attributable to the sale of towers in 2015 and 2014 have been excluded, which totaled 18 million euros (mainly in Chile) in 2015 and 4 million euros in 2014.

**Spectrum acquisition:** We have excluded the impact of spectrum acquisitions in 2015 and 2014. In 2015, these acquisitions totaled 338 million euros and related to Telefónica Argentina (196 million euros), Telefónica Ecuador (127 million euros), Telefónica Chile (6 million euros) and Telefónica México (8 million euros). In 2014, these acquisitions totaled 405 million euros and related to Telefónica Argentina (168 million euros), Telefónica Colombia (111 million euros) and Telefónica Venezuela and Central America (126 million euros).



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The table below shows 2015/2014 variations in reported and organic terms (the latter, calculated in accordance with the adjustments referred to above) of certain income statement and other measures, and the contribution of each item for which we have adjusted to our reported growth:

| TELEFÓNICA<br>HISPANOAMÉRICA<br>2015 | YoY variation    |                 | Contribution to reported growth (percentage points) |                 |                        |                         |
|--------------------------------------|------------------|-----------------|---|-----------------|------------------------|-------------------------|
|                                      | %Reported<br>YoY | %Organic<br>YoY | Exchange rate effect<br>and Hyperinflation          | Towers<br>sales | Restructuring<br>Costs | Spectrum<br>acquisition |
| Revenues                             | 9.4%             | 10.1%           | (0.6)   | --              | --                     | --                      |
| Other income                         | 36.5%            | 29.6%           | 2.1   | 5.1             | --                     | --                      |
| Supplies                             | 8.7%             | 7.2%            | 1.5   | --              | --                     | --                      |
| Personnel expenses                   | 10.6%            | 16.0%           | --  | --              | (4.1)                  | --                      |
| Other expenses                       | 13.6%            | 15.1%           | (1.4)   | --              | --                     | --                      |
| <b>OIBDA</b>                         | <b>7.1%</b>      | <b>7.2%</b>     | <b>(2.0)</b>  | <b>0.3</b>      | <b>1.5</b>             | <b>--</b>               |
| CapEx                                | 7.7%             | 17.2%           | (3.6)   | --              | --                     | (3.3)                   |
| <b>OpCF (OIBDA-CapEx)</b>            | <b>5.7%</b>      | <b>(7.0%)</b>   | <b>1.5</b>  | <b>1.0</b>      | <b>5.1</b>             | <b>7.7</b>              |

## Results Discussion

**Revenues** amounted to 14,387 million euros in 2015, increasing 9.4% year-on-year in reported terms mainly due to the good results of data revenues (fixed as well as mobile) and voice revenues, in both cases due to a higher customer base, increased consumption and higher data penetration. This increase was partially offset by foreign exchange effects and hyperinflation in Venezuela and the decrease in mobile termination rates. In organic terms, revenues increased 10.1% year-on-year.

Mobile service revenues reached 9,160 million euros in 2015, up 8.4% year-on-year in reported terms mainly due to increased revenues in Argentina, Peru, Mexico and Chile, as explained in greater a detail below, which was partially offset by the foreign exchange effects and the hyperinflation in Venezuela (which accounted for -2.2 p.p. of the year-on-year variation). Mobile service revenues performance by country was as follows:

In Argentina, mobile service revenues reached 2,194 million euros in 2015 and grew by 29.2% year-on-year in reported terms mainly due to the good performance of consumption and data penetration and, to a lesser extent, the growth of the voice business and the foreign exchange effect (which increased growth by 6.4 p.p.). In local currency, these revenues grew by 22.9%.

In Mexico, mobile service revenues reached 1,539 million euros in 2015, increasing by 8.9% in reported terms mainly due to a higher customer base and the positive performance of the data business. In local currency these revenues grew by 8.4%, accounting the foreign exchange effect for 0.5 p.p. of the year-on-year reported increase.

In Chile, mobile service revenues reached 1,177 million euros in 2015, up 5.8% in reported terms year-on-year mainly due to the foreign exchange effect (which accounted for 4.6 p.p. of the increase) and the increase in data revenues, which more than compensated the fall in the traditional voice business and the lower mobile termination rates. In local currency these revenues grew by 1.2%.

In Peru, mobile service revenues reached 1,390 million euros in 2015, up 11.2% in reported terms mainly due to the foreign exchange effect (which accounted for 7.0 p.p. of the increase) and the higher contract customer base, the data boom and higher inbound revenues.

In Venezuela and Central America, mobile service revenues reached 1,261 million euros in 2015, down 3.5% in reported terms mainly due to the foreign exchange effect and hyperinflation in Venezuela (which decreased growth in 35.1 p.p.). Excluding these effects, these revenues increased by 31.7% mainly due to the higher tariffs in all services in order to try to compensate the high inflation in Venezuela and the higher non-SMS data revenues (+83% in 2015), which represented 83.4% of total data revenues (+11.4 p.p. year-on-year).

Data revenues in the segment were up by 19.5% in reported terms in 2015, reaching 3,198 million euros mainly due to the increase in penetration of data which increased from 31.7% to 34.9% in 2015 and higher data usage. This increase was partially offset by foreign exchange effects and hyperinflation in Venezuela (which decreased growth by 4.2 p.p.). Excluding these effects, these revenues grew by 23.6% as a result of the aforementioned increase in penetration of data.

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Fixed business revenues reached 4,070 million euros in 2015, up 12.9% in reported terms mainly due to the increase in broadband and new services revenues (+20.5%). Revenues from broadband and new services, accounted for 64.7% of fixed revenues (+4.9 p.p. year-on-year). The growth was mainly related to Argentina which experienced a substantial increase in voice and broadband revenues, as well as Chile and Peru, which had increased broad band revenues. Excluding the foreign exchange effect and hyperinflation in Venezuela (which decreased growth by 2.9 p.p.) these revenues grew by 10.0%.

**ARPU** was up by 6.1% in 2015, due to the data ARPU increase (+19.9% year-on-year) due to the increase of smartphone penetration and higher average consumption, which offset voice ARPU decrease. The lower ARPU was mainly due to lower interconnection costs and the devaluation of certain Latin American currencies against the U.S. dollar, which more than offset the increase in outgoing voice ARPU (up 7.0% year-on-year).

**OIBDA** reached 4,356 million euros in 2015, up 7.1% in reported terms (+7.2% in organic terms), being Telefónica Argentina, Telefónica Peru and Telefónica Chile the main contributors to this growth, as higher revenues offset higher costs. OIBDA was positively affected by a spectrum swap in Mexico with AT&T in December 2015 (which contributed 79 million euros). The higher costs were mainly attributable to:

higher commercial costs, due to higher handset costs as a result of higher high-end handset sales (which more than offset lower interconnection costs resulting from the mobile termination rates reductions in Chile, Colombia, Peru and Mexico);

- higher personnel costs driven by increases in inflation in some countries of the region;
- higher costs related to commercial campaigns, higher network costs due to higher voice and data traffic; and
- higher costs resulting from the devaluation of certain Latin American currencies against the U.S. dollar.

Additional information by country is provided below:

Argentina: OIBDA reached 1,006 million euros, up by 25.4% in reported terms mainly due to the exchange rate effect and higher service revenues, more than offsetting the higher costs resulting from the overall prices increase, although Telefónica continued to carry out cost containment plans in order to offset the inflation effect. In local currency, the year-on-year variation was 19.2%.

Chile: OIBDA reached 760 million euros, up 7.4% in reported terms mainly due to the exchange rate effect and higher service revenues, lower supply costs due to regulatory changes (lower interconnection costs resulting from the mobile termination rates reduction) and efficiency measures that helped to offset the commercial effort made to gain higher value customers. In local currency, the year-on-year variation was 2.7%.

Peru: OIBDA reached 943 million euros, up by 11.8% in reported terms mainly due to the exchange rate effect and higher service revenues, which more than offset higher commercial costs resulting from higher competitive pressure in the Peruvian market. In local currency OIBDA decreased by 4.7% year-on-year.

Venezuela and Central America: OIBDA reached 342 million euros, down by 26.1% in reported terms mainly due to the exchange rate effect and hyperinflation in Venezuela. Excluding these impacts, OIBDA grew 15.8% mainly driven by higher service revenues, which compensated the overall rise in prices, and higher purchases in dollars for services and equipment purchases, which were affected by the currency devaluation in Venezuela.

**OIBDA margin** reached 30.3% in 2015, with a year-on-year decrease of 0.6 p.p. in reported terms. This margin decrease was driven by lower margins in all countries in the segment except Mexico (which benefitted from higher commercial efforts focused on higher value segments), especially in Argentina and Colombia.

#### Our services and products

New digital technologies are the main driving force of social and economic transformation today. This premise is the basis upon which we build our vision: we want to provide access to digital life, using the best technology and without leaving anyone behind.

Connectivity is our ally in reducing the digital divide and, due to our fixed and mobile network infrastructure and the services we develop around it, we can aid progress in the communities in which we operate.

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To move towards this vision, at Telefónica we work on three basic fronts:

- 1) Providing access to technology through digital inclusion, in other words, by means of network roll-out and an accessible and affordable offer for all sectors of the population.
  
- 2) Developing innovative services that add value to our connectivity and which we develop through innovation: Big Data, the Internet of Things (IoT), eHealth, digital education and eFinances.
  
- 3) Incorporating sustainability principles to all of our product development processes.

## **Mobile business**

Telefónica offers a wide variety of mobile and related services and products to personal and business customers. Although they vary from country to country, Telefónica's principal services and products are as follows:

- **Mobile voice services:** Telefónica's principal service in all of its markets is mobile voice telephony.

**Value added services:** Customers in most of the markets have access to a range of enhanced mobile calling features, including voice mail, call hold, call waiting, call forwarding and three-way calling.

**Mobile data and Internet services:** Current data services offered include Short Messaging Services, or SMS, and Multimedia Messaging Services, or MMS, which allow customers to send messages with images, photographs, sound recordings and video recordings. Customers may also receive selected information, such as news, sports scores and stock quotes. Telefónica also provides mobile broadband connectivity and Internet access. Through mobile Internet access, customers are able to send and receive e-mail, browse the Internet, download games, purchase goods and services in m-commerce transactions and use Telefónica's other data and software services.

- **Wholesale services:** Telefónica has signed network usage agreements with several MVNOs in different countries.

**Corporate services:** Telefónica provides business solutions, including mobile infrastructure in offices, private networking and portals for corporate customers that provide flexible online billing.

**Roaming:** Roaming agreements allow Telefónica customers to use their mobile handsets when they are outside their service territories, including on an international basis.

**Fixed wireless:** Telefónica provides fixed voice telephony services through mobile networks in Brazil, Venezuela, Argentina, Peru, Mexico, Ecuador, El Salvador, Guatemala and Nicaragua.

**Trunking and paging:** Telefónica provides digital mobile services for closed user groups of clients and paging services in Spain and most of its operations in Latin America.

Fixed-line telephony business

The principal services Telefónica offers in its fixed businesses in Europe and Latin America are:

**Traditional fixed telecommunication services:** Telefónica's principal traditional fixed telecommunication services include PSTN lines; ISDN accesses; public telephone services; local, domestic and international long-distance and fixed-to-mobile communications services; corporate communications services; supplementary value added services (including call waiting, call forwarding, voice and text messaging, advanced voicemail services and conference-call facilities); video telephony; business oriented value-added services; intelligent network services; leasing and sale of handset equipment; and telephony information services.

**Internet and broadband multimedia services:** the principal Internet and broadband multimedia services include Internet service provider service; portal and network services; retail and wholesale broadband access through ADSL, naked ADSL (broadband connection without the monthly fixed line fee); narrowband switched access to Internet for Universal Service, and other technologies. Telefónica also offers high-speed Internet services through fiber to the home (FTTH) in certain markets (primarily Spain, Brazil and Chile) and VDSL-based services (primarily Spain and Germany). Telefónica also offers VoIP services in some markets.

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**Data and business-solutions services:** the data and business-solutions services principally include leased lines; virtual private network, or VPN, services; fiber optics services; the provision of hosting and application, or ASP, service, including web hosting, managed hosting, content delivery and application, and security services; outsourcing and consultancy services, including network management, or CGP; and desktop services and system integration and professional services.

**Wholesale services for telecommunication operators:** the wholesale services for telecommunication operators principally include domestic interconnection services; international wholesale services; leased lines for other operators; network deployment; and local loop leasing under the unbundled local loop regulation framework). It also includes bit stream services, bit stream naked, wholesale line rental accesses and leased ducts for other operators' fiber deployment.

Digital services

The main highlights in services developed by Telefónica Digital are:

**Video/TV services:** IPTV services (Internet protocol), over-the-top network television services, and cable and satellite TV. Advanced pay TV services are also offered, such as high-definition TV (HDTV), Multiroom (allowing clients to watch different TV channels in different rooms), Digital Video Recording (DVR), Multiscreen (all contents in everywhere), CatchUp contents, third party contents and Cloud Video Services (such as Last 7 days, RestartTV and Cloud DVR). In addition, Telefónica offers accessible content with subtitles, audio description and sign language functionalities through the Movistar+ 5s service. The aim is to contribute toward the inclusion of disabled people across the country.

**IoT (Internet of Things):** Telefónica Global IoT portfolio services include:

**Smart Connectivity:** horizontal services including mostly basic users (machines) managed through two different connectivity platforms, SmartM2M (developed and owned by Telefónica) and Jasper (third party developed)

**Smart Services:** full end-to-end “device + connectivity + application” solutions targeting to four pre-defined specific vertical sectors: Cities, Mobility, Energy and Retail

**Personal IoT:** set of services, focused on the B2C segment, supporting usual healthcare, safety and fitness practice through different electronic and communication processes (SMS and push messages, web-based solutions, tracking, wearables).

**Financial services and other payment services:** These services allow final customers and financial institutions to make money transfers, payments and mobile recharges.

**Security services:** A broad set of facilities (Managed Security, Cloud and Comms Security, Cybersecurity (threats, vulnerabilities and antifraud platforms)) targeting to protect information stored in different end customers' devices and networks from unauthorized access, use, disclosure, disruption or destruction, and including 11Paths developed services such as Latch, FaasT, Metashield or Tacyt.

**Cloud computing services:** Includes Managed Cloud, which allows us to build fully managed infrastructure environments for large enterprises and also manage the complex tools and applications that run on top of that infrastructure; and in addition, for small and medium sized businesses "All-in" Bundles (Comms+Devices+Cloud). Telefónica is bundling offers based on a Cloud Service Broker that provides a vast self-service experience to the customer and a large set of capabilities, flexibility and a comprehensive commercial offer.

**Advertising:** Portfolio of marketing channels that third party brands can use to acquire and engage with customers. Traditional channels such as messaging are utilized alongside new channels like programmatic display and sponsored connectivity – all fueled by powerful customer data.

**Big Data:** Includes the product "Smart Steps" which helps retailers, municipalities and public security bodies to understand the influx of people. Anonymous mobile data network and aggregates are used to calculate the influx of people in an area. Telefónica also offers B2B opt-in services to the financial sector (Smart Digits) for improving fraud prevention and credit scoring in Brazil, United Kingdom and Chile. Recently a Smart Steps joint venture has been launched with China Unicom based out of Beijing to sell data insights in China.



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### Sales and Marketing

Our sales and marketing strategy is aimed toward reinforcing our market position, generating brand awareness, promoting customer growth and achieving customer satisfaction. We use a variety of marketing initiatives and programs, including those that focus on customer value, with in-depth market segmentation; programs to promote customer loyalty; pricing initiatives aimed toward stimulating usage, including segmented packages and innovative tariff options; and initiatives that are responsive to the latest market trends, including those aimed toward boosting demand for our mobile Internet and mobile broadband offerings. In connection with these and our other sales and marketing initiatives, we market our products through a broad range of channels, including television, radio, billboards, telemarketing, direct mail and Internet advertising. We also sponsor a variety of local cultural and sporting events in order to enhance our brand recognition.

### Competition

The telecommunications industry is competitive and consumers generally have a choice of mobile and fixed line operators from which to select services. We are a global telecommunications services provider and face significant competition in most of the markets in which we operate. In Europe, our largest competitor is Vodafone and in Latin America, our largest competitor is América Móvil. Newer competitors, including handset manufacturers, MVNOs, internet companies and software providers, are also entering the market and offering integrated communications services.

We compete in our markets on the basis of the price of our services; the quality and range of features; the added value we offer with our service; additional services associated with those main services; the reliability of our network infrastructure and its technological attributes; and the desirability of our offerings, including bundled offerings of one type of service with another and, in the case of the mobile industry, in most of the markets offerings that include subsidized handsets.

To compete effectively with our competitors, we need to successfully market our products and services and to anticipate and respond to various competitive factors affecting the relevant markets, such as the introduction of new products and services, different pricing strategies and changes in consumer preferences. See “Risk Factors – Risks Relating to the Group’s Industry – The Company may not be able to adequately foresee and respond to technological changes and sector trends.”

### Strategic Partnerships

## **China Unicom**

Since 2005, we have had a stake in China Unicom and its predecessor company. On September 6, 2009 we entered into a strategic alliance agreement with China Unicom, which provides, among other areas for cooperation, joint procurement of infrastructure and client equipment, common development of mobile service platforms, joint provisions of service to multinational customers, roaming, research and development, sharing of best practices and technical, operational and management know-how, joint development of strategic initiatives in the area of network evolution, joint participation in international alliances and exchanges of senior management. In furtherance of this strategic alliance we entered into a subscription agreement with China Unicom, pursuant to which we increased our voting interest in the share capital of China Unicom to 8.06% and China Unicom obtained 0.87% voting interest in our share capital in October 2009.

Pursuant to the strategic alliance agreement mentioned above, China Unicom has agreed to use its best endeavors to maintain a listing of all the issued ordinary shares of China Unicom on the Hong Kong Stock Exchange. For so long as the strategic alliance agreement with us is in effect, China Unicom shall not (i) offer, issue or sell any significant number of its ordinary shares (including treasury shares), or any securities convertible into or other rights to subscribe for or purchase a significant number of China Unicom's ordinary shares (including treasury shares), to any current major competitor of Telefónica or (ii) make any significant investment, directly or indirectly, in any current major competitor of Telefónica. We made similar undertakings.

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The initial term of the strategic alliance agreement between us and China Unicom terminated on September 6, 2012 and it is subject to automatic annual renewals, subject to either party's right to terminate on six months' notice. Also, the strategic alliance agreement may be terminated by China Unicom if our shareholding in China Unicom drops below 5% of its issued share capital or if China Unicom's shareholding in us drops below 0.5% of our issued share capital. In addition, the strategic alliance agreement is subject to termination in the event either party is in default and automatically terminates on a change in control of China Unicom.

On January 28, 2011, China Unicom completed its acquisition of 21,827,499 Telefónica shares.

On June 10, 2012, Telefónica, S.A. through its 100% subsidiary, Telefónica Internacional, S.A.U., and China United Network Communications Group Company Limited ("Unicom Parent") through a 100% owned subsidiary, signed an agreement for the acquisition by this last company of 1,073,777,121 shares of China Unicom-Hong Kong-Limited, owned by Telefónica, equivalent to 4.56% of the issued share capital of China Unicom.

On July 21, 2012 the aforementioned agreement was complemented by a Supplemental Agreement which determined the acquisition of the shares at a price of HK\$10.02 per share, for a total amount of HK\$10,759,246,752.42 (approximately 1,142 million euros). The transaction was completed on July 30, 2012.

On November 10, 2014, Telefónica, through its 100% subsidiary, Telefónica Internacional, S.A.U., sold 597,844,100 shares of China Unicom, representing 2.5% of the share capital of the company, by means of a block trade, at a price of HK\$11.14 per share, for a total amount of HK\$6,660 million, approximately 687 million euros at the exchange rate as at the date of the sale.

Further to the sale, Telefónica maintains its commitment to the strategic alliance with China Unicom.

On December 18, 2015 a Smart Steps joint venture was launched with China Unicom based out of Beijing to sell data insights in China.

On July 10, 2016, Telefónica Internacional, S.A.U. (a 100% subsidiary of Telefónica, S.A.) sold 361,794,556 shares of China Unicom (Hong Kong) Limited ("**China Unicom HK**"), representing 1.51% of the share capital of the company, through a block trade process, at a price of 7.80 Hong Kong dollars per share, for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros.

As of the date of this Annual Report, Telefónica's shareholding in China Unicom amounts to approximately of 1% of its capital stock. Furthermore, Mr. César Alierta, former chairman of Telefónica, S.A. and currently a member of the Board of Directors of Telefónica, is a member of the Board of Directors of China Unicom while Mr. Wang Xiaochu, chairman of China Unicom, is a member of the Board of Directors of Telefónica.

### **Telecom Italia**

Through a series of transactions from 2007 to 2009, Telefónica acquired an indirect holding of 10.49% in the voting shares of Telecom Italia (7.21% of the dividend rights) through its holdings in Telco, S.p.A. ("Telco").

On June 16, 2014, the Italian shareholders of Telco (Assicurazioni Generali S.p.A., Intesa Sanpaolo, S.p.A. Mediobanca, S.p.A.) requested the initiation of the process of demerger of such company, as provided in the shareholders' agreement.

The implementation of such demerger process, which was approved by the General Shareholders' Meeting of Telco held on July 9, 2014, was subject to obtaining all the required anti-trust and telecommunications approvals (including in Brazil and Argentina). Once the aforementioned approvals were obtained, the demerger deed was executed on June 17, 2015, becoming effective on June 18, 2015 after its registration in the Madrid Mercantile Registry. As a consequence of the demerger, the Telecom Italia ordinary shares held by Telco – which represented 22.3% of the company's ordinary share capital – were allocated as follows: 14.72% to Telco TE, S.p.A., a newly created company owned by Telefónica; 4.31% to a newly created company owned by the Generali group; and 1.64% to each of the newly created companies owned by Intesa Sanpaolo and Mediobanca respectively.

Moreover, the shareholders' agreement in force between the shareholders of Telco ceased to have effect on June 18, 2015.

In accordance with the regulatory and competition commitments it had assumed, Telefónica completed the divestment of its entire stake in Telecom Italia during this period.

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The Telecom Italia group is principally engaged in the communications sector and, particularly, in telephone and data services on fixed lines for final and wholesale customers, in the development of fiber optic networks for wholesale customers in the provision of broadband services and Internet services, in domestic and international mobile telecommunications (especially in Brazil), in the television sector using both analog and digital terrestrial technology and in the office products sector. Telecom Italia operates primarily in Europe, the Mediterranean basin and in South America.

For more information, please see “Item 5. Operating and Financial Review and Prospects —Operating Results—Significant Factors Affecting the Comparability of our Results of Operations in the Period Under Review” and “Item 10. Additional Information—Material Contracts.”

Regulation

Please see Appendix VI to our Consolidated Financial Statements.

Licenses and Concessions

Please see Appendix VI to our Consolidated Financial Statements.

Seasonality

Our business is not significantly affected by seasonal trends.

Patents

Our business is not materially dependent upon the ownership of patents, commercial or financial contracts or new manufacturing processes.



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Disclosure Pursuant to Section 219 of the Iran Threat Reduction and Syria Human Rights Act

Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 added Section 13(r) to the Exchange Act. Section 13(r) requires an issuer to disclose in its annual or quarterly reports filed with the SEC whether the issuer or any of its affiliates has knowingly engaged in certain activities, transactions or dealings with the Government of Iran, relating to Iran or with designated natural persons or entities involved in terrorism or the proliferation of weapons of mass destruction during the period covered by the annual or quarterly report. Disclosure is required even when the activities were conducted outside the United States by non-U.S. entities and even when such activities were conducted in compliance with applicable law.

The following information is disclosed pursuant to Section 13(r). None of these activities involved U.S. affiliates of Telefónica.

Roaming Agreements with Iranian Operators

Some of our subsidiaries have entered into roaming agreements with Iranian telecommunication companies. Pursuant to such roaming agreements our subsidiaries' customers are able to roam in the particular Iranian network (outbound roaming) and customers of such Iranian operators are able to roam in our relevant subsidiary's network (inbound roaming). For outbound roaming, our subsidiaries pay the relevant Iranian operator roaming fees for use of its network by our customers, and for inbound roaming the Iranian operator pays the relevant subsidiary roaming fees for use of the respective network by its customers.

Our subsidiaries were party to the following roaming agreements with Iranian telecommunication companies in 2016:

*Telefónica Móviles España S.A.* (“**TME**”), our Spanish directly wholly-owned subsidiary, has respective roaming agreements with (i) Mobile Telecommunication Company of Iran (“**MTCI**”), (ii) MTN Irancell (“**Irancell**”), (iii) (1) Taliya (“**Taliya**”), and (iv) Telecommunication Kish Co (“**TKC**”). During 2016 TME recorded the following revenues related to these roaming agreements: (i) 105,261.99 euros from MTCI, (ii) 8,690.70 euros from Irancell, (iii) none from Taliya and (iv) none from TKC.

TME also holds a roaming hub through its 55% directly-owned subsidiary, Link2One, a.e.i.e. (“**L2O**”). Under the related agreement, L2O provides a roaming hub service to Irancell enabling the latter to maintain a relationship with other members of the hub. Some members of the hub are also entities of the Telefónica Group. During 2016 L2O recorded revenues of 172,707.82 euros from Irancell.

(2) *Telefónica Germany GmbH & Co. OHG* (“**TG**”), our German 63.22% indirectly-owned subsidiary, has respective roaming agreements with (i) MTCI and (ii) Irancell. During 2016 TG recorded revenues of (i) 380,001.54 euros from MTCI and (ii) 1,090.56 euros from Irancell.

(3) *Telefónica UK Ltd* (“**TUK**”), our English directly wholly-owned subsidiary, has a roaming agreement with Irancell. During 2016 TUK recorded 186.93 euros in roaming revenues under this agreement.

(4) *Telefónica Argentina, S.A.* and *Telefónica Móviles Argentina, S.A.* (together “**TA**”), our Argentinean directly wholly-owned subsidiaries, have a roaming agreement with Irancell. During 2016 TA recorded 41.82 euros in roaming revenues under this agreement.

(5) *Telefónica Brasil S.A.* (“**TB**”), our Brazilian 73.68% indirectly owned subsidiary, has a roaming agreement with Irancell. During 2016 TB recorded 5.39 euros in roaming revenues under this agreement.

(6) *Pegaso Comunicaciones y Sistemas, S.A. de C.V.* (“**PCS**”), our Mexican directly wholly-owned subsidiary, has a roaming agreement with Irancell. During 2016 PCS recorded 1.61 euros in roaming revenues under this agreement.

The net profit recorded by our subsidiaries pursuant to these agreements did not exceed the related revenues recorded thereunder.

The purpose of all of these agreements is to provide our customers with coverage in areas where we do not own networks. For this purpose, we intend to continue maintaining these agreements.

#### International Carrier Agreement with Iran

Telefónica de España has an international carrier agreement with Telecommunication Company of Iran (“**TCI**”).



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Pursuant to this agreement, both companies interconnect their networks to allow international exchange of telephone traffic. Telefónica de España recorded 16,023.82 euros in revenues under this agreement in 2016. The net profit recorded by Telefónica de España pursuant to this agreement did not exceed such revenues.

The purpose of this agreement is to allow the exchange of international telephone traffic. Consequently, we intend to continue maintaining this agreement.

C. Organizational Structure

See “—History and Development of the Company” and “—Business Overview”.

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D. Property, Plant and Equipment

Our central headquarters for the Telefónica Group are located in “Distrito Telefónica,” in Madrid, Spain.

Fixed Networks

We own fixed networks in Spain, Latin America and Europe, having an incumbent role in Spain, Argentina (the greater Buenos Aires metropolitan area and the southern portion of the country), Brazil (São Paulo), Chile, Peru and Colombia.

Following market trends, competitive environments, evolution of technologies and new multimedia and broadband services demanded by our customers, we have upgraded our networks in recent years in the following manners:

· progressive introduction of broadband access technologies over copper: ADSL, ADSL2+, VDSL2, etc., increasing the bandwidth capacity provided to our broadband clients several times in the last ten years;

· introduction of fiber access technologies (xPON) across different deployment scenarios: fiber to the home (FTTH), fiber to the building (FTTB), fiber to the curb (FTTC), fiber to the node (FTTN), etc., increasing the access speed up to 300 Mbps;

· service support based on powerful Internet Protocol/ Multiprotocol Label Switching (IP/MPLS) backbones, providing full connectivity to the rest of the network layers, such as access and control, to support services for business and customer market segments (fixed and mobile);

· migration of the legacy time division multiplexing (TDM) switching networks (PSTN and ISDN) to new generation network (NGN) over all-IP packet networks;

· migration from legacy transport technologies, such as asynchronous transfer mode (ATM), frame relay (FR), low-rate leased lines, plesiochronous digital hierarchy (PDH) and synchronous digital hierarchy (SDH), to the new generation of optical transport ones, such as dense wavelength division multiplexing (DWDM), coarse wavelength division multiplexing (CWDM) and new generation-synchronous digital hierarchy (NG-SDH);

introduction of IMS (Internet Multimedia Subsystem) to simplify the control of the network and ease the deployment of new services over the all-IP converged network;

empowerment of the intelligence of the network to better manage its use, to avoid saturations and frauds and to identify new business opportunities;

convergence of fixed and mobile networks, services and support systems from both technological and operational points of view; and

deployment of new services such as Pay TV, to customers connected through broadband accesses in Spain, Chile and Brazil.

### Mobile Networks

We operate mobile networks in Spain, the United Kingdom, Germany, Brazil, Argentina, Venezuela, Chile, Peru, Colombia, Mexico, Guatemala, Panama, El Salvador, Nicaragua, Costa Rica, Ecuador and Uruguay.

We use a number of mobile technologies in the countries in which we operate, namely: GSM, UMTS and LTE, the latter being already deployed in all our operations. We continue the work of upgrading our mobile networks in line with market trends, the demand of new services from customers and the evolution of technologies. The main steps we are currently taking include:

- evolution of broadband into mobile access using technologies such as HSUPA/HSPA+ and LTE;

deployment of new services such as mobile television and distribution services for next generation music, video and games;

exploration of the adequacy of new technologies such as HSPA and LTE to provide mobile accesses with increased bandwidth, in particular:

HSPA: we have extended our coverage up to the majority of the urban/suburban areas, and we have increased the -capacity of the network by upgrading the network technology to the latest available releases of UMTS standards 3GPP REL 6, REL 7 and REL 8;

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LTE: together with main vendors and sharing experience with other operators, we are exploiting the opportunities that LTE brings to create higher capacity at lower relative cost by user/traffic unit. We are now expanding the capacity of LTE networks in all operations, and we are planning the deployment of LTE-Advanced, the evolved version of LTE, in the coming years.

convergence of fixed and mobile networks, services and support systems from both technological and operational points of view.

### Satellite communications

The services provided using satellite platforms include television contribution signal to feed cable and IPTV head ends, DTH television, VSAT mainly for telephony and Internet access in rural areas, emergency solutions, corporate communications and international communications.

### Submarine cables

We are one of the world's largest submarine cable operators. We participate in approximately 25 international underwater cable systems (nine of which are moored in Spain) and own eleven domestic fiber optic cables.

There are submarine cable connections between Spain and Africa, America, Asia and Europe, respectively, which are jointly owned by us with other telecom operators. The SAM-1 cable, which we own, has a length of approximately 22,000 kilometers underwater and 3,000 kilometers terrestrial and links different countries such as the United States, Puerto Rico, Ecuador, Guatemala, Peru, Chile, Brazil, Argentina and Colombia.

Extensions of the submarine cable network are being deployed to help meet the capacity demand in the future. The BRUSA cable will link Brazil and the United States, while the Marea cable will link the United States and Europe through Spain. Both cables are expected to begin operating in 2018.

The principal services using the capacity of submarine cables are voice circuits, Internet and dedicated circuits for international traffic and for corporations and business customers.

On February 10, 2016, Telefónica announced the creation of Telxius, a company which brings together certain infrastructure assets of the Group, which enables the management of the Telefónica Group's infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telxius to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.

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Item 4A. Unresolved Staff Comments

Not applicable.

Item 5. Operating and Financial Review and Prospects

A. Operating Results

Presentation of Financial Information

The information in this section should be read in conjunction with our Consolidated Financial Statements and the notes thereto, included elsewhere in this Annual Report. Our Consolidated Financial Statements have been prepared in accordance with IFRS as issued by the IASB. See also “Presentation of Certain Financial Information Retrospective revisions”.

Following our signing of an agreement on March 24, 2015 with Hutchison for the sale and purchase of the entire issued share capital of Telefónica Europe plc and the reclassification of the results attributable to our operations in the United Kingdom as discontinued operations, our segments were amended in 2015 to reflect the elimination of the Telefónica United Kingdom segment.

Following the EC’s decision to prohibit such sale to Hutchison Whampoa Group, the Board of Directors of Telefónica,S.A. at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, Telefónica’s operations in the United Kingdom are no longer presented as discontinued operations and the respective assets and liabilities cease to be classified as held for sale. Thus, our segments were amended and are now the same as they were prior to the elimination of our Telefónica United Kingdom operating segment, which were approved by the Board of Directors of Telefónica, S.A. on February 26, 2014: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay).

These segments include the information related to wireline, wireless, DSL, TV, and other digital services provided in each country or countries. The results, assets and liabilities of the segments include the new companies that operate the towers business and, consequently the impacts of the intercompany sales of towers have been eliminated. Any services not specifically included in these new segments are part of “Other companies and eliminations”.

In 2013, Telefónica created the role of the Chief Commercial Digital Officer, who is responsible for fostering revenue growth. On the cost side, the Company has strengthened the role of the Chief Global Resources Officer. Both Officers report directly to the Chief Operating Officer (COO), as well as the local operators in Spain, Brazil, Germany and the United Kingdom, in addition to the Hispanoamérica unit (which excludes Brazil).

### *Non-GAAP financial information*

The management of the Group uses a series of measures in its decision-making, in addition to those expressly defined in the IFRS, because they provide additional information useful to assess the Group’s performance, solvency and liquidity. These measures should not be viewed in isolation or as a substitute for the measures presented according to the IFRS.

The non-GAAP financial measures included in this Annual Report are operating income before depreciation and amortization, net financial debt and net financial debt plus commitments and free cash flow.

### *Operating income before depreciation and amortization*

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Operating income before depreciation and amortization (OIBDA) is calculated by excluding solely depreciation and amortization from operating income. OIBDA is used to track the performance of the business and to establish operating and strategic targets of the Telefónica Group companies. OIBDA is a commonly reported measure and is widely used among analysts, investors and other interested parties in the telecommunications industry, although not a measure explicitly defined in IFRS, and therefore, may not be comparable to similar indicators used by other companies. OIBDA should not be considered as a substitute for operating income.

The following table provides a reconciliation of our OIBDA to operating income for the periods indicated.

Year ended December 31,

| Millions of euros                                     | 2014 (*) | 2015 (*) | 2016    |
|---|----------|----------|---------|
| Operating income before depreciation and amortization | 15,515   | 13,229   | 15,118  |
| Depreciation and amortization                         | (8,548)  | (9,704)  | (9,649) |
| Operating income                                      | 6,967    | 3,525    | 5,469   |

(\*)Amended data.

The following tables provide a reconciliation of OIBDA to operating income for us and each of our business areas for the periods indicated.

2016

| Millions of euros                                     | Telefónica       |                           |                    |                   |                 |                        | Total Group |
|---|------------------|---------------------------|--------------------|-------------------|-----------------|------------------------|-------------|
|   | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Hispano-américa | Other and eliminations |             |
| Operating income before depreciation and amortization | 4,467            | 1,709                     | 1,794              | 3,714             | 3,477           | (43)                   | 15,118      |
| Depreciation and amortization                         | (1,830)          | (1,090)                   | (2,211)            | (2,038)           | (2,190)         | (290)                  | (9,649)     |
| Operating income                                      | 2,637            | 619                       | (417)              | 1,676             | 1,287           | (333)                  | 5,469       |

2015 (\*)



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| Millions of euros                                     | Telefónica<br>Spain | Telefónica<br>United<br>Kingdom | Telefónica<br>Germany | Telefónica<br>Brazil | Telefónica          |                           | Total<br>Group |
|---|---------------------|---------------------------------|-----------------------|----------------------|---------------------|---------------------------|----------------|
|   |                     |                                 |                       |                      | Hispano-<br>américa | Other and<br>eliminations |                |
| Operating income before depreciation and amortization | 2,336               | 1,929                           | 1,858                 | 3,573                | 4,356               | (823)                     | 13,229         |
| Depreciation and amortization                         | (1,898)             | (1,196)                         | (2,128)               | (1,916)              | (2,241)             | (325)                     | (9,704)        |
| Operating income                                      | 438                 | 733                             | (270)                 | 1,657                | 2,115               | (1,148)                   | 3,525          |

(\*) Amended data.

2014 (\*)

| Millions of<br>euros                                  | Telefónica<br>Spain | Telefónica<br>United Kingdom | Telefónica<br>Germany | Telefónica<br>Brazil | Telefónica          |                           | Total<br>Group |       |         |
|---|---------------------|------------------------------|-----------------------|----------------------|---------------------|---------------------------|----------------|-------|---------|
|   |                     |                              |                       |                      | Hispano-<br>américa | Other and<br>eliminations |                |       |         |
| Operating income before depreciation and amortization |                     |                              | 5,671                 | 1,744                | 733                 | 3,543                     | 4,068          | (244) | 15,515  |
| Depreciation and amortization                         |                     |                              | (1,805)               | (1,121)              | (1,426)             | (1,762)                   | (2,034)        | (400) | (8,548) |
| Operating income                                      |                     |                              | 3,866                 | 623                  | (693)               | 1,781                     | 2,034          | (644) | 6,967   |

(\*) Amended data.

*Net financial debt and net financial debt plus commitments*

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As calculated by us, net financial debt includes: (i) current and non-current financial liabilities in our consolidated statement of financial position (which includes the negative mark-to-market value of derivatives) and (ii) other payables included in "Trade and other payables" (mainly corresponding to payables for deferred payment of radio spectrum). From these liabilities, it is subtracted: i) the cash and cash equivalents, ii) the current financial assets (which include short-term derivatives), iii) the positive mark-to-market value of derivatives with a maturity beyond one year, and iv) other interest-bearing assets (components of "Trade and other receivables" and "Non-current financial assets" in our consolidated statement of financial position).

We calculate net financial debt plus commitments by adding to net financial debt gross commitments related to employee benefits, and deducting the value of long-term assets associated with those commitments and the tax benefits arising from the future payments of those commitments.

We believe that net financial debt and net financial debt plus commitments are meaningful for investors and analysts because they provide an analysis of our solvency using the same measures used by our management. We use net financial debt and net financial debt plus commitments to calculate internally certain solvency and leverage ratios used by management. Nevertheless, neither net financial debt nor net financial debt plus commitments as calculated by us should be considered as a substitute for gross financial debt as presented in the consolidated statement of financial position.

The following table presents a reconciliation of net financial debt and net financial debt plus commitments as of December 31, 2016 and 2015 to the Telefónica Group's gross financial debt as indicated in the consolidated statement of financial position.

| Millions of euros  | 12/31/2016 | 12/31/2015 (*) |
|--|------------|----------------|
| Non-current financial liabilities                                    | 45,612     | 47,117         |
| Current financial liabilities  | 14,749     | 12,970         |
| Gross financial debt   | 60,361     | 60,087         |
| Cash and cash equivalents  | (3,736)    | (2,615)        |
| Current financial assets   | (2,954)    | (3,053)        |
| Positive mark-to-market value of long-term derivative instruments    | (5,048)    | (5,315)        |
| Other non-current liabilities included in "Trade and other payables" | 749        | 1,073          |
| Other current liabilities included in "Trade and other payables"     | 449        | 462            |
| Other assets included in "Non-current financial assets"              | (524)      | (691)          |
| Other assets included in "Current trade and other payables"          | (702)      | (787)          |

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|  |         |         |
|--|---------|---------|
| Net financial debt                             | 48,595  | 49,161  |
| Gross commitments related to employee benefits | 6,839   | 6,070   |
| Value of associated long-term assets           | (749)   | (736)   |
| Tax benefits                                   | (1,569) | (1,666) |
| Net commitments related to employee benefits   | 4,521   | 3,668   |
| Net financial debt plus commitments            | 53,116  | 52,829  |

(\* ) Amended data.

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*Free Cash Flow*

The Group's Free cash flow is calculated starting from "Net cash flow provided by operating activities" as indicated in the consolidated statement of cash flows; deducting (Payments on investments)/Proceeds from the sale of investments in property, plant and equipment and intangible assets, net (without considering cash received from the sale of real state), adding the cash received from government grants and deducting dividends paid to minority interests. The cash used to cancel commitments related to employee benefits is added back (originally included in the Net cash flow provided by operating activities) as it represents the payments of principal of the debt incurred with those employees.

We believe that Free cash flow is a meaningful measure for investors and analysts because it provides an analysis of the cash flow available to meet our debt repayment requirements and protect solvency levels (financial debt and commitments). It also provides information regarding amounts available to and remunerate the parent company's shareholders once our debt payment obligations are met. The same measure is used internally by our management. Nevertheless, the Free cash flow as calculated by us should not be considered as a substitute for the various flows of cash as presented in the consolidated statements of cash flows.

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The following table presents the reconciliation between the Telefónica Group's Net cash flow provided by operating activities as indicated in the consolidated statement of cash flows and the Free cash flow for 2016, 2015 and 2014:

| <b>Millions of euros</b>  | <b>2016</b>  | <b>2015</b>  | <b>2014</b>  |
|---|--------------|--------------|--------------|
| <b>Net cash flow provided by operating activities</b>   | 13,338       | 13,615       | 12,193       |
| (Payments on investments)/Proceeds from the sale of investments in property, plant and equipment and intangible assets, net | (9,187)      | (10,256)     | (8,865)      |
| Net cash received from sale of real state   | (8)          | (36)         | (3)          |
| Government grants received  | -            | 7            | 30           |
| Payments related to cancellation of commitments   | 738          | 721          | 789          |
| Dividends paid to minority shareholders   | (511)        | (537)        | (327)        |
| <b>Free Cash Flow</b>   | <b>4,370</b> | <b>3,514</b> | <b>3,817</b> |

## Significant Factors Affecting the Comparability of Our Results of Operations in the Periods under Review

Please see "Comparative information and main changes in the consolidation scope" in Note 2 to our Consolidated Financial Statements.

## Significant Changes in Accounting Policies

Please see Note 3(n) to our Consolidated Financial Statements.

## Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the amounts reflected in the Consolidated Financial Statements and accompanying notes. We base our estimates on historical experience, where applicable, and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from those estimates under different assumptions or conditions.

We consider an accounting estimate to be critical if:

it requires us to make assumptions because information was not available at the time or it included matters that were highly uncertain at the time we were making our estimate; and

changes in the estimate or different estimates that we could have selected may have had a material impact on our financial condition, results of operations or cash flows.

The various policies that are important to the portrayal of our financial condition, results of operations and cash flows include:

· accounting for long-lived assets, including goodwill;

· deferred taxes;

· provisions;

· revenue recognition; and

· exchange rate used to remeasure Venezuelan bolívar fuerte (BsF)-denominated items.

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*Accounting for long-lived assets, including goodwill*

Property, plant and equipment and intangible assets, other than goodwill, are recorded at acquisition cost. If such assets are acquired in a business combination, the acquisition cost is the estimated fair value of the acquired property, plant and equipment or intangible assets. Property, plant and equipment and intangible assets with definite useful lives are depreciated or amortized on a straight-line basis over their estimated useful lives.

Intangible assets with indefinite useful lives are not amortized, but are, instead, subject to an impairment test on a yearly basis and whenever there is an indication that such assets may be impaired.

Accounting for long-lived assets and intangible assets involves the use of estimates for determining: (a) the fair value at the acquisition date in the case of such assets acquired in a business combination, and (b) the useful lives of the assets over which they are to be depreciated or amortized. We believe that the estimates we make to determine an asset's useful life are "critical accounting estimates" because they require our management to make estimates about technological evolution and competitive uses of assets.

When an impairment in the carrying amount of an asset occurs, non-scheduled write-downs are made. We perform impairment tests of identifiable intangible and long-lived assets whenever there is reason to believe that the carrying value may exceed the recoverable amount, which is the higher of the asset's fair value less costs to sell and its value in use. Furthermore, previously recognized impairment losses may be reversed when changes in the estimates used to determine the asset's recoverable amount indicate that an impairment loss recognized in prior periods no longer exists or may have decreased.

The determination of whether the impairment of long-lived and intangible assets is necessary involves the use of significant estimates and judgment that includes, but is not limited to, the analysis of the cause of potential impairment in value, the timing of such potential impairment and an estimate of the amount of the impairment, which requires the estimation of the future expected cash flows, discount rates and the fair value of the assets.

Specifically, management has to make certain assumptions in respect of uncertain matters, such as growth in revenues, changes in market prices, operating margins, and technology developments and obsolescence, discontinuance of services and other changes in circumstances that indicate the need to perform an impairment test. Management's estimates about technology and its future development require significant judgment because the timing and nature of technological advances are difficult to predict.

Goodwill arises when the cost of a business combination exceeds the acquirer's interest in the net fair value of the identifiable assets acquired and liabilities assumed at the acquisition date. Goodwill is not amortized, but is, instead, subject to an impairment test on a yearly basis and whenever there is an indication that the goodwill may be impaired.

Non-scheduled write-downs of goodwill are made when an impairment in the carrying amount of goodwill occurs. We review, on a regular basis, the performance of our cash-generating units. We compare the carrying amount of the cash-generating unit to which the goodwill has been allocated with its recoverable amount. The determination of the recoverable amount of the cash-generating unit involves extensive use of estimates and significant management judgment is involved. Methods commonly used by us for valuations include discounted cash flow methods.

A significant change in the facts and circumstances that we relied upon in making our estimates may have a material impact on our operating results and financial condition.



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*Deferred income taxes*

The Group assesses the recoverability of deferred tax assets based on estimates of future earnings, and of all the available options to achieve an outcome, it considers the most efficient one in tax terms within the legal framework the Group is subject to. Such recoverability ultimately depends on the Group's ability to generate taxable earnings over the period for which the deferred tax assets remain deductible. This analysis is based on the estimated schedule for reversing deferred tax liabilities, as well as estimates of taxable earnings, which are sourced from internal projections that are continuously updated to reflect the latest trends.

The recognition of tax assets and liabilities depends on a series of factors, including estimates as to the timing and realization of deferred tax assets and the projected tax payment schedule. Actual Group company income tax receipts and payments could differ from the estimates made by the Group as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

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***Provisions***

Provisions are recorded when, at the end of the period, we have a present obligation as a result of past events, whose settlement requires an outflow of resources that is considered probable and can be measured reliably. This obligation may be legal or constructive, arising from, but not limited to, regulation, contracts, common practice or public commitments, which have created a valid expectation for third parties that we will assume certain responsibilities. The amount recorded is the best estimation performed by the management in respect of the expenditure that will be required to settle the obligations, considering all the information available at the closing date, including the advice of external experts, such as legal advisors or consultants.

If we are unable to reliably measure the obligation, no provision is recorded and information is then presented in the notes to the Consolidated Financial Statements.

Because of the inherent uncertainties in this estimation, actual expenditures may be different from the originally estimated amount recognized.

***Revenue recognition***

*Connection fees*

Revenues from connection fees originated when customers connect to our network are deferred over the average expected length of the customer relationship.

The expected customer relationship period is estimated based on recent historical experience of customer churn rates. Significant changes in our estimations may result in differences in the amount and timing of revenues recognized.

*Multiple-element arrangements*

Arrangements involving the delivery of bundled products or services are assessed to determine whether it is necessary to separate the arrangement into individual component deliverables, each with its own revenue recognition criteria.

Revenue relating to the bundled contracts is allocated to the different deliverables identified, based on their relative fair values (i.e., the fair value of each individual component deliverables in relation to the total fair value of the bundled deliverables), considering that amounts contingent upon delivery of undelivered items are not allocated to delivered items. Given that the handsets and airtime are price-sensitive and volatile in a competitive marketplace, the determination of fair values in the mobile phone business is quite complex.

Additionally, a significant change in the facts and circumstances upon which we based our fair value estimates may have an impact on the allocation of revenues among the different deliverables identified and, consequently, on future revenues.

***Exchange rate and inflation rates used to translate the financial statements of our Venezuelan subsidiaries***

As of December 31, 2016, there are multiple exchange mechanisms and three published exchange rates legally available for translation of the financial statements of the Venezuelan subsidiaries.

We review, on a regular basis, the economic conditions in Venezuela and the specific circumstances of our Venezuelan operations. Assessment of the exchange rate that better reflects the economics of Telefónica's business activities in Venezuela relies on several factors and is performed considering all the information available at the closing date, and entails the use of assumptions and estimates and significant management judgment.

Due to inherent uncertainties in the estimates required to determine the appropriate exchange rate for the conversion of BsF-denominated financial statements, actual cash flows denominated in such currency may differ from the amounts currently recognized on the basis of our estimates, as a result of changes in currency laws or changes in exchange mechanisms or published exchange rates that may have a material impact on the conversion rate used for our Venezuelan subsidiaries' financial statements, affecting the net monetary position of assets (liabilities) denominated in BsF.

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In addition to this, Venezuela is considered as a hyperinflationary economy since 2009. Telefónica recognizes the effects of inflation by restating the financial information of its Venezuelan operation using the “Indice Nacional de Precios al Consumidor de Venezuela” issued by the Central Bank of Venezuela, or the best estimate in case the final index is not available.

Significant management judgment is required to determine the appropriate inflation rate where the official rate is not available. The estimates and underlying assumptions are based on careful consideration of factors that are considered to be relevant and rely on all the information available at the closing date. Actual results may differ from these estimates as a result of changes in circumstances and assumptions about future developments in Venezuela due to evolving market conditions, uncertainty about currency and operating restrictions or other circumstances arising beyond the control of the Company.

## Operating Environment

Our results of operations are dependent, to a large extent, on the level of demand for our services in the countries in which we operate. Demand for services in those countries is affected by the performance of their respective economies, particularly household private consumption, but also gross domestic product, or GDP, inflation, or CPI, external accounts and unemployment rates.

During 2016, global activity was very similar to 2015 and recent developments suggest that growth in 2017 is going to be higher than in 2016. The European Union has grown for the third year in a row due to the improvement of internal demand, especially in Spain. However, political uncertainty in some European countries due to upcoming general elections and the British exit process from the European Union, could add risks to this outlook depending on their outcome.

In Latin America, economic growth in 2017 is expected to be higher than in 2016, although the growth rates are expected to be significantly lower than those achieved before the global recession. The recent recovery in commodity prices, especially oil and copper, are expected to provide some relief to the external accounts balances and to activity growth in the region. However, a faster monetary normalization in the United States, as well as doubts about growth and imbalances in China, could have an impact on inward external flows, making financing conditions in Latin American countries more stringent, which would affect household private consumption negatively.

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*Operating environment by country*

*Spain*

In 2016, Spanish GDP expanded by 3.2% (according to Consensus Economics Forecast (“CFe”), an independent research firm), the same growth rate as in 2015 and considerably higher than the growth rate of 1.4% in 2014, after the average annual contraction of 1.8% in 2009-2013.

This performance was explained by a positive evolution of internal demand, with household consumption increasing 3.2% in 2016 (CFe), compared to a 2.2% increase in 2014-15 and a contraction on average of -2.5% per year during 2009-13.

Investment also showed positive growth in 2016 for the third consecutive year in a row, at a rate of 3.9% (CFe) compared to an average 4.9% growth in 2014-15 and the 8.1% annual decline experienced on average in 2009-13. Inflation was 1.6% in 2016, compared with -0.1% and -1.1% in 2015 and 2014, respectively.

The current account showed again a surplus in 2016 of 1.7% of GDP (CFe), improving the 2014-15 average of 1.2% of GDP.

The unemployment rate continued its downward trend in 2016 after the 26.9% peak reached in the first quarter of 2013. The unemployment rate reached 19.2% at the end of 2016 (CFe), 1.7pp lower than at the end of 2015.

*United Kingdom*

In 2016, the British economy, measured in terms of GDP, is estimated to have increased by 1.9% (CFe) compared with a growth rate of 2.2% in 2015 and 3.1% in 2014. Household consumption was the main source of economic growth, increasing by 2.7% (CFe) in 2016, compared with a growth rate of 2.5% and 2.1% in 2015 and 2014, respectively, driven by its solid fundamentals, with the unemployment rate decreasing to 5% (CFe) on average, from 5.4% registered in 2015 and 6.2% in 2014. On the other hand, fixed capital investment was flat in 2016 (CFe), decelerating from an increase of 3.4% in 2015, and 6.7% in 2014, as high political and economic uncertainty that followed the Brexit referendum in June was likely weighting on firm’s investment decisions.

Inflation (CPI) increased by 1.6% year-on-year in 2016 accelerating from 0.2% in 2015 and 0.5% in 2014, with upward pressures coming from energy and food prices as well as recent exchange rate depreciation.

The British pound sterling experienced a sharp depreciation relative to the euro in 2016, falling by 17% year-on-year, from 0.74 GBP per EUR in 2015 (year-end) to 0.84 GBP per EUR in 2016 (year-end). The increase in uncertainty about the future trade and economic relations between the United Kingdom and the European Union after the Brexit referendum result, was the main reason behind the currency weakness.

### *Germany*

In 2016, the German economy grew by 1.9%, the highest rate since 2011 and after expanding on average 1.7% in 2014-15.

The economic growth in 2016, as well as in 2015, was mainly due to a positive contribution of the internal demand, especially private consumption that showed the highest growth rate in the last decade (2.0% in 2016 (CFe)), which offsets the negative contribution of the external sector to GDP growth.

In 2016 the CPI rate reached 1.7% year-on-year (compared with an average of 0.3% in 2014-15), and the unemployment rate stood at 5.8%, compared with 6.1% in 2015 and 6.4% in 2014.

### *Brazil*

Brazilian GDP decreased approximately 3.5% in 2016 (CFe), following another decrease of 3.8% in 2015 and an increase of 0.5% in 2014, according to the Brazilian Geography and Statistics Institute. Investments contracted by approximately 10.0% in 2016, after a decrease of 13.9% in 2015. Household consumption decreased by approximately 5.0% in 2016, from a 3.9% decrease in 2015.

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Inflation, as measured by the IPCA, increased by 6.3% in 2016 (above the inflation target established by the Brazilian Central Bank of 4.5% but within its range of tolerance), compared to 10.7% in 2015 and 6.4% in 2014. Due to decreasing inflation, the basic interest rate, the Special Clearance and Escrow System rate (Selic rate), was lowered from 14.25% at the end of 2015 to 13.75% at the end of 2016.

The current account deficit reached 23.7 billion U.S. dollars in 2016, compared to 58.9 billion U.S. dollars in 2015 and 104.2 billion U.S. dollars in 2014. In 2016, this deficit was financed by capital inflows, such as foreign direct investments, which reached 78.9 billion U.S. dollars, while portfolio investments would have had an outflow of 19.8 billion U.S. dollars. International reserves increased by 3.5 billion U.S. dollars in 2016, to a level of 372.2 billion U.S. dollars.

Despite the negative activity data, the country-risk decreased, on the back of lower political uncertainties and the approval of fiscal reforms. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI + Brazil) reached 328 basis points at the end of 2016, down from 523 basis points at the end of 2015 and 259 basis points at the end of 2014. The Brazilian real appreciated in 2016. It appreciated against the U.S. dollar by 16.5%, reaching an exchange rate of 3.26 reais per U.S. dollar on December 31, 2016, compared to 3.90 reais per U.S. dollar on December 31, 2015 and to 2.66 reais per U.S. dollar on December 31, 2014.

*Mexico*

Mexico's real GDP increased by an estimated 2.1% in 2016 (CFe), compared with a 2.6% and 2.3% increase in 2015 and 2014, respectively.

Inflation, as measured by the CPI, was 3.4% year-on-year in 2016 compared with 2.1% in 2015, within the Mexican Central Bank's tolerance range of 2% to 4%.

During 2016, exports decreased by 2.5% (CFe), private consumption increased by 2.7% (CFe) and investment increased by 0.8% compared with 2015.

The current account balance posted a deficit of 31 billion U.S. dollars in 2016 – according to CFe – compared with 33 billion U.S. dollars in 2015 (3.0% and 2.9% of GDP, respectively).

On December 31, 2016, the exchange rate relative to the U.S. dollar was 20.62 Mexican pesos to the U.S. dollar (17.18 and 14.75 on December 31, 2015 and 2014, respectively).

### *Venezuela*

No official data is available for GDP or for inflation for 2016. However, the expectations about the worsening of economic conditions in Venezuela were confirmed by forecasts published by CFe. According to this publication, GDP fell by 10.2% in 2016, after falling 5.7% in 2015.

Private consumption was estimated to have fallen by 11.6% in 2016 and public consumption was estimated to have contracted 6.0%. Additionally, investments are estimated to have declined by 20.3%.

Additionally, exports are estimated to have declined by 29.1% in 2016 and imports are estimated to have contracted by 37.7%. The trade balance was estimated to have reached a 3,900 million U.S. dollars surplus in 2016 compared with 2,300 million U.S. dollars in 2015, but much lower than the 27,200 million U.S. dollars surplus reached in 2014.

The inflationary spiral in Venezuela continues to accelerate its pace. According to CFe, prices are estimated to have increased 567.8% year-on-year in 2016, much higher than the 180.9% and 68.5% inflation rates reached in 2015 and 2014, respectively.

The unemployment rate was estimated to have averaged 9.6% in 2016, a significant increase with respect to the 6.8% and 7.0% average unemployment rates of 2015 and 2014, respectively.



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*Chile*

Chilean GDP expanded at an estimated rate of 1.7% (CFe), 0.6 percentage points below the rate registered in 2015 (2.3%) and 2.9 percentage points under the average annual growth rate for the 2010-2014 period (4.6%). Private consumption grew by an estimated 1.9% (CFe) in 2016, the same as in 2015 (1.9%) but 5.6 percent points under the average annual growth rate for the 2010-2014 period. Investment increased by 0.3% (CFe) after two years of consecutive contraction (-1.5% in 2015 and -4.2% in 2014). As most emerging economies, Chile faced headwinds from the international financial markets tightening, the decreasing commodity prices (especially copper prices), the emerging/advanced capital flows reallocation and subdued economic dynamism in its major commercial partners. Domestically, a persistent slack of confidence and decreasing expectations also weighed negatively on expenditure decisions.

The labor market remained substantially resilient to the economic underperformance for a third year in a row. The unemployment rate reached 6.1% at the end of 2016, with no major changes compared with 5.8% in 2015 and 6.0% in 2014. It remained among the lowest unemployment rates in the last decade. Nominal wages rose accordingly to historical averages.

Inflation, measured by CPI, reached 2.7% in 2016 compared with 4.4% in 2015 and 4.6% in 2014. The appreciation of the Chilean currency, the fall in international oil prices, an increasing supply of fresh food products (vegetables and fruits) and less indexation pressures from past inflation, among others, contributed to this outcome. Core inflation (excluding food and energy) reached 2.8%, 0.1 percentage points above total CPI growth. Both CPI and core CPI inflation ended 2016 around the long-term target of the Chilean Central Bank of 3%.

The Chilean Central Bank kept its reference interest rate unchanged along the year at 3.5%. The monetary policy aimed to anchor inflation expectations to long-term target (3%). In the last months of 2016 the Bank's Council resolutions revealed an increasing expansionary skew regarding future interest rate movements.

The fiscal deficit is estimated to have risen to 3.0% of GDP (CFe), increasing by 0.8 and 1.4 percentage points compared to deficits in 2015 and 2014, respectively.

The trade balance surplus reached 4.6 billion U.S. dollars, improving moderately with respect to 2015 (3.5 billion U.S. dollars), but lower than the 6.3 billion U.S. dollars recorded in 2014. Chilean exports evolved accordingly to copper prices downtrend and a reduced demand for Chilean non-mining exports. In turn, Chilean imports reflected the protracted weakness in domestic demand growth.

At the end of 2016, the nominal exchange rate was 669 Chilean Pesos per U.S. dollar, reflecting a year-over-year Chilean Peso appreciation of 5.3%. The exchange rate performance in 2016 was mainly explained by the recovery of copper prices during the last two months of the year.

### *Argentina*

Argentina's GDP decreased by an estimated 2.2% in 2016 (CFe), in contrast to the 2015 increase of 2.5%, the average annual growth rate of approximately 7.5% achieved from 2005 through 2008 and of 1.7% from 2009 to 2015.

The Argentine peso depreciated by 22% relative to the U.S. dollar, closing at 15.85 Argentine pesos per U.S. dollar at the end of 2016, compared with 12.94 Argentine pesos per U.S. dollar at the end of 2015 and 8.46 Argentine pesos per U.S. dollar at the end of 2014.

The Buenos Aires CPI increased by 41% in 2016 compared with 26.9% in 2015 and 38.0% in 2014.

The estimated current account deficit of 12.8 billion U.S. dollars in 2016 (CFe) is one of the highest in the last decade, although slightly lower than the deficit of 16.8 billion U.S. dollars of 2015. The estimated trade balance is of 0.4 billion U.S. dollars, with a 5.1% decrease in imports and a 0.6% increase in exports, both contributing significantly to this result.

Economic conditions negatively affected the unemployment rate, which increased to 8.9% in 2016 (CFe) from 7.0% in 2015 and 7.3% in 2014.

### *Colombia*

According to CFe, Colombian GDP is estimated to have grown by 2.0% in 2016, significantly below the 3.0% and 4.6% year-on-year growth recorded in 2015 and 2014, respectively. This deceleration was mainly attributable to the adjustment in investment due to a large decline in oil prices and a lower performance in household consumption.

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Despite the lower economic growth, the unemployment rate increased moderately. According to CFe the average unemployment rate estimated for 2016 was 9.3%, slightly above the 8.9% and 9.1% rates showed in 2015 and 2014, respectively.

According to CFe, in 2016 the current account deficit is estimated to have reached 14.2 billion U.S. dollars, representing 4.9% of GDP, which is a significant reduction compared with the 6.4% of GDP registered in 2015.

The Colombian peso depreciated by 11.2% against the U.S. dollar during 2016 (3,001 Colombian pesos per U.S. dollar at the close of 2016). This depreciation was mainly explained by the decrease in oil prices, which affected total exports. Moreover, the net portfolio investment decreased during the period magnifying the Colombian peso depreciation.

The inflation rate was 5.7% year-on-year at the end of 2016, compared with 6.8% year-on-year and 3.7% year-on-year at the end of 2015 and 2014, respectively. The pressure in food prices due to the ENSO (El Niño Southern Oscillation) raised the annual inflation rate to 9% in July of 2016, but in the following months an important correction occurred due to a better performance in food prices.

In 2016 the Colombian Central Bank decided to increase the interest rate by 175 basis points from 5.75% to 7.5%, in line with the increased inflationary pressures observed through the year.

*Peru*

Peruvian GDP expanded around its potential pace (3.9% according to de CFe, in contrast with the 3.3% expansion of 2015). The main drivers of this acceleration were the favorable development of private consumption (expected to have increased 3.6% in 2016, in contrast to the 3.4% growth of 2015), as well as the lower contraction of fixed investment, which is estimated to have decreased by 2% in 2016, much lower than the 5.1% contraction of 2015.

Consumer prices, as measured by the CPI, increased by 3.2% in 2016, slightly above the Central Bank's target of between 1% and 3% for the third consecutive year, compared with 4.4% in 2015 and 3.2% in 2014. Inflation remained near the upper limit of the Central Bank's target along the year, affected by droughts in several regions and the strong currency volatility.

The Peruvian Central Bank raised its interest key rate by 50 basis points from 3.75% in 2015 to 4.25% in 2016. According to the Central Bank, inflation expectations are within the target range. However, the inflation rate in the last quarter was above the upper limit of 3.0% due to higher prices for fuel and some food items, an effect that should show corrections soon.

The government budget is estimated to show a relatively moderate deficit of around 3.0% of GDP in 2016 (CFe), compared with a slight fiscal deficit of 2.1% in 2015. This is the result of a significant decrease in corporate tax collection due to the reduction from 30% to 28% in the corporate income tax rate.

In the foreign exchange market, the Peruvian Nuevo Sol strengthened by 1.7% against the U.S. dollar in 2016, reaching 3.36 Peruvian Nuevo Sol per U.S. dollar at the end of the year, compared with a depreciation of 14.6% in 2015 and 6.5% in 2014. The commercial surplus of 667 million U.S. dollars in 2016 (considerably higher than the 3,159 million U.S. dollars deficit in 2015) and constant financial capital inflows led to an increase of the international net reserves (US\$ 411 million), reaching 61,900 million U.S. dollars in 2016 compared to 61,500 million U.S. dollars in 2015 and 62,300 million U.S. dollars in 2014.

Country risk, measured by the J.P. Morgan Emerging Markets Bond Index (EMBIG Peru), declined 70 basis points to 170 basis points in 2016. The long-term sovereign debt rating is currently investment grade by Fitch, Standard and Poor's and Moody's rating agencies.

#### Exchange Rate Fluctuations

We publish our Consolidated Financial Statements in euros. Because a substantial portion of our assets, liabilities, revenues and expenses are denominated in currencies other than the euro, we are exposed to fluctuations in the values of these currencies against the euro. Currency fluctuations have had and may continue to have a material impact on our financial condition, results of operations and cash flows.

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We estimate that in 2016 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 8.0%. Currency fluctuations can also have a significant impact on our statement of financial position, particularly equity attributable to equity holders of the parent, and on our statement of cash flows, when translating the financial statements of subsidiaries located outside the Eurozone into euro. In 2016 equity attributable to equity holders of the parent increased by 2,049 million euros and cash and cash equivalents increased by approximately 185 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the appreciation of the Brazilian real, Chilean peso and the Colombian peso, partially offset, by the depreciation of the pound sterling, Argentinian peso and Mexican peso relative to the euro.

We estimate that in 2015 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 2.3%. In 2015 equity attributable to equity holders of the parent decreased by 4,657 million euros and cash and cash equivalents decreased by approximately 1,000 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the depreciation of the Brazilian real, Argentine peso and the Venezuelan bolívar fuerte, partially offset, by the appreciation of the pound sterling relative to the euro.

We estimate that in 2014 variations in currencies and hyperinflation in Venezuela decreased our consolidated revenues by approximately 12.1%. In 2014 equity attributable to equity holders of the parent decreased by 2,857 million euros and cash and cash equivalents decreased by approximately 1,616 million euros due to the translation of the financial statements of our foreign subsidiaries, principally due to the depreciation of the Venezuelan bolívar fuerte and the Argentine peso, partially offset by the appreciation of the pound sterling relative to the euro.

Venezuela is considered as a hyperinflationary economy since 2009. The inflation rates used to prepare the financial information included herein are based on the National Consumer Price Index of Venezuela (Indice Nacional de Precios al Consumidor de Venezuela) published by the Central Bank of Venezuela, or where a definitive index is not available, the best estimation. On an annual basis, these rates are 511.1%, 190.8% and 64.1% for 2016, 2015 and 2014, respectively. The exchange rates used to convert items denominated in Venezuelan bolívar fuerte, once adjusted for inflation, in the Consolidated Financial Statements are the closing rates as of December 31, 2016, 2015 and 2014, which were 674 bolivars per U.S. dollar (by reference to DICOM), 199 bolivars per U.S. dollar (by reference to SIMADI) and 49.988 bolivars per U.S. dollar (by reference to SICAD II), respectively.

The table below sets forth the average exchange rates against the euro of the U.S. dollar and the key currencies that impacted our consolidated results of operations for the periods indicated. Positive percentage changes represent a decline in the value of the applicable currency relative to the euro, and negative percentage changes represent increases in the value of the applicable currency relative to the euro.

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|                               | 2014(1)  | 2015(1)  | 2016(1)  | % change 2014 to 2015 | % change 2015 to 2016 |
|-------------------------------|----------|----------|----------|-----------------------|-----------------------|
|                               | Average  | Average  | Average  | Average               | Average               |
| Pound Sterling                | 0.81     | 0.73     | 0.82     | (9.88)%               | 11.92%                |
| U.S. Dollar                   | 1.33     | 1.11     | 1.11     | (16.54)%              | -                     |
| Brazilian Real                | 3.12     | 3.64     | 3.83     | 16.67%                | 5.30%                 |
| Argentine Peso                | 10.75    | 10.22    | 16.31    | (4.93)%               | 59.63%                |
| Peruvian Nuevo Sol            | 3.77     | 3.53     | 3.73     | (6.37)%               | 5.75%                 |
| Chilean Peso                  | 756.71   | 723.91   | 747.50   | (4.33)%               | 6.26%                 |
| Mexican Peso                  | 17.65    | 17.57    | 20.63    | (0.45)%               | 17.41%                |
| Venezuelan Bolívar Fuerte (2) | 60.69    | 216.31   | 710.23   | n.m.                  | n.m.                  |
| Czech Crown                   | 27.53    | 27.28    | 27.03    | (0.91)%               | (0.92)%               |
| Colombian Peso                | 2,650.03 | 3,016.49 | 3,369.06 | 13.83%                | 11.69%                |
| Guatemalan Quetzal            | 10.25    | 8.49     | 8.41     | (17.17)%              | (0.99)%               |

*Source: Central treasury bank of the respective countries.*

(1) These exchange rates are used to convert the income statements of our subsidiaries from local currency to euro.

(2) As Venezuela is considered a hyperinflationary country, the income statement from operations in Venezuela is accounted for pursuant to the closing exchange rate of bolívar fuerte to euro.

We describe certain risks relating to exchange rate fluctuations in “Item 3. Key Information—Risk Factors,” and we describe our policy with respect to limiting our exposure to short-term fluctuations in exchange rates under “Item 11. Quantitative and Qualitative Disclosures About Market Risk.”

## Group Results of Operations

Please see “Item 4 —Information on the Company — Business Overview — Financial Results.”

## B. Liquidity and Capital Resources

## Cash Flow Analysis

The table below sets forth consolidated cash flow information for the periods indicated. Positive figures refer to cash inflows and those in parenthesis refer to cash outflows.

|                                       | 2014    | 2015     | 2016    |
|---------------------------------------|---------|----------|---------|
| (millions of euros)                   |         |          |         |
| Net cash from operating activities    | 12,193  | 13,615   | 13,338  |
| Net cash used in investing activities | (9,968) | (12,917) | (8,208) |
| Net cash used in financing activities | (4,041) | (3,612)  | (4,220) |

For a discussion of our cash flows for the years ended December 31, 2014, 2015 and 2016, please see Note 20 to our Consolidated Financial Statements.

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Anticipated Uses of Funds

Our principal liquidity and capital resource requirements consist of the following:

- costs and expenses relating to the operation of our business;
- debt service requirements relating to our existing and future debt;
- capital expenditures for existing and new operations;
- acquisitions of new licenses or other operators or companies engaged in complementary or related businesses; and
- dividend, other shareholder remuneration, and pre-retirement payments.

In 2017, we expect to continue transforming our networks, evolving them towards all-IP hyper-connected networks, by investing in FTTx in key markets, and by expanding our mobile networks with LTE in most of our operations, and also with 3G. We also expect to continue investing in IT as a critical factor in our transformation. We expect to continue to invest in TV and digital content to take advantage of the opportunities in the digital markets. We may also use funds to acquire new licenses engaged in complementary or related businesses in the digital world.

We also have liquidity requirements related to the costs and expenses relating to the operation of our business, financial investments, our payment of dividends, shareholder remuneration and pre-retirement payment commitments.

We also have liquidity requirements related to debt service requirements in connection with our existing and future debt. At December 31, 2016, we had gross financial debt of 60,361 million euros compared with 60,087 million euros at December 31, 2015. For the amortization schedule of our consolidated gross financial debt at December 31, 2016 and a further description of financing activity in 2016, see “—Anticipated Sources of Liquidity” below. Our net financial debt decreased by 566 million euros to 48,595 million euros at December 31, 2016, compared with 49,161 million euros at December 31, 2015. The factors contributing to decreased debt in 2016 include: (i) our 2016 cash flow generation of 4,370 million euros; (ii) 500 million euros in net financial investments, mainly due to our China Unicom and Telef  divestment (see Note 2 to our Consolidated Financial Statements); and (iii) the lower euro value of foreign-denominated net financial debt amounting to 91 million euros. The factors contributing to increased debt in 2016 include: (i) remuneration to shareholders (including dividends, issuance of capital instruments, purchase of treasury stock and payment of coupons on undated deeply subordinated securities) amounting to 2,389 million euros; (ii) the payment of labor-related commitments (738 million euros), mainly related to early retirements; and (iii) other factors affecting the liabilities amounting to 1,268 million euros (including the refinancing of commercial liabilities).



For a reconciliation of net financial debt to gross financial debt (the sum of current and non-current interest-bearing liabilities), see “—Presentation of Financial Information—Non-GAAP financial information—Net financial debt and net financial debt plus commitments”.

For a discussion of our liquidity risk management policy, see Note 16 to our Consolidated Financial Statements.

#### Anticipated Sources of Liquidity

Cash flows from operations are our primary source of cash funding for existing operations, capital expenditures, investments, licenses, interest obligations and principal payments. We also rely on external financing, including a variety of short- and medium-term financial instruments, principally bonds and debentures, undated deeply subordinated securities and borrowings from financial institutions. Cash and cash equivalents are mainly held in euros and euro-denominated instruments.

In recent years, we raised funds by issuing equity instruments, principally undated deeply subordinated securities, mandatory convertible notes and new shares.

#### *Financing*

The following table shows the amortization schedule of our consolidated gross financial debt at December 31, 2016 as stated in euro. We may have exchange rate financial derivatives as instruments assigned to the underlying debt instruments. The table below includes the fair value of derivatives classified as financial liabilities (i.e., those with a negative mark-to-market) and excludes the fair value of derivatives classified as current financial assets (1,872 million euros), and those classified as non-current (5,048 million euros) (i.e., those with a positive mark-to-market). For description of the liquidity risk we face, see Note 16 to our Consolidated Financial Statements, and for a description of our financial liabilities, see Note 13 to our Consolidated Financial Statements.

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Millions of euros

| Maturity                            | Current |       |       |       |       | Non-current      |                   | Total  |
|-------------------------------------|---------|-------|-------|-------|-------|------------------|-------------------|--------|
|                                     | 2017    | 2018  | 2019  | 2020  | 2021  | Subsequent years | Non-current total |        |
| Debentures and bonds                | 7,559   | 4,992 | 3,501 | 4,951 | 4,765 | 16,316           | 34,525            | 42,084 |
| Promissory notes & commercial paper | 3,061   | –     | –     | 113   | –     | 186              | 299               | 3,360  |
| Other marketable debt securities    | –       | –     | –     | –     | –     | –                | –                 | –      |
| Total Issues                        | 10,620  | 4,992 | 3,501 | 5,064 | 4,765 | 16,502           | 34,824            | 45,444 |
| Loans and other payables            | 3,357   | 1,903 | 1,336 | 780   | 1,482 | 2,540            | 8,041             | 11,398 |
| Derivative instruments              | 772     | 300   | 348   | 1,003 | 533   | 563              | 2,747             | 3,519  |
| Total                               | 14,749  | 7,195 | 5,185 | 6,847 | 6,780 | 19,605           | 45,612            | 60,361 |

Notes:

- Estimated future interest payments as of December 31, 2016 on our interest-bearing debt (not included above) are as follows: 2,168 million euros in 2017, 1,694 million euros in 2018, 1,436 million euros in 2019, 1,185 million euros in 2020, 956 million euros in 2021 and 5,185 million euros in subsequent years. With respect to floating rate debt, we estimate future interest payments as the forward rates derived from yield curves quoted for the different currencies on December 31, 2016.

During 2016, we obtained financing totaling approximately 10,542 million euros, excluding the euro commercial paper program and short-term banking loans, 9.5% of which were treated as equity (hybrid) and the remaining amount as financial debt. The activity focused mainly on strengthening our liquidity position, refinancing debt maturities in an environment of very low interest rates, and extending debt maturities.

For a description of our financing, see Note 13 to our Consolidated Financial Statements.

In 2017, through the date of this Annual Report, our debt issuances and principal financing arrangements consisted of:

On January 17, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed with the FCA in London on September 13, 2016 in an aggregate nominal amount of 1,750 million euros. This issuance was split into two series: one series, amounting to 1,250 million euros, maturing on January 17, 2025 and with an annual coupon of 1.528%, and the other series, amounting to 500 million euros maturing on October 17, 2028 and with an annual coupon of 2.318%. Both series of notes are guaranteed by Telefónica, S.A;

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On January 17, 2017, Telefónica, S.A. amended the bilateral loan, signed originally on June 26, 2014 for an amount of 2,000 million euros and with an outstanding amount of 1,500 million euros, divided in two tranches with a new amortization schedule: tranche A for 500 million euros maturing on June 26, 2017 and tranche B for 1,000 million euros maturing on June 26, 2019. Later, on February 17, 2017, Telefónica, S.A. signed a new amendment to its bilateral loan extending the maturity date of the tranche A for 500 million euros until June 26, 2019;

On January 25, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed with the FCA in London on September 13, 2016 in an aggregate nominal amount of 150 million euros, maturing on January 25, 2019. The notes are guaranteed by Telefónica, S.A.;

On February 8, 2017, Telefónica Brasil, S.A. issued notes (debentures) in an aggregate notional amount of 2,000 million brazilian reais (approximately 600 million euros) maturing on February 8, 2022.

On February 15, 2017, Telefónica Europe, B.V. drew down an aggregate principal amount of 750 million euros of its long-term financing of 1,500 million euros signed on November 28, 2016 and maturing in 2024.

On February 17, 2017, Telefónica Germany GmbH & Co. OHG agreed a 12 month extension on its 750 million euros syndicated credit facility dated on March 22, 2016 up to March 22, 2022.

Our borrowing requirements are not significantly affected by seasonal trends.

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*Availability of funds*

At December 31, 2016, we had funds available (including cash and cash equivalents and undrawn lines of credit) totaling 21,274 million euros. This amount included: undrawn lines of credit for an amount of 14,627 million euros (13,491 million euros maturing in more than 12 months); cash and cash equivalents and current financial assets other than those in Venezuela.

We believe that, in addition to internal generation of funds, our working capital, our medium-term note program, our euro commercial paper program, our corporate domestic promissory note program and available lines of credit will allow us to meet our future capital requirements, including (according to our liquidity policy) gross debt maturities over the next twelve months.

For a description of our liquidity and undrawn lines of credit available at December 31, 2016, see Notes 12 and 13 to our Consolidated Financial Statements, and for a discussion of our liquidity risk management and our capital management, see Note 16 to our Consolidated Financial Statements.

Telefónica, S.A. is the parent company of the Telefónica Group and receives funding from its subsidiaries in the form of dividends and loans. Consequently, restrictions on the ability of the Group's subsidiaries to transfer funds to Telefónica, S.A. in the form of cash dividends, loans or advances, capital repatriation and other forms would negatively affect our liquidity and thus our business.

Certain Latin American economies, such as currently Venezuela, or Argentina in the past, have experienced shortages in foreign currency reserves and their respective governments have adopted restrictions on the ability to transfer funds out of the country and convert local currencies into U.S. dollars. This may limit our ability to repatriate funds out of certain subsidiaries from such countries. However, regarding net repatriation of funds to Spain, in 2016 we received 781 million euros from our Latin American subsidiaries, of which 726 million euros was from dividends and 55 million euros was from other items.

*Credit Ratings*

Our ability to use external sources of financing will depend in large part on our credit ratings. We believe that we are well-positioned to raise capital in financial markets. However, negative conditions in the financial markets or a downgrade of any of the ratings of our debt or the Kingdom of Spain's debt by any of Fitch, Moody's and/or Standard & Poor's may increase the cost of our future borrowings or may make it more difficult to access the public debt markets. In connection with the credit rating agencies' review of our debt ratings, the rating agencies may give

considerable weight to general macroeconomic and political conditions (including sovereign credit rating prospects), the performance of our businesses in countries where we operate, our financial and shareholder remuneration policy, our M&A policy, our ability to integrate acquired companies and our ability to refinance debt.

At December 31, 2016, Telefónica, S.A.'s long-term issuer default rating is "BBB stable outlook" from Fitch, "Baa3 stable outlook" from Moody's and "BBB stable outlook" from Standard & Poor's. During 2016, there were changes in the credit ratings by the three agencies. Moody's downgraded the rating to "Baa3 stable" from "Baa2 negative" on November 7, 2016, Fitch downgraded the rating to "BBB stable" from "BBB+ stable" on September 5, 2016 and Standard and Poor's revised the outlook to "stable" from "positive" on May 17, 2016.

The EC's decision to block the proposed sale of O2 U.K. to Hutchison's Three U.K. had an impact on Telefónica's credit ratings and outlooks by Moody's and Standard and Poor's, as they considered that such decision would delay the Company's deleveraging process. During 2016, we have taken certain measures to protect our credit rating. These measures mainly include: the change in the shareholder remuneration policy, together with the announcement of the commitment to maintain a solid investment grade credit rating. Regarding the 2016 fiscal year dividend, Telefónica will pay 0.55 euros per share, of which 0.35 euros was paid in November 2016 through a voluntary scrip dividend and of which 0.20 euros will be paid in cash in the second quarter of 2017. Regarding the 2017 dividend, Telefónica will pay an amount of 0.40 euros per share in cash, of which 0.20 euros would be paid in the fourth quarter of 2017 and of which 0.20 euros would be paid in the second quarter of 2018. Additionally, it is worth highlighting the strong financing activity undertaken during 2016 together with the maintenance of an appropriate level of liquidity, an active portfolio management through the announced intention to continue analyzing best strategic alternatives for O2 UK and Telxius, the executed sale of Telefé and the partial disposal of China Unicom, as well as the issuance of undated deeply subordinated securities as a solvency protection measure to mitigate negative impacts on our Consolidated Financial Statements.

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### Intragroup Loans

We lend funds to our operating subsidiaries, directly or through holding companies that head our different lines of business. At December 31, 2016, we had loans outstanding totaling 5,671 million euros (9,142 million euros at December 31, 2015) to companies in the Telefónica Group (including subsidiaries located in Latin American countries). These funds are derived from retained cash flows, loans, bonds, issuances of undated deeply subordinated securities and other sources (such as asset disposals).

### C. Research and Development, Patents and Licenses, etc.

Telefónica remains committed to technological innovation as a fundamental tool for being one of the main actors in the new digital universe, with the capacity to help to create a more sustainable world while achieving competitive advantages and distinctive products. By introducing new technologies and developing business solutions and processes, we aim to become a more effective, efficient and customer-oriented Group.

Telefónica bases its innovation strategy on the balance between two main models:

Promoting our **internal research, development and innovation (R&D&i) capabilities**, for which we have developed our own innovation model, which allows us to promote the application of technical research in developing commercial products and services using the knowledge developed in research centers, technological institutes and universities, among other sources;

Promoting the creation of **open innovation ecosystems**, in which the “**Open Future**” initiative stands out as a global program designed to connect entrepreneurs, start-ups, investors, venture capital funds and public and private organizations around the world which promote innovation in collaboration with other actors.

In parallel with these two models, Telefónica seeks to promote the development of sustainable solutions that generate a positive impact on the economic, social and technological progress of the regions in which we operate. To this effect, in addition to the investment made in promoting sustainable innovation projects and in the activities that are developed to guarantee the accessibility of our solutions to all groups, a new subsidiary has been created that is focused on product innovation and the development of disruptive technologies.

Telefónica firmly believes that competitive advantage cannot be based solely on acquired technology, and so has always considered the promotion of internal innovation, research and development activities as a strategic axis, in an effort to achieve this differentiation and move forward in other activities which guarantee the sustainability of our

business.

To this effect, the Telefónica Group's internal innovation policy focuses on contributing with solutions that guarantee Telefónica's commitment to developing a responsible business under the criteria of economic, social and environmental sustainability, by:

· Developing new products and services that enable growth and competition in an increasingly global environment, while being adapted to the diversity and local needs of each market;

· Encouraging the return of innovation through open innovation and creating value from the technology generated;

· Increasing our customers' loyalty and satisfaction;

· Increasing the revenues, profits and value of the Company;

· Increasing the quality of our infrastructure and services, as well as our relationship with our technology providers and solutions;

· Improving business processes and operations with the aim of optimizing resources, increasing efficiency and reducing environmental impact;

During 2016 we carried out numerous technological innovation projects focused on sustainability, process efficiency, the creation of new sources of revenue, customer satisfaction, the consolidation of our presence in new markets and technological leadership.

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We also initiated projects to promote an increase in the access to information technology, new services focused on new Internet business models, advanced user interfaces, distribution of TV and multimedia contents and other value added services, taking advantage of the potential of the new infrastructures. These projects, among others, were undertaken based on our objective to quickly identify emerging technologies that may have a relevant impact on our business, and to test these technologies on pilots related to new platform services, applications and prototypes.

A significant part of the innovation activities and projects are carried out by Telefónica Investigación y Desarrollo S.A.U. (Telefónica I+D), a wholly-owned subsidiary gives support mainly to our business lines. Telefónica I+D receives support from other companies and universities in the execution of its functions. The mission of the company is focused on improving our competitiveness through technological innovation and product development. Telefónica I+D is also responsible for experimental and applied research and for the development of products to increase our range of services and reduce operating costs.

The technological innovation activities of Telefónica I+D focus on three main areas:

The development of new networks, mainly carried out in collaboration with Telefónica's Global Resources area. These activities are related to new radio and fibre optic access technologies (technologies on the virtualization of network functions, in line with the technological trend known as SDN or defined networks via software) and on topics related to network optimization and *zero touch*, which enable us to have a much more flexible and adaptable network that is dynamically adaptable to the new requirements of digital services and customers.

2. The development of new products and services which are carried out within the framework of the digital services strategy. The following stand out among these activities:

o Interpersonal communication of the future with natural access, taking advantage of the possibilities of the Internet and smartphones;

o Services related to Big Data, regarding the concept of the Fourth Platform, whose vision is to return the value associated with the data it generates to the customer;

o Video and multimedia services (combining text, audio, images and video) with a user experience on all connected devices;

o Advanced solutions in emerging ICT businesses, such as *cloud computing* cloud or security;

o Management of Internet of Things (IoT) services, related to enriched mobility, energy efficiency and smart retail;



Using users' communication profiles to obtain opportunities to exploit different products and business models  
o (marketing campaigns, targeted advertising, contextual services, churn reduction, cross-selling, etc.).

Experimental and applied research: With a medium and long-term outlook, Telefónica also has “**Scientific Groups**”  
3. whose mission is to investigate the possibilities of new networks and services and to solve the technological, social and environmental challenges that arise.

It should be noted that in 2016 Telefónica I+D Chile, a 100% subsidiary of Telefónica Chile, which was launched in 2014 in collaboration with the Chilean government, for the development of the first products and the generation of the first patents in "enriched mobility", Smart Industry and Smart Agro.

As of December 31, 2016, Telefónica I+D had 612 employees (654 employees in 2015).

The total I+D expense in the Group for 2016 amounted to 906 million euros, 14.1% less than the 1,055 million euros incurred in 2015 (1,111 million euros in 2014). This expense represents 1.7%, 1.9% and 2.2% of the Group's consolidated revenue for 2016, 2015 and 2014, respectively. These figures were calculated using guidelines of the Organization for Economic Co-operation and Development (OECD).

During 2016, Telefónica registered 27 new patent applications, including three through the American office (USPTO), two through the Chilean office (INAPI) and 22 through the Spanish patent and trademark office (OEPM), seven of which were international (PCT) and 15 European applications. Moreover, one utility model was registered in the Spanish patent and trademark office, also through the OEPM.

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Regarding the development of open innovation in Telefónica, the company has the Open Future unit, which includes an open, global program designed to connect entrepreneurs, startups, investors, and public and private organizations from around the world.

The main objective of Open Future\_ is to detect, develop and enhance the talent and technological entrepreneurship in all its phases, for that which drives and accelerates the growth of ideas, projects, initiatives and companies. The integral character of Telefónica Open Future enables innovation to be developed in different stages. It is structured around seven initiatives, the objectives of which are as follows:

**Drive** (Think Big and Talentum Startups).

**Accelerate** (Crowdworking and Wayra).

**Invest** (Telefónica Ventures, Amérigo and CIP Telefónica).

Telefónica Open Future, is present in 16 countries, ended 2016 as one of the main investors in the Spanish area of open innovation and positioning itself as one of the major funds in Europe and Latin America in venture capital investment.

D. Trend Information

In 2016, Telefónica made great progress towards long-term sustainable and profitable growth in service revenues, continuing to increase efficiencies and capturing synergies thanks to the integrated vision of the businesses, processes and technologies. This allowed us to maintain a strong investment effort in order to be able to offer our customers excellent connectivity. In recent years, the Company has moved forward in its business transformation:

Firstly, Telefónica has defined a new business model with data-oriented offers, bundled services, including converged fixed and mobile services, as well as digital capabilities as part of the global transformation focused on responding to the change in our customers' consumer habits. An essential part of our effort has been the investment in fiber- and LTE networks, which we believe will allow the monetization of data as well as of digital services. In this way, Telefónica has significantly increased data accesses, including 82 million smartphones accesses, 4.8 million Pay TV accesses and 6.6 million fiber accesses during the 2014-2016 period. Additionally, average revenue per access increased by 2.8% year-on-year over the 2015-2016 period, from a year-on-year increase of 1.9% over the 2014-2015 period.

Secondly, changing consumer habits have resulted in a decreasing demand for voice services and an increasing demand for data, due to video downloads and internet connectivity through smartphones. This new trend has allowed us since 2015 to compensate the drop in voice revenues (excluding falls in interconnection tariffs) with higher data and service over connectivity, to be able to start seeing a positive trend in average revenue per access in the majority of our markets.

Thirdly, Telefónica has reinforced its competitive position thanks to an active management of the asset portfolio and to the consolidation of its participation in key markets in 2015: Germany (with the acquisition of E-Plus), Brazil (with the acquisition of GVT) and Spain (with the acquisition of DTS). These strategic acquisitions in key markets coupled with divestments in non-strategic markets, have allowed Telefónica to capture significant synergies.

Lastly, Telefónica launched in 2014 a simplification program focused on increasing growth and capturing synergies across the board; commercial offer simplification; IT network and global process modernization (through higher investments in IT and commercial systems as well as call center costs reduction); and improving sales channels with a more efficient back office. All these measures allow for the liberalization of resources that can be used for transformation, improving network and accelerating the digitalization process.

On the other hand, various factors have contributed to the fact that Telefónica has experienced a downward trend in some key financial performance indicators during the 2014-2016 period.

First, changes in foreign exchange rates, particularly in 2015 with the depreciation of the Brazilian real against the euro and the effects of the depreciation of the Venezuelan bolivar. In 2016 such currencies continued to depreciate and the Company's results were also affected by devaluations in the United Kingdom, Argentina and Mexico, adversely and significantly affecting revenue growth.

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Second, the high inflation in certain countries affected cost growth in numerous markets where Telefónica is present which were not offset by the increase in tariffs.

Third, after a period of significant expansion, Telefónica has generally reduced the scope of its activities and exited certain countries in recent years to reduce its level of indebtedness and strengthen Telefónica's capacity for future growth.

Fourth, Telefónica's business is highly regulated, which affects its revenues and imposes costs on its operations. For example, regulation sets the fixed rates that Telefónica charges for calls received from other companies' networks, and regulators have progressively lowered these rates in recent years.

Fifth, in recent years Telefónica has experienced an intense competition in the markets where it operates, resulting in more bundled offers and making it difficult to monetize value added services.

In the last two years, within the above mentioned simplification process, Telefónica has redefined its processes, readapting its resource necessities, resulting in various provisions which have affected, results in 2015 as well as in 2016.

In the 2014-2016 period these negative factors have contributed to a downward trend in some of Telefónica's key market indicators, such as the Profit for the year (-26.2% during the period). On the other hand, the positive result of the strategy with a focus on sustainable and profitable growth, is reflected in the Revenue trend during the 2014-2016 period, up 3.3%.

### E. Off-Balance Sheet Arrangements

We have commitments that could require us to make material payments in the future. These commitments are not included in our consolidated statement of financial position at December 31, 2016 although they are described in the notes to our Consolidated Financial Statements. For summary of our off-balance sheet commitments, see Note 21(b) and Note 16 to our Consolidated Financial Statements.

### F. Tabular Disclosure of Contractual Obligations

The following table describes our contractual obligations and commitments with definitive payment terms which may require significant cash outlays in the future. The amounts payable (including accrued interest payments) are as of December 31, 2016. For additional information, see our Consolidated Financial Statements.

| Millions of euros                             | Payments Due by Period |                  |               |               |                   |
|---|------------------------|------------------|---------------|---------------|-------------------|
|   | Total                  | Less than 1 year | 1-3 years     | 3-5 years     | More than 5 years |
| Financial liabilities (1)(2)                  | <b>60,361</b>          | 14,749           | 12,380        | 13,627        | 19,605            |
| Operating lease obligations (3)               | <b>10,460</b>          | 1,801            | 2,861         | 2,229         | 3,569             |
| Purchase and other contractual obligations(4) | <b>12,426</b>          | 5,391            | 3,883         | 1,204         | 1,948             |
| Other liabilities (5)                         | <b>4,944</b>           | 1,218            | 3,726         | –             | –                 |
| Total   | <b>88,191</b>          | <b>23,159</b>    | <b>22,850</b> | <b>17,060</b> | <b>25,122</b>     |

(1) Capital (finance) lease obligations are not calculated separately and are instead included as part of our long-term debt obligations.

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Estimated future interest payments as of December 31, 2016 on our interest-bearing debt (not included above) are as follows: 2,168 million euros in 2017, 1,694 million euros in 2018, 1,436 million euros in 2019, 1,185 million euros in 2020, 956 million euros in 2021 and 5,185 million euros in subsequent years. With respect to floating rate debt, we estimate future interest payments as the forward rates derived from yield curves quoted for the different currencies on December 31, 2016. This item includes the fair value of derivatives classified as financial liabilities (2) (i.e., those with a negative mark-to-market) and excludes the fair value of derivatives classified as current financial assets (1,872 million euros), and those classified as non-current (5,048 million euros) (i.e., those with a positive mark-to-market). For a more detailed description of our financial derivative transactions, see Note 16 to our Consolidated Financial Statements. For details of the composition of this item, see “Liquidity and Capital Resources—Anticipated Sources of Liquidity”).

This item includes definitive payments (non-cancellable without penalty cost). Our operating lease obligations have in some cases extension options conditioned on the applicable law of each country. Accordingly, we have included only those amounts that represent the initial contract period. At December 31, 2016, the present value of (3) future payments for operating leases was approximately 7,894 million euros (2,450 million euros in Telefónica Brazil, 1,748 million euros in Telefónica Hispanoamérica, 882 million euros in Telefónica Spain, 2,294 million euros in Telefónica Germany, 418 million euros in Telefónica United Kingdom and 102 million euros in other companies). For a more detailed information about payments due under this item, see Note 18 to our Consolidated Financial Statements.

(4) This item includes definitive payments (non-cancellable without penalty cost) due for agreements to purchase goods (such as network equipment) and services.

“Other liabilities” include: (a) long-term obligations that require us to make cash payments, excluding financial debt obligations included in the table under “Financial Liabilities” above and (b) other provisions. Because of the nature (5) of the risks covered by “Other liabilities” such as other provisions, it is not possible to determine a reliable schedule of potential payments, if any. For details of the composition of other provisions, see Note 15 to our Consolidated Financial Statements.

In addition, at December 31, 2016, we had short-term and long-term employee benefits provisions amounting to 1,002 million euros and 6,147 million euros, respectively, not included in the table above (see Note 15 to our Consolidated Financial Statements).

For details of the composition of, and changes in, our debt, see “—Liquidity and Capital Resources—Anticipated Sources of Liquidity” and Note 13 to our Consolidated Financial Statements.

Item 6. Directors, Senior Management and Employees

A. Directors and Senior Management

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During 2016, our Board of Directors met 12 times. At February 23, 2017, our Board of Directors had met two times during 2017. At February 23, 2017, our directors, their respective positions on our Board and the year they were first appointed as a director were as follows:

| Name  | Age | First Appointed | Current Term Ends |
|---|-----|-----------------|-------------------|
| <b>Chairman</b>   |     |                 |                   |
| Mr. José María Álvarez-Pallete López (1)                    | 53  | 2006            | 2017              |
| <b>Vice-Chairmen</b>  |     |                 |                   |
| Mr. Isidro Fainé Casas (1)(2)                               | 74  | 1994            | 2020              |
| Mr. José María Abril Pérez (1)(3)(6)                        | 64  | 2007            | 2018              |
| Mr. Julio Linares López (5)(8)                              | 71  | 2005            | 2020              |
| <b>Members</b>  |     |                 |                   |
| Mr. César Alierta Izuel                                     | 71  | 1997            | 2017              |
| Ms. Eva Castillo Sanz (5)(6)(8)                             | 54  | 2008            | 2018              |
| Mr. Juan Ignacio Cirac Sasturain (6)                        | 51  | 2016            | 2020              |
| Mr. José Javier Echenique Landiribar (1)(4)                 | 65  | 2016            | 2020              |
| Mr. Peter Erskine (1)(6)(7)                                 | 65  | 2006            | 2020              |
| Ms. Sabina Fluxà Thienemann (7)                             | 36  | 2016            | 2020              |
| Mr. Luiz Fernando Furlán                                    | 70  | 2008            | 2018              |
| Mr. Gonzalo Hinojosa Fernández de Angulo (1)(4)(5)(6)(7)(8) | 71  | 2002            | 2017              |
| Mr. Pablo Isla Álvarez de Tejera (7)                        | 53  | 2002            | 2017              |
| Mr. Peter Löscher (6)                                       | 59  | 2016            | 2020              |
| Mr. Antonio Massanell Lavilla (2)(4)(5)(6)(8)               | 62  | 1995            | 2020              |
| Mr. Ignacio Moreno Martínez (3)(4)(5)(8)                    | 59  | 2011            | 2017              |
| Mr. Francisco Javier de Paz Mancho (1)(4)(5)(7)             | 58  | 2007            | 2018              |
| Mr. Wang Xiaochu (9)  | 58  | 2015            | 2020              |

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- (1) Member of the Executive Commission of the Board of Directors.
- (2) Nominated by Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona (“**la Caixa**”).
- (3) Nominated by Banco Bilbao Vizcaya Argentaria, S.A. (“**BBVA**”).
- (4) Member of the Audit and Control Committee.
- (5) Member of the Regulation and Institutional Affairs Committee.
- (6) Member of the Strategy and Innovation Committee.
- (7) Member of the Nominating, Compensation and Corporate Governance Committee.
- (8) Member of the Service Quality and Customer Service Committee.
- (9) Nominated by China Unicom (Hong Kong) Limited.

Board Committees

At February 23, 2017, the committees of our Board of Directors and members thereof are as follows:

*Executive Commission*

Our Board of Directors has expressly delegated all of its authority and power to the Executive Commission except as prohibited by the Spanish Corporation Act, under our Articles of Association, or under our Board Regulations. This commission is made up of fewer directors and meets more frequently than our Board of Directors. The members of the Executive Commission are Mr. José María Álvarez-Pallete López (Chairman), Mr. Isidro Fainé Casas, Mr. José María Abril Pérez, Mr. José Javier Echenique Landiribar, Mr. Peter Erskine, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Francisco Javier de Paz Mancho and Mr. Ramiro Sánchez de Lerín García-Ovies, as secretary.

*Audit and Control Committee*

The Audit and Control Committee functions are regulated by our bylaws and our Board Regulations. The Audit and Control Committee has the primary objective of providing support to our Board of Directors in its supervisory and oversight functions, specifically having the following responsibilities:



To report to the shareholders at the General Shareholders' Meeting regarding matters raised therein for which it is responsible.

To submit to the Board of Directors proposals for the selection, appointment, re-election and replacement of the external auditor, as well as the terms and conditions of the contract therewith, and regularly obtain from such external auditor information regarding the audit plan and the implementation thereof, in addition to the preservation of its independence in the performance of its duties.

To supervise the effectiveness of the Company's internal control system, the internal audit and the systems for the management of risks, including tax risks, as well as to discuss with the auditor the significant weaknesses in the internal control system detected during the audit.

To supervise the process of preparation and submission of regulated financial information.

To establish and maintain appropriate relations with the auditor in order to receive, for review by the Committee, information on all matters that could jeopardize the independence thereof, as well as any other matters relating to the audit procedure, and such other communications as may be provided for in auditing legislation and in technical auditing regulations. In any event, the Audit and Control Committee must receive annually written confirmation from the auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as information regarding additional services of any kind provided to such entities by the auditor, or by the persons or entities related thereto, pursuant to the legislation in force.

To issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion regarding the independence of the auditor. This report must in all cases include an opinion on the provision of the additional services referred to in the preceding paragraph.

To report to the Board of Directors in advance on all matters contemplated by law, the By-Laws and the Regulations of the Board of Directors.

Any other powers granted to it under the Regulations of the Board of Directors.

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The Audit and Control Committee meets at least once per quarter and as many times as considered necessary. During 2016, the Audit and Control Committee met thirteen times and, as of the date of this Annual Report, had met two times in 2017. The members of the Audit and Control Committee are Mr. José Javier Echenique Landiribar (chairman), Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Antonio Massanell Lavilla, Mr. Ignacio Moreno Martínez and Mr. Francisco Javier de Paz Mancho. Our Board of Directors has determined that Mr. José Javier Echenique Landiribar, Mr. Antonio Massanell Lavilla and Mr. Ignacio Moreno Martínez meet the requirements of an “audit committee financial expert” as such term is defined by the SEC.

*Nominating, Compensation and Corporate Governance Committee*

The Nominating, Compensation and Corporate Governance Committee is responsible for, among other things, reporting to our Board of Directors with respect to proposals for the appointment, re-election and removal of directors, members of the Executive Commission and the other committees of our Board of Directors and top members of our management and management of our subsidiaries. In addition, the Nominating, Compensation and Corporate Governance Committee is responsible for proposing to the Board of Directors, within the framework established in the bylaws, the compensation for the directors and reviewing it periodically to ensure that it is in keeping with the tasks performed by them, as provided in Article 35 of the Board Regulations, to propose to the Board of Directors, within the framework established in the bylaws, 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 Telefónica, including the basic terms of their contracts, for purposes of contractual implementation thereof and to supervise compliance with the corporate governance rules in effect from time to time.

The members of the Nominating, Compensation and Corporate Governance Committee are Mr. Francisco Javier de Paz Mancho (chairman), Mr. Peter Erskine, Ms. Sabina Fluxà Thienemann, Mr. Gonzalo Hinojosa Fernández de Angulo and Mr. Pablo Isla Álvarez de Tejera. During 2016, the Nominating, Compensation and Corporate Governance Committee met eleven times, and as of the date of this Annual Report, it had met two times in 2017.

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***Regulation and Institutional Affairs Committee***

The Regulation and Institutional Affairs Committee was created in 2016 by merging the Regulation Committee and the Institutional Affairs Committee. The main objective of the Regulation and Institutional Affairs Committee is to monitor the main regulatory matters which affect us. Additionally, the Regulation and Institutional Affairs Committee acts as a communication and information channel between our management team and our Board of Directors concerning regulatory matters. Another responsibility is to review, report and propose to the Board of Directors the principles that are to govern the Group's Sponsorship and Patronage Policy, to monitor such policy, and to individually approve sponsorships or patronages the amount or importance of which exceed the limit set by the Board and which require its approval. The Committee is also responsible for promoting the development of the Telefónica Group's Corporate Reputation and Responsibility project and its institutional affairs.

The members of the Regulation and Institutional Affairs Committee are Mr. Julio Linares López (chairman), Ms. Eva Castillo Sanz, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Antonio Massanell Lavilla, Mr. Ignacio Moreno Martínez and Mr. Francisco Javier de Paz Mancho. During 2016, the Regulation Committee met once while the Institutional Affairs Committee met four times. Additionally, since the Regulation and Institutional Affairs Committee has been in place, there were seven meetings during 2016 and as of the date of this Annual Report the Committee has met two times in 2017.

***Service Quality and Customer Service Committee***

The Service Quality and Customer Service Committee is responsible for monitoring and reviewing the standards of quality of the main services we provide. The Service Quality and Customer Service Committee evaluates the level of quality of the services we provide to our customers. The members of the Service Quality and Customer Service Committee are Mr. Antonio Massanell Lavilla (chairman), Ms. Eva Castillo Sanz, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Julio Linares López and Mr. Ignacio Moreno Martínez. During 2016 the Service Quality and Customer Service Committee met four times and as of the date of this Annual Report has met once in 2017.

***Strategy and Innovation Committee***

In 2016, the Strategy Committee and the Innovation Committee merged into a new Committee, the so-called Strategy and Innovation Committee. Without prejudice to any other tasks that the Board of Directors may assign thereto, the primary duty of this new Committee is to support the Board of Directors in the analysis and implementation of the global strategy policy of the Telefónica Group. The Strategy and Innovation Committee is also responsible for advising and assisting in all matters regarding innovation. Its main object is to examine, analyze and periodically monitor the Group's innovation projects, provide guidance and help ensure the implementation and development of innovation initiatives across the Group. The members of the Strategy and Innovation Committee are Mr. Peter Erskine

(chairman), Mr. José María Abril Pérez, Ms. Eva Castillo Sanz, Mr. Juan Ignacio Cirac Sasturain, Mr. Gonzalo Hinojosa Fernández de Angulo, Mr. Peter Löscher and Mr. Antonio Massanell Lavilla. The Strategy Committee met four times during 2016 and the Innovation Committee met three times. Since the Strategy and Innovation Committee was created in 2016, it met seven times, and as of the date of this Annual Report, it met two times in 2017.

### *Biographies of Directors*

Mr. José María Álvarez-Pallete López serves as our Executive Chairman and Chairman of our Board of Directors. He is currently a trustee of the Telefónica Foundation and he has served, from September 11, 2011, to September 2012, as Chairman of Telefónica Europe. He began his career at Arthur Young Auditors in 1987. In 1988, he joined Benito & Monjardín/Kidder, Peabody & Co., where he held various positions in the research and corporate finance departments. In 1991, he held the “Associate” training course in New York and participated in investment projects of the GE Group in Spain. In 1995, he joined Compañía Valenciana de Cementos Portland, S.A. (Cemex) as head of the Investor Relations and Analysis department. In 1996 he was promoted to Chief Financial Officer of Cemex Group in Spain, and in 1998, to Chief Administration and Financial Officer of Cemex in Indonesia, headquartered in Jakarta, and he was appointed member of the Board of Cemex Asia, Ltd. In February 1999 he joined the Telefónica Group as General Manager of Finance for Telefónica International, S.A. In September of the same year he was promoted to Chief Financial Officer of Telefónica. In July 2002, he was appointed Chairman and Chief Executive Officer of Telefónica Internacional, S.A.; in July 2006 General Manager of Telefónica Latin America, and in March 2009, Chairman of Telefónica Latin America. He has been the Chairman of Telefónica Europa since September 2011 and a member of Telefónica’s, S.A. Board of Directors since July 2006. Since September 2012 and until April 2016, Mr. Álvarez-Pallete served as Chief Operating Officer. He has also been Chairman of the Board of Directors of Telefónica Internacional S.A.U. and of the Supervisory Board of Brasilcel, N.V and Cesky Telecom and Vice-Chairman of the Board of Directors of Telesp, S.A. and Telefónica Móviles México, S.A. He was member of the Board of Directors of the following companies: Telecomunicações de Sao Paulo; Telefónica Datacorp, S.A.; Telefónica del Perú, S.A.A.; Colombia Telecomunicaciones, ESP; Telefónica Móviles México; Telefónica Larga Distancia de Puerto Rico, S.A.; Admira Media; Inmobiliaria Telefónica; TPI; Telefónica Móviles; Telefónica Holding Argentina; Telefónica de España; Telefónica O2 Europe; Portugal Telecom and China Netcom. He was Alternate Director of the following companies: Telefónica Chile, S.A.; Telefónica Móviles Colombia, S.A.; Telefónica de Argentina, S.A.; and Telefónica Móviles Chile. He has also been Chairman of Antares, Fonditel, Telfisa and Telefónica North América, and Vice-Chairman of Telefónica del Perú. He has been awarded as ‘CFO Europe Best Practices’ at Mergers & Acquisitions in 2000, and in 2003 as Member of Merit of the Carlos III Foundation of the Iberian-American Forum. On July 2007, Mr. Álvarez-Pallete was appointed as "Gold Master in Executive Leadership" and on 2011 he received the Personality of the year in Economics Award granted by “El Economista”. On December 2013 he received the Excellence 2013 Award and Fast Company magazine named him one of the 100 most creative Personalities in Business during 2014. Mr. Álvarez-Pallete holds a degree in Economics from the Complutense University in Madrid. He also studied Economics at the Université Libre i Belgique and holds an International Management Program from the Pan-American Institute of Executive Business Administration (IPADE) and a Diplome of Advanced Studies (DEA) from the Department of Financial Economics and Accounting of the Complutense University of Madrid.

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Mr. Isidro Fainé Casas serves as Vice-Chairman of our Board of Directors. For over 40 years, Mr. Fainé has worked in several financial institutions, including amongst others: Banco Atlántico, S.A., (1964), Banco de Asunción (Paraguay) (1969), Banca Riva y García, S.A. (1973), Banca Jover, S.A. (1974), and Banco Unión, S.A. (1978). In 1982, he joined "la Caixa" as Deputy Executive General Manager, subsequently taking on various positions of responsibility. In April 1991, he was appointed Deputy Executive Managing Director and in 1999 rose to General Manager of the bank, before becoming Chairman from June 2007 to June 2014. Mr. Fainé is currently Chairman of the Board of trustees of the Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona "la Caixa", of Criteria Caixa, S.A.U., and of the Spanish Confederation of Savings Banks (CECA). He is also Chairman of the European Savings Banks Group (ESGB) and Chairman of Gas Natural, SDG, S.A. Additionally, he is Deputy Chairman of the World Savings Banks Institute (WSBI). Furthermore, he is a member of the Boards of Directors of Banco Português de Investimento, S.A. (BPI), of the Bank of East Asia and of Suez Environnement Company. He is currently the Chairman of the Spanish Confederation of Executives (CEDE), the Spanish Chapter of the Club of Rome and the Círculo Financiero. Mr. Fainé holds a Doctorate degree in Economics, a Diploma in Senior Management from IESE Business School and an ISMP certificate in Business Administration from Harvard University. He is a member of the Royal Academy of Economics and Finance and of the Royal Academy of Doctorate Holders.

Mr. José María Abril Pérez serves as Vice-Chairman of our Board of Directors. From 1975 to 1982 he served as Financial Manager of Sociedad Anónima de Alimentación (SAAL). Since then, and until he joined the Banco Bilbao Vizcaya Argentaria Group (BBVA), he was Financial Manager of Sancel-Scott Ibérica, S.A. In 1985 he joined Banco Bilbao, S.A. as Managing Director of Investment Corporate Banking. From January to April 1993, he was appointed Executive Coordinator of Banco Español de Crédito, S.A. In 1998, he became General Manager of the Industrial Group of BBV. In 1999, he was appointed member of the Executive Committee of the BBV Group. He has also been a member of the Board of Directors of Repsol, S.A., Iberia, S.A., Corporación IBV, and Vice-Chairman of Bolsas y Mercados Españoles, S.A. In 2002 he became Managing Director of the Wholesale and Investment Banking Division and a member of the Executive Committee of Banco Bilbao Vizcaya Argentaria, S.A., and he is now in retirement. He holds a degree in Economics from the University of Deusto (Bilbao, Spain) and he was professor of such University for nine years.

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Mr. Julio Linares López serves as Vice-Chairman of our Board of Directors since September 2012 and was our Chief Operating Officer from December 2007 to September 2012. He is also trustee of the Telefónica Foundation. In May 1970, he joined our Research and Development Center, where he held several positions until he was appointed head of our Technology Department in 1984. In April 1990, he was appointed General Manager of Telefónica Research and Development, S.A. In December 1994, he became Deputy General Manager of the Marketing and Services Development department in the commercial area and subsequently, Deputy General Manager for Corporate Marketing. In July 1997, he was appointed Chief Executive Officer of Telefónica Multimedia, S.A. and Chairman of Telefónica Cable and Producciones Multitemáticas, S.A. in the Telefónica multimedia business. In May 1998, he was appointed General Manager of Strategy and Technology in Telefónica, S.A. In January 2000, he was appointed Executive Chairman of Telefónica de España, S.A., being also president of certain Telefónica subsidiaries such as TELYCO or Cable, positions which he held until December 2005 when he was appointed our Managing Director for Coordination, Business Development and Synergies in Telefónica, S.A., a member of its Board of Directors and Secretary of the Executive Committee. In June 2005, Mr. Linares was appointed Chairman of the Supervisory Board of Cesky Telecom. Mr. Linares was a Director of Telecom Italia until December 13, 2013. From December 2007 to September 2012, he was CEO of Telefónica, S.A. He is currently member of the GSM Association Board. He is a trustee of the Mobile World Capital Barcelona Foundation and of the CEDE (Confederación Española de Directivos y Ejecutivos) Foundation. He is also a member of the Association Management Board for Managerial Progress, member of the Executive Committee and the Board and Chairman of the Digital Society Committee of the CEOE (Confederación Española de Organizaciones Empresariales). Furthermore, he is a member of COIT (Official College of Telecommunications Engineering), AEIT (Spanish Association of Telecommunications Engineers) and member of the Advisory council of the Higher Technical School of Engineers Telecommunications. Mr. Linares holds a degree in Telecommunications Engineering from the Polytechnic University of Madrid (Universidad Politécnica de Madrid).

Mr. César Alierta Izuel serves as a Director of our Board of Directors and the Chairman of Telefónica Foundation. Mr. Alierta began his career in 1970 as general manager of the capital markets division at Banco Urquijo, S.A. in Madrid, where he worked until 1985. Subsequently, he founded and served as Chairman of Beta Capital Sociedad de Valores, S.A. which he combined as from 1991 with his post as Chairman of the Spanish Financial Analysts' Association (Instituto Español de Analistas Financieros). Between 1996 and 2000, he was Director and Chairman of Tabacalera, S.A. At that time Tabacalera, S.A. changed its name into Altadis, S.A. (following its merger with the French Group, Seita-Société Nationale D'Éxploration Industrielle des Tabacs et Allumettes) and he became Director and Chairman of Altadis, S.A. He has also been a member of the Board of Directors of the Madrid Stock Exchange (Bolsa de Madrid), Plus Ultra Compañía de Seguros y Reaseguros, S.A., Telefónica Internacional and Iberia, S.A. In January 1997, Mr. Alierta was appointed as a Director of Telefónica and on July 26, 2000, he was appointed as our Executive Chairman, serving until April 2016. Mr. Alierta is Director of China Unicom (Hong Kong) Limited since October 15, 2008, and of International Consolidated Airlines Group (IAG) since September 2010. He is also a trustee of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona ("la Caixa"). Mr. Alierta has been a Director of Telecom Italia from November 8, 2007, to December 13, 2013. Mr. Alierta holds a Law degree from the University of Zaragoza and an MBA from Columbia University (New York) and is currently a member of the Columbia Business School Board of Overseers, and Chairman of the Social Board of the UNED (National Long Distance Spanish University).

Ms. Eva Castillo Sanz serves as a Director of our Board of Directors. Ms. Castillo began her career at the Spanish broker Beta Capital Sociedad de Valores, S.A., where she worked for five years. After that, she worked for another five years for Goldman Sachs International in London in the International Equity Markets Department. In 1997, Ms. Castillo joined Merrill Lynch as head of Equity Markets for Spain and Portugal. In 1999, she was promoted to Country Manager for Spain and Portugal and in 2000 she became Chief Executive Officer of Merrill Lynch Capital

Markets Spain. After that, Ms. Castillo was appointed Chief Operating Officer for EMEA Equity Markets. In October 2003, she was appointed head of Global Markets & Investment Banking in Spain and Portugal, as well as president of Merrill Lynch Spain. Until December 2009, she headed Global Wealth Management business operations in Europe, the Middle East and Africa, including Merrill Lynch Bank (Suisse) and the International Trust and Wealth Structuring business. She was a member of the Merrill Lynch EMEA Executive Committee, the Global Wealth Management Executive and Operating Committees. Ms. Castillo was Chairwoman of Telefónica Europe and a member of Telefónica's Executive Committee from September 2012 to February 2014. From February 2011 to February 2013, Ms. Castillo was member of the Board of Directors of Old Mutual, Plc. and since May 2010 until January 2014 she was Chairperson of the Board of Telefónica Czech Republic, a.s. Currently, Ms. Castillo is the Chairperson of the Supervisory Board of Telefónica Deutschland Holding AG, member of the Board of Directors of Bankia, S.A., of Visa Europe and of the Telefónica Foundation. She is also a member of the Board of the Comillas-ICAI Foundation and member of the Board of Entreculturas Foundation. Ms. Castillo holds degrees in Business and Law (ICADE – E3) from the Universidad Pontificia de Comillas of Madrid.

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Mr. Juan Ignacio Cirac Sasturain serves as a Director of our Board of Directors. Mr. Cirac began his career as full professor at the Applied Physics Department of Castilla La Mancha University, after which he became a research associate at the Joint Institute for Laboratory Astrophysics of University of Colorado (1993-1994). In 1996, he was tutoring at Institut für Theoretische Physik of Leopold Franzens Universität Innsbruck, until 2001, since when Mr. Cirac became Director of the Theory Division of Max-Planck Institut für Quantenoptik and member of the Max Planck society. Since 2002, he held the title of Honorarprofessor at Technical University of Munich and during 2014 and 2015 Mr. Cirac was the Managing Director of the Technical University of Munich. Since 2016, Mr. Cirac is a speaker of the International Max-Planck Research School Quantum Science and Technology. Among other activities since 2015 he is a member of the Advisory Board of the Institute for the Interdisciplinary Information Sciences at Tsinghua University, and a member of the Advisory Board of the Russian Quantum Center since 2012. Mr. Cirac is also a member of the Advisory Board of Annalen der Physik, as well as of the Review Panel, QSIT of Swiss National Science Foundation. He has received several awards, such as the Hamburg Prize for Theoretical Physics, the Medal of Honor of Fundación García Cabrerizo or the Wolf Prize in Physics. He holds degree in Theoretical Physics from Universidad Complutense de Madrid as well as a Ph.D. in Physics from such University. He is specialized in Theoretical Quantum Optics, Quantum Information, Atomic Physics, and Quantum Many- Body Physics.

Mr. José Javier Echenique Landiribar serves as a Director of our Board of Directors. Mr. Echenique has been a Board Member and General Director of Allianz-Ercos as well as a General Director of BBVA Group, where he was responsible for wholesale business like Global Investment Banking or Global Corporate Banking among others. He has also been Member of the Board of Directors of Telefónica Móviles, S.A. and Telefónica Móviles México. Mr. Echenique was President of Banco Guipuzcoano as well as Board of Sevillana de Electricidad, S.A., Acesa and Hidroeléctrica del Cantábrico, Corporation IBV and Metrovacesa. Furthermore, he used to be Member of the Board of Corporación Patricio Echeverría, Grupo BBVA Seguros, Grupo Edhardt, Uralita, Grupo Porres (Mexico) and Abertis Infraestructuras, S.A. Mr. Echenique is currently Vice-President of the Board of Directors of Banco Sabadell, S.A. He is also Board Member of Repsol, S.A., ACS Actividades de Construcción y Servicios, S.A., ACS Servicios, Comunicaciones y Energía, S.L. and Grupo Empresarial ENCE, S.A. He holds degrees in Economics and Actuarial Sciences from Basque Country University (UPV), where he was a professor of Social Security's Quantitative Techniques of the Economic Sciences School of Bilbao for several years.

Mr. Peter Erskine serves as a Director of our Board of Directors. He began his career in the field of marketing in Polycell and in Colgate Palmolive. He worked for several years at the Mars Group, serving as Vice-Chairman for Europe of Mars Electronics. In 1990 he was appointed Vice-Chairman of Marketing and Sales of Unitel. From 1993 to 1998, he held a number of senior positions, including Director of British Telecom (BT) Mobile and President and Chief Executive Officer of Concert. In 1998 he became Managing Director of BT Cellnet. Subsequently, in 2001 he became Chief Executive Officer and a Director of the Board of Directors of Telefónica Europe, Plc. In 2006 he became Executive Chairman of Telefónica Europe, Plc (until December 31, 2007, after which he became a Non-Executive Director) and from July 2006 until December 2007 he served as General Manager of the business unit Telefónica Europe. In January 2009 he joined the Board of Ladbrokes Plc. as a Non-Executive Director until December 2015, becoming Chairman in May 2009. He stood down from the Board in December 2015, having taken a lead role in the merger of Ladbrokes PLC with Gala Coral Group. Currently, he is Chairman of the Henley Business School Strategy Board, member of the Council of Reading University and also serves as a member of the University's Strategy and Finance Committee. Since May 2016, he serves as member of the Supervisory Board of Telefónica Deutschland Holding AG. In 1973, he received a degree in Psychology from Liverpool University and he holds an Honorary Doctorate from University of Reading.



Ms. Sabina Fluxà Thienemann serves as a Director of our Board of Directors. Ms. Fluxà has also completed a High Business Management Program at IESE. In January 2005, she joined Iberostar Group, where she is currently the Co-Vice Executive President and CEO. She is also Regional Advisory Board Member of BBVA and Member of the Board of Directors of APD Illes Balears, as well as the Sponsor of Iberostar Foundation and Eneavor Foundation. She has received from ESADE a degree in Business Management and Administration and an MBA.

Mr. Luiz Fernando Furlán serves as a Director of our Board of Directors. He is currently a member of the Board of Directors of Telefônica Brasil, S.A., BRF-Brasil Foods, S.A. (Brazil) and AGCO Corporation (USA). Throughout his career he has been a member of the Board of Directors of several companies in Brazil and abroad such as Chairman of Sadia, S.A., Co-Chairman of BRF-Brasil Foods, S.A., member of the Advisory/ Consultive Board of Panasonic (Japan) and Wal-Mart (USA) and a member of the Advisory/Consultive Board of Abertis Infraestructuras, S.A. (Spain). From 2003 to 2007 he was Minister of Development, Industry and Foreign Trade of Brazil. He holds a degree in Chemical Engineering from the Industrial Engineering Faculty of São Paulo and in Business Administration from University of Santana (São Paulo), with specialization in financial administration from Fundação Getúlio Vargas (São Paulo).

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Mr. Gonzalo Hinojosa Fernández de Angulo serves as a Director of our Board of Directors and of Telefónica del Perú, S.A.A. He began his career in 1966 in Cortefiel, S.A. and served in several management positions since then. From 1976 to 1985 Mr. Hinojosa was General Manager of Cortefiel, S.A. and from 1985 until 2005 he served as Chief Executive Officer of Cortefiel Group, a post which he combined with his appointment as Chairman from 1998 until 2006. From 1991 through 2002, he served as a Director of Banco Central Hispano Americano, S.A. and as a Director of Portland Valderribas, S.A. He has also served as a Director of Altadis, S.A. (1998-2007). He received on 1986 Manager of the Year by Revista Mercado and the Best Manager award by the Marketing School on 1988. He was also awarded as Best Manager of Madrid in 1991 and the GQ 2005 Prize to the best professional career. Mr. Hinojosa has a degree in Industrial Engineering from the Industrial Engineers Technical School of the Polytechnic University of Madrid (Escuela Técnica Superior de Ingenieros Industriales de la Universidad Politécnica de Madrid).

Mr. Pablo Isla Álvarez de Tejera serves as a Director of our Board of Directors. Mr. Isla began his career in 1989 as a State's Attorney (abogado del Estado), holding the first position of his class. He joined the Body of State's Attorneys that year and was assigned to the Spanish Ministry of Transportation, Tourism and Communications. In 1991 he moved to the General Management of the Legal Services of the Spanish Government (Dirección General del Servicio Jurídico del Estado). From 1992 to 1996, Mr. Isla served as General Manager of the Legal Services Department of Banco Popular, S.A. In 1996, he was appointed General Manager of the National Heritage Department of the Treasury Department of Spain (Ministerio de Economía y Hacienda). He also served as General Secretary of Banco Popular Español, S.A. from 1998 to 2000. In July 2000, Mr. Isla was appointed Chairman of the board of Grupo Altadis and Co-Chairman of such company. In June 2005, Mr. Isla was appointed the Deputy Chairman and Chief Executive Officer of Inditex, S.A. Since 2011, Mr. Isla is the current Chairman and CEO of Inditex, S.A. Mr. Isla has a degree in Law from the Complutense University of Madrid.

Mr. Peter Löscher serves as a Director of our Board of Directors. Mr. Löscher was the President of Global Human Health and a Member of the Executive Board of Merck & Co., CEO of GE Healthcare Bio – Sciences and Member of GE's Corporate Executive Council. He was also COO and member of the Board of Amersham Plc. Senior leadership position in Aventis and Hoeschst. From 2014 to 2016, he was the CEO of Renova Management AG. Currently, Mr. Löscher is Chairman of the Supervisory Board of OMV Aktiengesellschaft, and of Sulzer AG, and Member of the Supervisory Board of Deutsche Bank AG. He is also Honorary Professor at Tongi University Shanghai and he holds the Grand Decoration of Honor in Gold of the Republic of Austria, the Order of Friendship of the Russian Federation and is Knight Commander of the Order of Civil Merit of Spain. Mr. Löscher studied Economics at Vienna University of Economics, where he also got his MBA, and Business at the Chinese University of Hong Kong. He completed the Advanced Management Program (AMP) at Harvard Business School and an Honorary Doctorate of Engineering from Michigan State University and is Doctor Honoris Causa of Slovak University of Engineering in Bratislava.

Mr. Antonio Massanell Lavilla serves as a Director of our Board of Directors. In 1971 he joined the Caja de Ahorros y Pensiones de Barcelona ("La Caixa"), where he held several posts and in 1990, he was appointed Assistant Manager and Secretary of the Steering Committee, and from 1999 to June 2011 he served as Executive General Assistant Manager. From 1990 to 1992 he served as member of the board of Directors of Sociedad Española de Medios de Pago, S.A. and as Chairman of the Steering Committee of Sistema 6000 de la Confederación Española de Cajas de Ahorros. He was appointed Director of Visa Spain (1995-1998), Director of Autema (1991-2003), Director of Inmobiliaria Colonial (1992-2003), Director of Baqueira Beret (1998-2006), Director of Occidental Hotels Management, B.V. (2003-2007), Chairman of Port Aventura Entertainment, S.A. (2009-2012) and Vice Chairman of Mediterránea Beach & Golf

Community, S.A. (2009-2016). He also served as Chairman of Barcelona Digital Centre Tecnològic (former Fundació Barcelona Digital) and as member of the Board of Directors of Boursorama, S.A. Mr. Massanell has been Deputy Chairman of Caixa Bank since June 2014. He is currently member of the Board of Directors of SAREB (Sociedad de Gestión de Activos Inmobiliarios procedentes de la Reestructuración Bancaria), member of the Supervisory board of ERSTE Group Bank AG, as well as Director of Repsol, S.A. He is also Non-Executive Chairman of Cecabank. He is Vice-Chairman of the Board of Trustees of COTEC, Chairman of the Barcelona Centre Financer Europeu association, member of the Plenary Body of the Chamber of Commerce of Barcelona and member of Euro Retail Payments Board (ERPB). Mr. Antonio Massanell Lavilla holds a degree in Economics from the University of Barcelona.

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Mr. Ignacio Moreno Martínez serves as a Director on our Board of Directors. Previous posts include head of Corporate Banking and Private Equity at Banco de Vizcaya, Banco Santander de Negocios, and Mercapital. He also served as Deputy General Manager of Corporate and Institutional Banking at Corporación Bancaria de España, S.A. – Argentaria, Chief Executive Officer of Desarrollo Urbanístico Chamartín, S.A., and Chairman of Argentaria Bolsa, Sociedad de Valores. In addition, he also served as General Manager of the Chairman’s Office at Banco Bilbao Vizcaya Argentaria, S.A., Chairman Executive Officer of Vista Capital Expansión, S.A., SGEGR – Private Equity and Chairman Executive Officer of N+1 Private Equity. Mr. Moreno is currently Chairman of Testa Residencial, Socimi, S.A., of Metrovacesa Suelo y Promoción, S.A., Metrovacesa Promoción y Arrendamiento, S.A., and representative of Sociedad Cardomana Servicios y Gestiones, S.L. in the Board of Directors of Secuoya Grupo de Comunicación, S.A. Mr. Moreno is also Senior Advisor of BC Partners Ltd. Mr. Moreno holds a degree in Economics and Business Studies from the University of Bilbao, and a Master’s degree in Marketing and Sales Management from the Instituto de Empresa and an MBA from INSEAD.

Mr. Francisco Javier De Paz Mancho serves as a Director of our Board of Directors. From 1984 to 1993 he was the General Secretary of Juventudes Socialistas and the member of the PSOE Executive. From 1990 to 1993, he was general secretary of the Spanish Consumers Association (Unión de Consumidores de España, UCE). From 1993 to 1996, he served as General Manager of Internal Trade of the Spanish Ministry of Tourism and Commerce and Director of Tabacalera, S.A. From 1994 to 1996, he was Chairman of the Observatory of Trading of the Spanish Ministry of Tourism and Commerce (Observatorio de la Distribución Comercial del Ministerio de Comercio y Turismo); from 1996 to 2004, he was Corporate Strategy Manager of the Panrico Donuts Group and Deputy Chairman. From 1998 to 2004, he served as Director of Mutua de Accidentes de Zaragoza (MAZ). From 2004 to 2006, he was Director of Tunel de Cadí, S.A.C. and from 2003 to 2004, he served as Chairman of the Patronal Pan y Bollería Marca (COE). From 2004 to 2007, he was Chairman of the National Company MERCASA. He has also been a member of the Board of Directors of Altadis, S.A., and of the Economic and Social Board and its Permanent Commission. From July 2006 to November 2014, he has been a member of the Executive Committee of the Chambers Board (Consejo Superior de Cámaras) and from 2008 to 2012 he has been the Chairman of Atento Inversiones y Teleservicios, S.A.U. Currently, he is Director of Telefónica de Argentina, S.A. Telefônica Brasil, S.A. and Telefónica Móviles México, S.A. de C.V. He is also Chairman of Telefónica Ingeniería de Seguridad, S.A.U. Mr. de Paz has a diploma in Publicity and Information and undertook studies in Law. He completed a Programa de Alta Dirección de Empresas from the IESE Business School (Instituto de Estudios Superiores de la Empresa, University of Navarra).

Mr. Wang Xiaochu serves as a Director of our Board of Directors. Prior to joining Telefónica, Mr. Wang served as Deputy Director General and Director General of the Hangzhou Telecommunications Bureau in Zhejiang province; Director General of the Tianjin Posts and Telecommunications Administration; Chairman and Chief Executive Officer of China Mobile (Hong Kong) Limited; Vice President of China Mobile Communications Corporation; an Executive Director, Chairman and Chief Executive Officer of China Telecom Corporation Limited; President and Chairman of China Telecommunications Corporation; and Chairman and Non-executive Director of China Communications Services Corporation Limited. Furthermore, Mr. Wang serves as the Chairman of China United Network Communications Group Company Limited, and as an Executive Director, Chairman and Chief Executive Officer of China Unicom (Hong Kong) Limited. He is a professor level senior engineer, graduated from Beijing Institute of Posts and Telecommunications in 1989 and he received a doctorate degree in Business Administration from the Hong Kong Polytechnic University in 2005.

Executive Officers/Management Team

At February 23, 2017, our executive management team consisted of the following individuals:

| Name                                     | Position   | Appointed | Age |
|--|--|-----------|-----|
| Mr. José María Álvarez-Pallete López     | Chairman of the Board of Directors and Chief Executive Officer | 2016      | 53  |
| Mr. Guillermo Ansaldo Lutz               | Chief Global Resources Officer                                 | 2011      | 55  |
| Mr. Ramiro Sánchez de Lerín Garcia-Ovies | General Legal Secretary and Secretary to the Board             | 2005      | 62  |
| Mr. Angel Vilá Boix                      | Chief Strategy and Finance Officer                             | 2011      | 52  |
| Mr. Mariano de Beer                      | Chief Commercial Digital Officer                               | 2017      | 46  |
| Mr. Juan Francisco Gallego Arrechea      | General Manager of Internal Audit                              | 2016      | 50  |

Biographies of the Executive Officers and Senior Management

We present below the biographies of our executive officers and senior management who do not also serve on our Board of Directors.

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Mr. Guillermo Ansaldo Lutz serves as Chief Global Resources Officer (CGRO) of Telefónica Global Resources operating unit since September 2011, he is also member of the Executive Committee of Telefónica. From 1989 to 2000 he worked for McKinsey & Company holding different positions in Spain and Argentina. In 1995, he was appointed partner of McKinsey & Company in Argentina. From 2000 to 2004 he was the Chief Executive Officer of Telefónica de Argentina, S.A. and since April 2005, he held the position of Chief Executive Officer of Telefónica de España, S.A. From December 2007 to September 2011 he was Chairman and Chief Executive Officer of Telefónica de España, S.A. He holds a degree in Industrial Engineering from the Universidad de Buenos Aires and an MBA from The Amos Tuck School of Business Administration, Dartmouth College.

Mr. Ramiro Sánchez de Lerín García-Ovies serves as our General Secretary and Secretary to our Board of Directors. He is also a member of the Executive Committee. He began his career in Arthur Andersen, first working for its audit department and later for its tax department. In 1982, he became a State's Attorney (Abogado del Estado) and started working for the local tax authorities in Madrid (Delegación de Hacienda de Madrid). Afterwards he was assigned to the State Secretariat for the European Communities and later to the Foreign Affairs Ministry. He has been General Secretary and Secretary of the Board of Elosúa, S.A., Tabacalera, S.A., Altadis, S.A. and Xfera Móviles, S.A. He has also held teaching positions in Instituto Católico de Administración y Dirección de Empresas (ICADE), Instituto de Empresa and Escuela de Hacienda Pública.

Mr. Ángel Vilá Boix is Chief Strategy and Finance Officer and member of the Executive Committee at Telefónica, S.A. He currently is a Board member in listed subsidiaries Telefónica Germany and Telefónica Brazil, as well as a Trustee in the Telefónica Foundation. Mr. Vilá joined Telefónica in 1997. He held positions of Group Controller, CFO of Telefónica Internacional, Group Head of Corporate Development and Chief Financial and Corporate Development Officer. In 2015 he was appointed Chief Strategy and Finance Officer. In his tenure, Ángel Vilá has executed landmark corporate transactions such as the acquisitions of O2, Vivo, EPlus, GVT, Telco/TI or the Telefonica Germany IPO. Prior to joining Telefónica, he held positions at Citigroup, McKinsey&Co, Ferrovial and Planeta. In the financial sector, he has served in the Board of directors of Banco Bilbao Vizcaya Argentaria (BBVA) and on the Advisory Panel of Macquarie MEIF Infrastructure funds. In the TMT sector, he was Chairman of Telefónica Contenidos, Vice Chairman of Telco Spa (Italy) and Board member of Endemol, Digital+, Atento, Telefonica Czech, CTC Chile, Indra SSI and Terra Lycos. Institutional Investor nominated Ángel Vilá as the Best CFO in European Telecoms in 2015. He was also honored with the Thomson Reuters Extel Pan-European Awards as No.1 CFO in Spain both in 2013 and 2014, as well as No.1 CFO for Telecommunications in Europe in 2014. Mr. Ángel Vilá holds a MBA from Columbia Business School where he studied with a Fulbright La Caixa fellowship. He was distinguished in the Beta Gamma Sigma Honor Society and the Dean's List. Prior to Columbia University, he graduated in Industrial Engineering from Universitat Politècnica de Catalunya in Barcelona.

Mr. Mariano de Beer is the Chief Commercial Digital Officer of Telefónica S.A. In this role, he is responsible for driving revenue growth globally, developing a holistic view for the consumer and enterprise segments, curating the commercial offer and evolving the channels to ensure the best commercial experience for Telefónica customers. He is in charge of innovation within the group. Mr. De Beer is member of the Telefónica Group Executive Committee. During the last years, he has held the position of President of Microsoft Brazil and most recently President of Microsoft Latam – New Markets, after a solid, successful career in the telecommunications industry. Mariano joined Telefónica's team in Brazil in 1998 from McKinsey & Co., where he held a variety of positions within the company, mainly in the Residential and SME segments. In 2006, he joined the Senior Management Committee of Telefónica

International as Director of SME for Latin America, until 2008, when he returned to Brazil as CEO of Telefónica and subsequently Chairman of the Vivo Corporate Unit. After leaving Telefónica and before joining Microsoft, he worked in the RBS Brazilian conglomerate, where he led the Education Unit of the group as CEO, with the mission of expanding and strengthening the Education Project of RBS. Mariano graduated from UADE in Argentina, obtained an MBA from Georgetown University and he has completed Executive Programs at INSEAD, IESE and Stanford University School of Business.

Mr. Juan Francisco Gallego Arrechea is the Chief Audit Executive of the Telefónica Group since 2016. He began his career in Arthur Andersen, where he specialized in audit and financial consulting for business groups. In June 2000, he joined the Telefónica Group working as the Chairman of Consolidation and Accounting Policies and serving, from 2009, as Chief Accounting Officer. Mr. Gallego is speaker and member of work teams in several master programs, conferences and courses on the matter of audit, consolidation and accounting practices held by regulators, private institutions and universities. He obtained a degree in Economic Science at Universidad Complutense in Madrid.

#### B. Compensation

Please see Note 21(f) and Appendix II to our Consolidated Financial Statements for information on the compensation paid to members of our Board of Directors and Executive Officers/Senior Management Team during the year 2016.

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Incentive Plans

Please see Note 19 to our Consolidated Financial Statements.

C. Board Practices

Please see “—Directors and Senior Management” above.

D. Employees

Please see “Headcount” in Note 18 to our Consolidated Financial Statements.

In 2015 Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U. and Telefónica Soluciones de Informática y Comunicaciones de España, S.A.U. signed the first Collective Agreement of Related Companies (CEV). This agreement contemplated, among other elements, a plan of measures for individual suspension of the employment relationship in 2016 and 2017. In December 2016, the CEV was extended until 2018, by virtue of the provisions of this same agreement. In 2016, the expense relating to the forecast payments to meet the commitments resulting from the extension of this program was recognized. A total of 789 million euros were recorded for the Individual Suspension Plan in 2016 (2,896 million euros in 2015) (see Note 15 to our Consolidated Financial Statements).

E. Share Ownership

At February 23, 2017, the following members of our Board of Directors beneficially owned directly or indirectly an aggregate of 8,792,360 shares, representing approximately 0.1794% of our capital stock.

| Name or corporate name of director | Number of direct voting rights | Number of indirect voting rights | % of total voting rights |
|------------------------------------|--------------------------------|----------------------------------|--------------------------|
|                                    | 1,230,745                      | -                                | 0.025                    |



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|   |           |         |       |
|---|-----------|---------|-------|
| Mr. José María Álvarez-Pallete<br>López     |           |         |       |
| Mr. Isidro Fainé Casas                      | 595,382   | -       | 0.012 |
| Mr. José María Abril Pérez                  | 157,077   | 158,211 | 0.006 |
| Mr. Julio Linares López                     | 480,889   | 8,440   | 0.010 |
| Mr. César Alierta Izuel                     | 5,505,144 | -       | 0.112 |
| Ms. Eva Castillo Sanz                       | 113,594   | -       | 0.002 |
| Mr. Juan Ignacio Cirac Sasturain            | -         | -       | 0.000 |
| Mr. José Javier Echenique<br>Landiribar     | 31,850    | 75,712  | 0.002 |
| Mr. Peter Erskine                           | 42,733    | -       | 0.001 |
| Ms. Sabina Fluxà Thienemann                 | -         | -       | 0.000 |
| Mr. Luiz Fernando Furlán                    | 38,423    | -       | 0.001 |
| Mr. Gonzalo Hinojosa Fernández<br>de Angulo | 51,135    | 206,815 | 0.005 |
| Mr. Pablo Isla Álvarez de Tejera            | 10,294    | -       | 0.000 |
| Mr. Peter Löscher                           | -         | -       | 0.000 |
| Mr. Antonio Massanell Lavilla               | 2,743     | -       | 0.000 |
| Mr. Ignacio Moreno Martínez                 | 18,311    | -       | 0.000 |
| Mr. Francisco Javier de Paz<br>Mancho       | 64,862    | -       | 0.001 |
| Mr. Wang Xiaochu                            | -         | -       | 0.000 |

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At February 23, 2017, members of our executive management team (excluding members of our Board of Directors listed above) beneficially owned an aggregate of 1,172,069 of our shares, representing approximately 0.024 % of our capital stock.

None of our directors or executive officers beneficially owned shares representing one percent or more of our share capital at February 23, 2017.

None of our directors and executive officers held options in respect of shares representing one percent or more of our share capital at February 23, 2017.

Please see “Share-based payment plans” in Note 19 to our Consolidated Financial Statements.

Item 7. Major Shareholders and Related Party Transactions

A. Major Shareholders

General

At February 23, 2017, we had 5,037,804,990 shares outstanding, each having a nominal value of 1.00 euro per share. All outstanding shares have the same rights.

At February 23, 2017, according to information provided to us or to the Spanish National Securities Commission (Comisión Nacional de Mercado de Valores or the “CNMV”), beneficial owners of 3% or more of our voting stock were as follows:

| Name of Beneficial Owner   | Number of Shares |             | Percent |
|--|------------------|-------------|---------|
|  | Direct           | Indirect    |         |
| Banco Bilbao Vizcaya Argentaria, S.A.(1)                                       | 318,861,940      | -           | 6.32%   |
| Fundación Bancaria Caixa d’ Estalvis i Pensions de Barcelona (“la Caixa”)(2) - |                  | 259,651,258 | 5.15%   |

Blackrock, Inc.(3) - 336,154,823 6.70%

(1) Based on the information provided by Banco Bilbao Vizcaya Argentaria, S.A. as at December 31, 2016 for the 2016 Annual Report on Corporate Governance.

(2) Based on information provided by Fundació Bancaria Caixa d' Estalvis i Pensions de Barcelona ("la Caixa") as at December 31, 2016 for the 2015 Annual Report on Corporate Governance. The indirect shareholding is held by Caixabank, S.A. which owns 259,461,788 shares and by Vidacaixa, S.A. de Seguros y Reaseguros which owns 189,470 shares.

(3) According to the form on Schedule 13G filed on January 30, 2017 with the SEC. Though the reported beneficial ownership Blackrock, Inc. has sole voting power with respect to 304,764,164 shares (representing 6.04% of Telefónica's share capital as of the date of this Annual Report) and has shared power to vote with respect to 24,700 shares (representing 0.66% of Telefónica's share capital as of the date of this Annual Report).

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To the extent that our shares are represented by account in the book-entry form, we do not keep a shareholder registry and our ownership structure cannot be known precisely. Based on the information available to us there is no individual or corporation that directly or indirectly through one or more intermediaries may exercise any type of control over us. Nevertheless, we have certain shareholders whose holdings are considered material.

### Ownership Limitations

There are no limitations with respect to the ownership of our assets or share capital except those related to assets derived from the application of the reciprocity principle. Article 6 of the General Telecommunications Law, or the GTL, provides for the application of the reciprocity principle under existing international treaties or agreements signed and ratified by Spain. The Spanish government, upon request, may authorize exceptions to the reciprocity principle contained in the GTL.

### B. Related Party Transactions

During 2014, 2015 and 2016 and through the date of this Annual Report, the Directors and senior executives did not enter into any transaction with Telefónica, S.A. or any Telefónica Group company other than those in the Group's normal trading activity and business.

Our Board of Directors' Regulations grant the Board of Directors the exclusive power to authorize any transactions with major shareholders or with our directors. Prior to authorizing any such transaction, our Board will receive an opinion from the Nominating, Compensation and Corporate Governance Committee addressing the fairness of the transaction to our shareholders and us. Any of our directors that may have an interest in the proposed transaction must abstain from voting on the proposed transaction.

Please see Note 10 to our Consolidated Financial Statements for further information.

### Related Party Transactions with Significant Shareholders

Two of our major shareholders are financial institutions (see “—Major Shareholders—General” above). We have entered into related party transactions with both companies within our ordinary course of business, and always on arm's length terms. During 2016 and through the date of this Annual Report, the executed transactions were generally loans, capital markets or derivative transactions provided to us by these financial institutions and agreements for us to provide

telecommunications and broadband services to such institutions.

Please see Note 10 to our Consolidated Financial Statements for further information.

#### Intra-Group Loans

We are the parent company of the Telefónica Group and operate through our subsidiaries and affiliated companies. We coordinate group policies, including financial policy and, in some cases, actual financial management is conducted by us. Most of the transactions we perform with other members of the Telefónica Group relate to financing transactions, including covering their needs for funds and providing interest rate and exchange rate hedges.

At December 31, 2016, as recorded in our parent company accounts, we loaned a total of 5,671 million euros (9,142 million euros at December 31, 2015) to companies of the Telefónica Group while companies of the Telefónica Group and their associates loaned us a total of 49,583 million euros (48,738 million euros at December 31, 2015), of which 10,620 million euros (8,560 million euros at December 31, 2015) was loaned to us by Telefónica Europe, B.V. and 34,742 million euros (36,937 million euros at December 31, 2015) was loaned to us by Telefónica Emisiones S.A.U., our financing subsidiaries devoted to raising funds in the capital markets, 3,577 million euros (2,571 million euros at December 31, 2015) was loaned by us to Telfisa Global, B.V., our financing subsidiary charged with centralizing and managing the cash pooling of our subsidiaries in Latin America, Europe and the United States and 644 million euros (145 million euros at December 31, 2015) was loaned to us by Telefónica Participaciones, S.A.U..

With respect to the balances with associated companies, the line item “Non-current financial assets” on the consolidated statement of financial position at December 31, 2016, includes “Loans to Associates” amounting to 16 million euros (21 million euros at December 31, 2015).

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C. Interests of Experts and Counsel

Not applicable.

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Item 8. Financial Information

Consolidated Financial Statements

Please see Item 18.

Legal Proceedings

Telefónica and its group companies are party to several legal proceedings which are currently in progress in the courts of law and the arbitration bodies of the various countries in which we are present.

Based on the advice of our legal counsel we believe it is reasonable to assume that these legal proceedings will not materially affect the financial condition or solvency of the Telefónica Group.

The following unresolved legal proceedings or those underway in 2016 are highlighted (see Note 17 to the Consolidated Financial Statements for details of tax-related cases):

**Appeal against the decision by Agência Nacional de Telecomunicações (“ANATEL”) regarding the inclusion of interconnection and network usage revenues in the Fundo de Universalização de Serviços de Telecomunicações**

Vivo Group operators (currently Telefônica de Brasil), together with other cellular operators, appealed ANATEL’s decision of December 16, 2005, to include interconnection and network usage revenues and expenses in the calculation of the amounts payable into the Fund for Universal Access to Telecommunications Services (“FUST”) – a fund which pays for the obligations to provide Universal Service -with retroactive application from 2000. On March 13, 2006, Regional Federal Court no. 1. granted a precautionary measure which stopped the application of ANATEL’s decision. On March 6, 2007, a ruling in favor of the wireless operators was issued, stating that it was not appropriate to include the revenues received by transfer from other operators in the taxable income for the FUST’s calculation and rejecting the retroactive application of ANATEL’s decision. On January 26, 2016, ANATEL filed an appeal to overturn this decision with Brasilia Regional Federal Court no. 1.

At the same time, Telefônica Brasil and Telefónica Empresas, S.A., together with other wireline operators through ABRAFIX (Associação Brasileira de Concessionárias de Serviço Telefônico Fixo Comutado) appealed ANATEL's decision of December 16, 2005, also obtaining the precautionary measures requested. On June 21, 2007, Federal Regional Court no. 1 ruled that it was not appropriate to include the interconnection and network usage revenues in the FUST's taxable income and rejected the retroactive application of ANATEL's decision. ANATEL filed an appeal to overturn this ruling on April 29, 2008, before Brasília Federal Regional Court no. 1, which was dismissed on May 10, 2016. ANATEL filed an appeal against this dismissal.

The fixed operators filed an appeal to clarify that revenues obtained through interconnection and dedicated line operation should not be included in the calculation of the amounts payable to the FUST. In addition, the court was also requested to rule on two grounds which had not been analyzed in the initial decision: (i) that the FUST has become obsolete, among other reasons, by the advance of mobile telephony; and (ii) that amounts collected are not applied to the purpose for which the FUST was created, since only a very low percentage of the revenues collected by the FUST is used to finance fixed telephony. Although the petition for clarification was dismissed on August 23, 2016, the court noted that the FUST should not be funded with revenues from interconnection and dedicated line operation.

The amount of the claim is quantified at 1% of the interconnection revenues.

#### **Public civil procedure by the São Paulo government against Telefônica Brasil for alleged reiterated malfunctioning in services provided**

This proceeding was filed by the Public Ministry of the State of São Paulo for alleged reiterated malfunctioning in the services provided by Telefônica Brasil, seeking compensation for damages to the customers affected. A general claim was filed by the Public Ministry of the State of São Paulo, for 1 billion Brazilian reais (approximately 225 million euros), calculated on the company's revenue base over the last five years.

In April 2010, a ruling against the Telefónica Group was issued in first instance. The full impact of this proceeding will not be known until there is a final ruling, and the total amount of persons affected by and party to the proceeding is known. At that moment, the amount of the indemnity will be established, ranging between 1 billion and 60 million reais (approximately, between 225 and 13 million euros), depending on the number of parties. On May 5, 2010, Telefônica Brasil filed an appeal before the São Paulo Court of Justice, suspending the effect of the ruling.



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On April 13, 2015, the appeal was judged in favor of Telefónica, by unanimous vote, reversing the earlier decision in first instance.

The Public Prosecutor filed an extraordinary petition for review at the High Court of Brasilia which refused to consider the petition due to the lack of legal requirements. A new appeal may be filed against such refusal.

**Appeal against the Decision of the EC dated January 23, 2013 to sanction Telefónica for the infringement of Article 101 of the Treaty on the functioning of the European Union**

On January 19, 2011, the EC initiated formal proceedings to investigate whether Telefónica, S.A. (Telefónica) and Portugal Telecom SGPS, S.A. (Portugal Telecom) had infringed European Union anti-trust laws with respect to a clause contained in the sale and purchase agreement of Portugal Telecom's ownership interest in Brasilcel, N.V., a joint venture in which both were venturers and which was the owner of the Brazilian company Vivo.

On January 23, 2013, the EC passed a ruling on the formal proceedings. The ruling imposed a fine on Telefónica of 67 million euros, as the EC ruled that Telefónica and Portugal Telecom committed an infraction of Article 101 of the Treaty on the Functioning of the European Union for having entered into the agreement set forth in Clause Nine of the sale and purchase agreement of Portugal Telecom's ownership interest of Brasilcel, N.V.

On April 9, 2013, Telefónica filed an appeal for annulment of this ruling with the European Union General Court. On August 6, 2013, the European Union General Court notified Telefónica of the response issued by the EC, in which the EC reaffirmed the main arguments of its ruling and, specially, that Clause Nine includes a competition restriction. On September 30, 2013, Telefónica filed its reply. On December 18, 2013, the EC filed its appeal.

A hearing was held on May 19, 2015, at the European Union General Court.

On June 28, 2016, the European Union General Court ruled. Although it declares the existence of an infringement of competition law, it annuls Article 2 of the contested Decision and requires the EC to reassess the amount of the fine imposed. The General Court considers that the EC has not neutralized the allegations and evidences provided by Telefónica on services in which there was not potential competition or were outside the scope of Clause Nine.

Telefónica understands that there are grounds for believing that the ruling does not suit at law; consequently, it filed an appeal to the Court of Justice of the European Union, on September 11, 2016.

On November 23, 2016, the EC filed its response against the Telefónica's appeal. On January 30, 2017, Telefónica filed its response.

**Claim of consumers association "FACUA" against Telefónica de España in connection with the increase of the price of Movistar Fusión**

On September 5, 2016, notification was given to Telefónica de España of a claim filed against it by the consumers association ("FACUA").

Through such claim, the association exercises an action to protect consumers' and users' collective interests stipulated in articles 11 of the Civil Procedure Act (*Ley de Enjuiciamiento Civil*) and 24.1 of the Consumer and Users Protection Act (*Ley General de Defensa de los Consumidores y Usuarios*) on the basis of alleged disloyalty towards the consumers, arising from the raising of the prices of the product "Movistar Fusión" from May 5, 2015, by an amount of 5 euros per month.

The claim contains a declaratory statement stating that disloyalty arises from misleading advertising regarding the price rise and a prohibitory injunction, requesting that Telefónica de España be ordered not to apply such price rise and to prohibit its future application to all customers who became customers of Movistar Fusión prior to May 5, 2015. It contains, besides, a third statement, requesting Telefónica de España to be condemned to repay the excess amounts collected as a result of the rise in prices to those customers who have chosen to maintain the service contracted, together with accrued interest on such amount.

The claim was filed for an undetermined amount, given the impossibility of determining *a priori* the total amount of the claim. On October 28, 2016, Telefónica de España filed the response. A hearing will be held on March 7, 2017.

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### **Decision by the High Court regarding the acquisition by Telefónica of shares in Český Telecom by way of tender offer**

Venten Management Limited ("**Venten**") and Lexburg Enterprises Limited ("**Lexburg**"), were minority shareholders of CESKY TELECOM. In September 2005 both companies sold their shares to Telefónica in a mandatory tender offer. Subsequently Venten and Lexburg, in 2006 and 2009, respectively, filed actions against Telefónica claiming a higher price than the price for which they sold their shares in the mandatory tender offer.

On August 5, 2016, the hearing before the High Court in Prague took place in order to decide the appeal against the second decision of the Municipal Court, which had been favourable to Telefónica's position (as was also the case with the first decision of the Municipal Court). At the end of the hearing, the High Court announced the Second Appellate Decision by which it reversed the second decision of the Municipal Court and ordered Telefónica to pay 644 million Czech koruna (approximately 23 million euros) to Venten and 227 million Czech koruna (approximately 8 million euros) to Lexburg, in each case plus interest.

On December 28, 2016, the decision was notified to Telefónica. Telefónica has filed an extraordinary appeal, requesting the suspension of the effects of the decision.

### **Other contingencies**

Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

### **Tax Proceedings**

#### **Inspections in the tax group in Spain**

With regard to the tax inspection for the years 2001 to 2004, the Supreme Court issued a ruling in 2015, accepting the tax losses incurred by the Group in relation to the transfer of certain interests in TeleSudeste, Telefónica Móviles México and Lycos as tax deductible, rejecting the other contentions, and therefore the contingencies related to this process disappeared. This resulted in recognition of a tax expense of 49 million euros in the 2015 consolidated income

statement. However, this did not require payment of any tax because the Company applied unused tax loss carryforwards to offset the effect of these adjustments, at the corresponding tax rate for each period.

In 2012, tax inspections for all taxes for the years 2005 to 2007 were completed, with the Company signing off a corporate income tax assessment of 135 million euros, which was paid in 2012, whilst disputing other adjustments with which it disagreed. Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, since the adjustments proposed were offset by unused tax loss carryforwards, the Company filed an appeal with the Central Economic-Administrative Court against these adjustments in May 2015, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends.

In July 2015 tax inspections for all taxes for the years 2008 to 2011 were completed, with the Company signing off certain corporate income tax assessments and disputing others. This resulted in 2015 in an expense amounting to 206 million euros. However, this did not require any tax payment, as the adjustments arising from the inspection were offset by unused tax loss carryforwards, at the corresponding tax rate for each period.

Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, in July 2015 the Company filed an appeal with the Central Economic-Administrative Court against the adjustments it disputes, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends, and the criteria to use tax loss carryforwards in the years subject to settlement.

At 2016 year end, it is not expected that there is any need to recognize additional liabilities for the outcome of this litigation.

### **Telefónica Brazil**

The Telefónica Group is involved in a range of tax litigation in Brazil over direct and indirect taxes (including those relating to GVT). This includes a number of appeals relating to ICMS tax (a tax similar to VAT, levied on telecommunications services). There is a dispute with the Brazilian tax authorities over which services should be subject to settlement of this tax. In 2016 the tax authorities embarked upon a new round of inspections in this regard.

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To date the most significant issues have focused on the requirement to collect ICMS on penalties charged to customers for non-compliance, Internet advertising services, and complementary or additional services to the basic telecommunications services such as value-added services, modem rental, and the application of this tax on the basic fee (*assinatura básica*).

All related procedures are being contested in all instances (administrative and court proceedings). The aggregate amount of the relevant proceedings, updated to take into account interest, fines and other items, is approximately 14,676 million Brazilian reais (approximately 4,272 million euros). No provisions have been set aside for these matters, as the risk of them giving rise to liabilities is not probable. Telefónica Brazil has obtained independent expert reports supporting its position, i.e. that the aforesaid services are not subject to ICMS.

In addition, in December 2016, Telefónica Brazil received a proposed adjustment from the tax authorities in relation to the tax amortization, from October to December 2011, of the goodwill generated by Telefónica Brazil's acquisition and merger of Vivo. This procedure is at its first administrative stage and no provisions have been made since the potential risk associated to this proceeding has been classified as “not probable” and Telefónica Brazil has received independent expert reports that support this view.

## **Telefónica del Perú**

With regard to tax matters in Peru, litigation continues over corporate income tax for 2000 and 2001, payments on account in respect of the year 2000, recoverable balances for 1998 and 1999, and the interest and penalties that should apply to these.

In August 2015, the court of second instance handed down a ruling partially upholding the position of Telefónica del Perú, ruling in its favor on three of the five objections filed by the tax authorities and appealed against to the courts, relating, inter alia, to corporate income tax for 2000-2001 (among others). This dispute accounts for more than 75% of the total amount under litigation, with the objections relating to insolvency provisions, interest on borrowing and leases of space for public telephones. Both the tax authorities and the company have filed appeals against the decision in higher courts.

At the date of this Annual Report, the settlements carried out by SUNAT for 2000 and 2001 are in the final instance of the legal process (under review by the Supreme Court) and a ruling has not yet been released.

In connection with these proceedings in Peru, the Group and its legal advisors consider that the Group's position continues to be based on robust legal arguments.

In parallel to the aforementioned court proceedings, the tax authorities proceeded to collect corporate income tax due for the years 2000-2001 and payments on account of corporate income tax in respect of the year 2000. There were successive reductions to the sums claimed in the two cases following appeals filed by Telefónica del Perú against the settlements and due to the precautionary measures imposed. The company paid out 286 million Peruvian soles (approximately, 80 million euros) in 2012 and 2013 pending the final rulings.

In the context of these execution processes, in June 2015 the tax authorities issued Compliance Resolutions demanding payment of 1,521 million Peruvian soles (approximately 431 million euros). An appeal was filed against this with the Tax Court, and the adoption of precautionary suspension measures duly requested from the legal authorities (as a definitive court ruling on these cases is currently pending). No ruling was made in relation to these appeals in 2016.

Given the sentences and rulings handed down in June and August 2015, the Group decided to recognize a provision in the 2015 consolidated financial statements of 431 million euros (see Note 15 to the Consolidated Financial Statements).

#### **Tax deductibility of financial goodwill**

Spain added a new article 12.5 to its Corporate Income Tax Law, which came into force on January 1, 2002. The article regulated the deductibility of tax amortization of financial goodwill arising from the acquisition of non-Spanish companies, which could be amortized over 20 years at 5% per annum. Following the entry into force of the Laws 9/2011 of August 19, 2011 and 16/2013 of October 29, 2013, the amount of goodwill amortization deductible for tax purposes under article 12.5 for the years 2011 to 2015 was reduced from 5% to 1%. The effect is temporary because the 4% not amortized during five years (20% in total) will be recovered extending the deduction period from the initial 20 years to 25 years.

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The Telefónica Group, under this regulation, has been amortizing for tax purposes the financial goodwill from its investments, both direct and indirect, in O2, BellSouth and Coltél (prior to December 21, 2007) and Vivo (acquired in 2010). The positive accumulated effect in the corresponding settlements of corporate income tax from 2004 to the closing of December 31, 2016, was 1,053 million euros.

In relation to this tax incentive, the European Commission (“EC”) has in recent years commenced three proceedings against the Spanish State as it deems that this tax benefit could constitute an example of state aid. Although the EC itself acknowledged the validity of its first two decisions for those investors that invested in European companies (for operations carried out before December 21, 2007 in the first decision, and before May 21, 2011 for investments in other countries in the second decision), in its third decision from October 15, 2014 it calls into question the applicability of the principle of legitimate expectations in the application of the incentive for indirect acquisitions, whatever the date of acquisition may have been.

As of the date of this Annual Report the three decisions continue subject to a final ruling. The first two decisions were annulled by two judgments of the General Court of the European Union, which were appealed by the EC before the Court of Justice of the European Union and sent again to the General Court by the Judgment dated December 21, 2016, to reassess the tax incentive. The third decision is still pending a judgment at first instance. Furthermore, there are doubts in the Spanish courts regarding the classification of the incentive as a deduction and if this deduction would remain in the case of a subsequent transfer of the relevant stake.

The Group has continued provisioning the amount of the goodwill amortized for tax purposes, corresponding mainly to the purchase of Vivo, for a total of 147 million euros at December 31, 2016 (79 million euros at December 31, 2015). The amount relating to the companies of the O2 Group was reversed after the EC’s decision to prohibit the sale of Telefónica United Kingdom (see Note 23 to the Consolidated Financial Statements).

## **Years open for inspection**

The years open for review by the tax inspection authorities for the main applicable taxes vary from one consolidated company to another, based on each country’s tax legislation, taking into account their respective statute-of-limitations periods. In Spain, following the tax audit completed in 2015, the taxes from 2012 onwards are open to inspection with respect to the main companies of the Spanish tax group.

In the other countries in which the Telefónica Group has a significant presence, the years open for inspection by the relevant authorities are generally as follows:

The last twelve years in Germany.

The last ten years in El Salvador.

The last eight years in United Kingdom.

The last six years in Argentina and Colombia.

The last five years in Brazil, Mexico, Uruguay and the Netherlands.

The last four years in Venezuela, Peru, Guatemala, Nicaragua and Costa Rica.

The last three years in Chile, Ecuador, the United States and Panama.

The tax inspection of the open years is not expected to give rise to additional material liabilities for the Group.

Dividend information and shareholders' return

***Dividend background***

The table below sets forth the annual dividends declared per share and the year to which such dividends correspond. Generally, the dividend for a given year is paid in two tranches, one in the second-half of the relevant year and the other during the first half of the following year.



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| Year ended December 31, | Dividends per share (euro) |
|-------------------------|----------------------------|
| 2016 <sup>(1)</sup>     | 0.55                       |
| 2015 <sup>(2)</sup>     | 0.75                       |
| 2014 <sup>(3)</sup>     | 0.75                       |
| 2013 <sup>(4)</sup>     | 0.75                       |
| 2012 <sup>(5)</sup>     | —                          |

Company's shareholder remuneration in 2016 consists of paying a dividend of 0.55 euros per share. A scrip dividend of up to 0.35 euros was paid in November 2016, consisting of the assignment of free allotment rights with (1) an irrevocable purchase commitment by the Company, and a subsequent capital increase by means of the issue of new shares to fulfill said allotments. The second tranche of the dividend of 0.20 euros per share will be paid in cash in the second quarter of 2017.

A scrip dividend of up to 0.35 euros was paid in November 2015, consisting of the assignment of free allotment rights with an irrevocable purchase commitment by the Company, and a subsequent capital increase by means of (2) the issue of new shares to fulfill said allotments. A cash dividend of 0.40 euros per share charged to unrestricted reserves was paid in cash on May 19, 2016.

A scrip dividend of up to 0.35 euros was paid in November 2014, consisting of the assignment of free allotment rights with an irrevocable purchase commitment by the Company, and a subsequent capital increase by means of (3) the issue of new shares to fulfill said allotments. A cash dividend of 0.40 euros per share from 2015 net income was paid on May 12, 2015.

A cash dividend of 0.35 euros per share was paid on November 6, 2013, charged against unrestricted reserves. A (4) cash dividend of 0.40 euros per share from 2014 net income was paid on May 7, 2014.

As of July 25, 2012, the Board of Directors cancelled the dividend and share buyback program corresponding to (5) 2012 (including November 2012 and May 2013 cash and scrip payments, respectively).

As of October 27, 2016, Telefónica announced that its Board of Directors had decided to modify the dividend policy for the years 2016 and 2017. Regarding 2017, a dividend in the amount of 0.40 euros per share will be paid: 0.20 euros payable in the fourth quarter of 2017 and 0.20 euros payable in the second quarter of 2018. Both tranches will be paid in cash. The adoption of the corresponding corporate resolutions will be proposed in due course.

Payments of any future dividends will be dependent on the Group's earnings, cash generation, solvency, liquidity, flexibility to make strategic investments, and shareholders' and investors' expectations at the time, all of which may be influenced by a variety of factors. See "Cautionary Statement Regarding Forward-Looking Statements."

***Treasury shares and share buyback program***

We have 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; and

other purposes in accordance with prevailing legislation. In the past, treasury shares purchased on the stock market were exchanged for other shares or securities (as in the case of preferred capital securities), swapped for stakes in other companies (e.g. China Unicom, Telco, S.p.A., or Telefônica Brasil in 2015) or acquired to reduce the number of shares in circulation (by redeeming the shares acquired), thereby improving 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.

For a description on treasury shares, see Note 12 g) to our Consolidated Financial Statements.

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## Item 9. The Offering and Listing

## A. Offer and Listing Details

## General

Our ordinary shares, nominal value 1.00 euro each, are currently listed on each of the Madrid, Barcelona, Bilbao and Valencia stock exchanges and are quoted through the Automated Quotation System under the symbol “TEF”. They are also listed on the London and Buenos Aires stock exchanges. Our ADSs are listed on the New York Stock Exchange and the Lima Stock Exchange.

The table below sets forth, for the periods indicated, the reported high and low quoted closing prices, as adjusted for all stock splits, for our shares on the Madrid Stock Exchange, which is the principal Spanish market for our shares, and our ADSs on the New York Stock Exchange:

|                                  | Per Share |        | Per ADS      |       |
|----------------------------------|-----------|--------|--------------|-------|
|                                  | (in euro) |        | (in dollars) |       |
|                                  | High      | Low    | High         | Low   |
| Year ended December 31, 2012     | 13.710    | 8.630  | 17.76        | 10.25 |
| Year ended December 31, 2013     | 13.105    | 9.492  | 18.02        | 12.43 |
| Year ended December 31, 2014     | 13.370    | 10.865 | 17.40        | 13.99 |
| Year ended December 31, 2015     | 14.210    | 10.020 | 15.64        | 10.96 |
| Year ended December 31, 2016     | 10.175    | 7.661  | 11.35        | 8.18  |
| Quarter ended March 31, 2015     | 13.925    | 11.355 | 15.64        | 13.45 |
| Quarter ended June 30, 2015      | 13.855    | 12.560 | 15.32        | 14.07 |
| Quarter ended September 30, 2015 | 14.210    | 10.640 | 15.48        | 11.93 |
| Quarter ended December 31, 2015  | 12.395    | 10.020 | 13.44        | 10.96 |
| Quarter ended March 31, 2016     | 10.175    | 8.484  | 11.35        | 9.65  |
| Quarter ended June 30, 2016      | 10.005    | 7.661  | 11.27        | 8.50  |
| Quarter ended September 30, 2016 | 9.750     | 8.146  | 10.93        | 9.12  |
| Quarter ended December 31, 2016  | 9.260     | 7.700  | 10.16        | 8.18  |
| Month ended August 31, 2016      | 9.081     | 8.450  | 10.09        | 9.46  |

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|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Month ended September 30, 2016                            | 9.750 | 9.015 | 10.93 | 10.08 |
| Month ended October 31, 2016                              | 9.260 | 8.694 | 10.16 | 9.59  |
| Month ended November 30, 2016                             | 9.178 | 7.825 | 10.07 | 8.26  |
| Month ended December 31, 2016                             | 8.925 | 7.700 | 9.23  | 8.18  |
| Month ended January 31, 2017                              | 9.220 | 8.850 | 9.80  | 9.32  |
| Month ended February 21, 2017 (through February 21, 2017) | 9.401 | 8.877 | 9.90  | 9.46  |

Source: Madrid Stock Exchange Information and Bloomberg.

On February 21, 2017, the closing price of our shares on the Automated Quotation System of the Spanish Stock Exchanges was 9.401 euro per share, equal to 10.012 dollars at the Noon Buying Rate on February 10, 2017 for cable transfers in euro as certified for customs purposes by the Federal Reserve Bank of New York on that date.

Our ADSs are listed on the New York Stock Exchange under the symbol “TEF”. Citibank, N.A. is the Depositary issuing ADSs in form of certificated ADSs (American Depositary Receipts, or ADRs) or uncertificated ADSs pursuant to the deposit agreement dated as of November 13, 1996, as amended as of December 3, 1999 and as further amended as of June 23, 2000 and as of March 9, 2007 among Telefónica, the Depositary and the holders from time to time of ADSs (the “Deposit Agreement”).

At December 31, 2016, 131,924,178 of our shares were held in the form of ADSs by 688 holders of record, including Cede & Co., the nominee of Depository Trust Company (“DTC”). The number of ADSs outstanding was 145,944,492 at December 31, 2015.

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Spanish Securities Market Legislation

The Spanish Securities Markets Act (Ley del Mercado de Valores, or the “LMV”), enacted in 1988 and further amended, regulates the primary and secondary securities markets in Spain by establishing principles for their organization and operation, rules governing the activities of persons and institutions operating in these markets and a system for their supervision. This legislation and the regulation implementing it (mainly, as far as private issuers are concerned, the Royal Legislative Decree 4/2015, of October 23, approving the restated text of the LMV, the Royal Decree 1310/2005, of November 4, in relation to the issuance of securities and its admission to listing in official secondary markets, and Royal Decree 1362/2007, of October 19, concerning the transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market):

- establishes an independent regulatory authority, the CNMV, to supervise the securities markets;

- establishes the rules for surveillance, supervision and sanction provided for the representation of transferable securities by book entries or by certificate;

- establishes a framework for the issuance of securities;

- establishes a framework for trading activities;

- establishes the disclosure obligations of issuers, particularly the obligation to file annual audited financial statements and to make public quarterly financial information;

- establishes the framework for tender offers;

- establishes the code of conduct for all market participants; and

- regulates market abuse infringements.

On March 11, 2005, Royal Decree Law 5/2005 was approved, modifying the LMV in order to implement the Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading. The Directive: (i) harmonizes the requirements for the process of approval of the prospectuses in order to grant to the issuer a single passport for such document, valid throughout the European Union; (ii) incorporates the application of the country of origin principle by which the prospectus will be approved by the Member States of the European Union where the issuer has its registered office but it also introduces the possibility that in certain circumstances, such as issues with high minimum denominations (1,000 euros or more), the issuer may designate the relevant European Union competent authority for prospectus

approval.

Subsequently, Royal Decree 1310/2005, further amended by Royal Decree 878/2015, partially developed the LMV in relation to the admission to trading of securities in the official secondary markets, the sales or subscription public offers and the prospectus required to those effects.

Royal Decree 1333/2005, further amended by Royal Decree 364/2007, developed the LMV in relation to market abuse, implementing Directive 2003/6/EC of the European Parliament and of the Council, relating insider dealing and market manipulation practices (“market abuse”).

On April 12, 2007, Law 6/2007 was approved, modifying the LMV in order to implement the Directive 2004/25/EC of the European Parliament and of the Council relating to public tender offers and the Directive 2004/109/EC relating to the transparency of issuers. Law 6/2007 intends: (i) to encourage an efficient market for corporate control, while protecting the rights of minority shareholders of listed companies and (ii) to enforce transparency in financial markets.

In relation to public tender offers, Law 6/2007 (i) establishes the cases in which a company must launch a takeover bid over the whole share capital of the relevant company; (ii) establishes that takeover bids shall be launched once a specific stake on the share capital of the company has been reached; (iii) adds new obligations for the board of directors of the target companies of the takeover bid in terms of defensive measures against the takeover bid; and (iv) regulates the squeeze-out and sell-out procedure when a 90% of the share capital is held following a takeover bid. Royal Decree 1066/2007, as amended, completes the regulation currently in place for takeover bids in Spain.

Regarding transparency of issuers whose shares are accepted to trading on an official market, Law 6/2007 (i) modifies the reporting requirements of the periodic financial information of listed companies and issuers of listed securities; (ii) establishes a new disclosure regime for significant shareholders; (iii) adds new information and disclosure requirements for issuers of listed securities; (iv) establishes a civil liability procedure of the issuer and board of directors in connection with the financial information disclosed by issuers of securities; and (v) confers new supervisory powers upon the CNMV with respect to the review of accounting information.

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On December 19, 2007, Law 47/2007 was approved, modifying the LMV in order to implement the Directive 2004/39/EC of the European Parliament and of the Council, on Markets in Financial Instruments (MiFID); the Directive 2006/73/EC of the European Parliament and of the Council on organizational requirements and operating conditions regarding the Market in Financial Instruments Directive, and the Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions. Its principal aim is to establish a general legal framework for financial markets in the European Union, in particular with regard to financial services, as well as to ensure appropriate transparency for investors through a regular flow of the relevant information concerning security issuers. Amongst other things, the new regime (i) establishes new multilateral trading facilities for listing shares apart from the stock markets; (ii) reinforces the measures for the protection of investors; (iii) establishes new organizational requirements for investment firms; (iv) implements new supervisory powers for CNMV, establishing cooperation mechanisms amongst national supervisory authorities.

On July 4, 2009, Law 3/2009, regarding structural modifications on Spanish corporations (Ley 3/2009, de 3 de abril, sobre modificaciones estructurales de las sociedades mercantiles) came into force, modifying the maximum threshold established in the Spanish Corporation Act as to the number of treasury shares held by listed companies and their subsidiaries from 5% up to 10% of their total capital outstanding.

On August 1, 2011, Law 25/2011, partially reforming the Spanish Corporation Act and transposing Directive 2007/36/EC of the European Parliament and of the Council of July 11 relating to the exercise of certain rights shareholders in listed companies (Ley 25/2011, de 1 de agosto, de reforma parcial de la Ley de Sociedades de Capital y de incorporación de la Directiva 2007/36/CE, del Parlamento Europeo y del Consejo, de 11 de Julio, sobre el ejercicio de determinados derechos de los accionistas de las sociedades cotizadas) was approved.

In December 2012, Royal Decree 1698/2012, amending regulations regarding prospectus and transparency requirements due on securities issues by the transposition of Directive 2010/73/EU of the European Parliament and of the Council of November 24, 2010, by amending Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, pursues essentially the reduction of administrative burdens related to the publication of a prospectus for the public offering of securities and admission to trading on markets within the European Union.

On March 20, 2013, ECC/461/2013 regulation was approved. This regulation establishes the content and structure of the annual report on corporate governance, the annual compensation report and other information mechanisms for public listed companies, the savings bank and other entities that issue securities admitted to trading on regulated securities markets. The aforementioned regulation was amended by Order ECC/2515/2013, of December 26, which develops article 86.2 of the LMV and by Order ECC/2575/2015, of November 30.

On June 12, 2013, Circular 5/2013 of the National Securities Market Commission (CNMV), was approved. This regulation establishes the templates of the annual report on corporate governance for public listed companies, savings

banks and other entities that issue securities admitted to trading on regulated markets. This regulation is applicable to annual reports on corporate governance to be submitted from January 1, 2014 onwards.

On June 12, 2013, Circular 4/2013 of the CNMV was approved. This regulation establishes the templates of the annual report on director's compensation for public listed companies and members of the board of directors and the supervisory board of savings banks that issue securities admitted to trading on regulated securities markets. This regulation is applicable to the compensation report for the year 2013 onwards and will be put to a vote by the next ordinary general shareholders' meeting on a consultative basis and as a separate item on the agenda.

On June 12, 2014, Directive 2014/65/EU of the European Parliament and of the Council of May 15, 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MIFID II), and Regulation (EU) 600/2014 of the European Parliament and Council of May 15, 2014 on markets in financial instruments and amending Regulation (EU) 648/2012 (MiFIR).

On December 3, 2014, Law 31/2014, amending the Spanish Corporation Act was enacted. The new law introduces changes in matters related to general shareholders' meetings, and shareholders rights. It also, modifies the legal status of members of the Board of Directors, including their compensation, practices and composition, and sets forth new rules on the composition of Board Committees. Law 31/2014 entered into force on December 24, 2014, although certain specific provisions affecting listed companies will not be effective until after the first general shareholders' meeting held by such companies in 2015, in which companies will have to amend their bylaws to bring them in line with the new provisions of Law 31/2014.



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On April 16, 2014, Regulation (UE) n° 596/2014 (Market Abuse Regulation) of European Parliament and of the Council on the market abuse was approved. The regulation repeals Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC. This Regulation, directly applicable in all European Union Member States from July 3, 2016.

On June 23, 2015, Circular 3/2015 of the CNMV established the information and technical and legal specifications that must be published on public listed companies, savings banks and other entities' website, in order to duly comply with the principle of transparency.

On October 2, 2015, Royal Decree 878/2015 was approved with the aim of reaching a greater level of efficiency and safety in the Spanish Automated Quotation System as well as contributing to the development towards an integrated European financial services market. This Royal Decree was enacted to fully implement the provisions of Directive 2013/50/UE of the European Parliament and of the Council, which amended Directive 2004/109/EC of the European Parliament and of the Council on harmonization of transparency requirements for issuers of listed securities, into Spanish legislation.

On October 23, 2015, Royal Legislative Decree 4/2015 was approved to consolidate and unify in a single text the legislative instruments that govern the activities of individuals and institutions in the Spanish securities markets.

On December 22, 2015, Circular 7/2015 of the CNMV amended those provisions of the Circular 5/2013 that relate to the templates of the annual report on corporate governance to be used by public listed companies, savings banks and other entities, and those provisions of Circular 4/2013 that relate to the templates of the annual report on director's compensation for public listed companies.

On December 22, 2015, Circular 8/2015 of the CNMV published new forms establishing the notification templates for directors, executives and close relatives to communicate their significant shareholdings and for issuers to communicate transactions relating to own shares, with the aim to comply with the obligations introduced by Royal Decree 1362/2007, Royal Decree 878/2015 and Market Abuse Regulation. Individuals bound by such Circular must use the new forms from April 1, 2016.

Securities Trading in Spain

The Spanish securities market for equity securities consists of four stock exchanges located in Madrid, Bilbao, Barcelona and Valencia and the Automated Quotation System, or Mercado Continuo. During 2016, the Automated Quotation System accounted for the majority of the total trading volume of equity securities on the Spanish Stock

Exchanges.

*Automated Quotation System*

The Automated Quotation System links the Spanish Stock Exchanges, providing those securities listed on it with a uniform continuous market that eliminates certain of the differences among the local exchanges. The principal features of the system are the computerized matching of buy and sell orders at the time of entry of the order. Each order is executed as soon as a matching order is entered, but can be modified or canceled until executed. The activity of the market can be continuously monitored by investors and brokers. The Automated Quotation System is operated and regulated by Sociedad de Bolsas, S.A., a corporation owned by the companies that manage the local exchanges. All trades on the Automated Quotation System must be placed through a brokerage firm, an official stock broker or a dealer firm that is a member of a Spanish Stock Exchange. Beginning January 1, 2000, Spanish banks were allowed to become members of the Spanish Stock Exchanges and, therefore, can trade through the Automated Quotation System.

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In a pre-opening session held from 8:30 a.m. to 9:00 a.m. each trading day, an opening price is established for each security traded on the Automated Quotation System based on a real-time auction. The regime concerning opening prices was changed by an internal rule issued by the Sociedad de Bolsas. Pursuant to such rule, each stock in the continuous market is assigned a static and a dynamic range within which its price can fluctuate. The price of a stock may rise or fall within its static range (which is published once a month and is calculated according to the stock's average historic price volatility) above or below its opening price (which shall be the closing price of the previous session). When the stock trades outside of this range, the trading of the stock is suspended for 5 minutes, during which an auction takes place. After this auction, the price of the stock can once again rise or fall within its static range above or below its last auction price (which will be considered as the new static price before triggering another auction). Furthermore, the price of a stock cannot rise or fall by more than its dynamic price range (which is fixed and published once a month and is calculated according to the stock's average intra-day volatility), from the last price at which it has traded. If the price variation exceeds the stock's dynamic range, a five minute auction is triggered. Between 5:30 p.m. and 5:35 p.m. a closing price is established for each security through an auction system similar to the one held for the pre-opening early in the morning.

Trading hours for block trades are also from 9:00 a.m. to 5:30 p.m. Between 5:30 p.m. and 8:00 p.m., certain trades may occur outside the computerized matching system without prior authorization from Sociedad de Bolsas, S.A. at a price within the range of 5% above the higher of the average price and closing price for the day and 5% below the lower of the average price and closing price for the day if there are no outstanding bids or offers, respectively, on the system matching or bettering the terms of the proposed off-system transaction and, if, among other things, the trade involves more than 300,000 euros and more than 20% of the average daily trading volume of the stock during the preceding three months. These trades must also relate to individual orders from the same person or entity and be reported to the Sociedad de Bolsas, S.A. before 8:00 p.m. At any time trades may take place (with the prior authorization of the Sociedad de Bolsas, S.A.) at any price if:

· the trade involves more than 1.5 million euros and more than 40% of the average daily volume of the stock during the preceding three months;

· the transaction derives from a merger or spin-off process, or from the reorganization of a group of companies;

· the transaction is executed for the purposes of settling a litigation or completing a complex group of contracts; or

· Sociedad de Bolsas, S.A. finds other justifiable cause.

Information with respect to the computerized trades between 9:00 a.m. and 5:30 p.m. is made public immediately, and information with respect to trades outside the computerized matching system is reported to Sociedad de Bolsas, S.A. by the end of the trading day and published in the Boletín de Cotización and in the computer system by the beginning of the next trading day.

*Clearance and settlement system*

The Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores S.A.U., (whose commercial name is Iberclear), was created by the Ley 44/2002 de Medidas de Reforma del Sistema Financiero, enacted on November 22, 2002 to increase the efficiency of the Spanish financial markets. Such law introduced a new article, 44-bis to the LMV which established the framework for the constitution of Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores S.A.U.

Iberclear is regulated by the Spanish Securities Act and where appropriate by Royal Decree 505/1987 of April 3, 1987, Royal Decree 166/1992 of February 14, 1992, and by any other related regulation. This company, which is a wholly owned subsidiary of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. (Bolsas y Mercados Españoles), has the following functions:

Keeping accounting records in the form of book entries of securities traded in Securities Markets or in public debt markets, and securities traded in other secondary official markets or multilateral trading facilities, at the request of their governing bodies.

Keeping accounting records of other securities not listed for trading in secondary official markets, regulated markets or multilateral trading facilities, at the request of their governing bodies.

To manage settlement and, if necessary, clearing of securities and cash deriving from transactions executed on securities.

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To render technical and operating services directly related to those of registration, clearing and settlement of securities and any others required for Iberclear to collaborate and coordinate its actions with other areas and systems of registration, clearing and settlement of securities, for which it may have to be authorized under the Rules of Central Securities Depositories.

Any other duties assigned by the Spanish Government, subject to prior reports from the CNMV and, if applicable, the Bank of Spain.

Iberclear will provide the CNMV, the Bank of Spain and the Ministry of Economy with the information that these entities may request regarding the registry clearance and settlement performed within the systems managed by Iberclear.

Transactions carried out on the Spanish Stock Exchanges are cleared and settled through Iberclear.

Only members of the system are entitled to use Iberclear, and membership is restricted to authorized broker members of the Spanish Stock Exchanges, the Bank of Spain (when an agreement, approved by the Spanish Ministry of Economy and Finance, is reached with Iberclear) and, with the approval of the CNMV, other brokers not members of the Spanish Stock Exchanges, banks, savings banks and foreign settlement and clearing systems. The clearance and settlement system and its members are responsible for maintaining records of purchases and sales under the book-entry system. Shares of listed Spanish companies are held in book-entry form. Iberclear, which manages the clearance and settlement system, maintains a registry reflecting the number of shares held by each of its member entities (each, an entidad participante) as well as the amount of such shares held on behalf of beneficial owners. Each member entity, in turn, maintains a registry of the owners of such shares. Spanish law considers the legal owner of the shares to be the member entity appearing in the records of Iberclear as holding the relevant shares in its own name or the investor appearing in the records of the member entity as holding the shares.

The settlement of any transactions must be made two business days following the date on which the transaction was carried out.

Obtaining legal title to shares of a company listed on a Spanish Stock Exchange requires the participation of a Spanish official stockbroker, broker-dealer or other entity authorized under Spanish law to record the transfer of shares. To evidence title to shares, at the owner's request, the relevant member entity must issue a certificate of ownership. In the event the owner is a member entity, Iberclear is in charge of the issuance of the certificate with respect to the shares held in the member entity's name.

Brokerage commissions are not regulated. Brokers' fees, to the extent charged, will apply upon transfer of title of shares from the Depository to a holder of ADRs in exchange for such ADSs, and upon any later sale of such shares by

such holder. Transfers of ADSs do not require the participation of an official stockbroker. The Deposit Agreement provides that holders depositing shares with the Depositary in exchange for ADSs or withdrawing shares in exchange for ADSs will pay the fees of the official stockbroker or other person or entity authorized under Spanish law applicable both to such holder and to the Depositary.

On 2015, due to the changes introduced into the applicable legislation, Bolsas y Mercados Españoles developed a Clearing and Settlement Reform in Spain, implemented throughout 2016 and 2017 in two main phases:

April 27, 2016, when a new Central Counterparty (CCP) was implemented and the new platform for equity settlement was introduced.

September 18, 2017, when the Fixed Income settlement system will be introduced to the new platform and the TARGET2-Securities (TS2) will be implemented.

This reform involves the following three fundamental modifications, having impact on several operating practices.

A new Central Counterparty was incorporated, the so-called BME Clearing, whose intervention takes place between the contract and settlement date, assuming the risk of the counterparty and, where applicable, conducting the clearing transactions and simplifying the settlement.

Another modification is the application in all kinds of securities of a new system of recording, clearing and settlement. This sole system eliminates the need to use register references by introducing a register based on balances, where Iberclear and each member entity manage their respective records.

The last decision entails the integration of the Central de Anotaciones de Deuda (CADE) and the Servicio de Compensación y Liquidación de Valores (SLCV) system into a unique platform.

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The Spanish equity market is structured around three infrastructures, which are the following: the Spanish Stock Exchange Interconnection System (SIBE) trading platform, BME Clearing and Iberclear (the Central Securities Depository).

As consequence of the above, several modifications have occurred such as: (i) financial entities can be members of the new infrastructures; (ii) Stock Exchange members have to contract with a General Clearing member of the CCP; (iii) CCP members have to contract with an Iberclear Settlement Participant; (iv) CCP formulates the netting of transactions prior to settlement instructions; (v) the existence of Individual Accounts in the CCP and the Central Securities Deposit; (vi) the maximization of settle transaction in case of delay of delivery of securities by Iberclear; (vii) Collective Deposit change into the CCP guarantee system; or (viii) the introduction of Post Trading Interface communication system.

Furthermore, changes are also applicable to the Trading Member systems in relation with trading, post trading and control procedures, in order to adapt to the new regime.

B. Plan of Distribution

Not applicable.

C. Markets

Please see “—Offer and Listing Details” above.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

F. Expenses of the Issue

Not applicable.

Item 10. Additional Information

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association

The following summary describes certain material considerations concerning our capital stock and briefly describes certain provisions of our bylaws and Spanish law.

Corporate Objectives

Article 5 of Title I of our bylaws sets forth our corporate purposes:



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The provision and operation of all kinds of public or private telecommunications services and, for such purpose, the design, installation, maintenance, repair, improvement, acquisition, disposition, interconnection, management, administration of, and any other activity not included in the preceding enumeration with respect to, all kinds of telecommunications networks, lines, satellites, equipment, systems and technical infrastructure whether now existing or to be created in the future, including the premises in which any and all of the foregoing items are located;

the provision and operation of all kinds of services that are ancillary or supplemental to or result from telecommunications services;

the research and development, promotion and application of all kinds of component principles, equipment and systems directly or indirectly used for telecommunications;

manufacturing and production activities and, in general, all other forms of industrial activity in connection with telecommunications; and

acquisition, disposition and, in general, all other forms of commercial activity in connection with telecommunications.

## Director Qualification

In order to be elected as a director, a person must have held a number of our shares representing a nominal value of no less than 3,000 euros for at least three years prior to his or her election. These shares may not be transferred so long as such person remains a director. This requirement does not apply to any person who, at the time of his or her appointment, has either a labor or professional relationship with the company or is expressly exempted from such requirement by a vote of at least 85% of the Board of Directors.

## Interested Transactions

When a director or persons related to him or her has an interest in a transaction with us or with any of the companies of our Group, such transaction (if unrelated to the ordinary course of our business or if not performed on an arm's length basis involving consideration that is significant to the Company and otherwise) must be presented to the Nominating, Compensation and Corporate Governance Committee. Such committee shall assess the transaction from the point of view of equal treatment of shareholders and the arm's length basis of the transaction and shall be included in the Annual Corporate Governance Report and in the periodic information of the Company upon the terms set forth in applicable laws and regulations. The performance of such transactions requires the authorization of our Board of Directors, after the favorable report of the committee. The interested director must refrain from participating in votes that affect such transaction.

## Significant Differences in Corporate Governance Practices

### *Corporate governance guidelines*

For a description of our corporate governance practices see “Item 16G. Corporate Governance.”

## Description of Our Capital Stock

### *Description of share capital*

At February 23, 2017, our issued share capital consisted of 5,037,804,990 ordinary registered shares with a nominal value of 1.00 euro each.

Our shareholders have delegated to the Board of Directors the authority to issue up to 2,469,208,757 new shares (equal to half of Telefónica’s share capital on June 12, 2015, the date of the authorization). The Board of Directors is authorized to exclude preemptive rights, in whole or in part, pursuant to the applicable provisions of the Spanish Corporation Act. The Board’s authorization to issue new shares expires on June 12, 2020.

### *Meetings and voting rights*

We hold our ordinary general shareholders’ meeting during the first six months of each fiscal year on a date fixed by the Board of Directors. Extraordinary general shareholders’ meetings may be called, from time to time, at the discretion of our Board of Directors or upon the request of shareholders representing at least 3% of our paid-in share capital. The minimum percentage required to exercise this right was lowered from 5% to 3% by Law 31/2014.

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We publish notices of all ordinary and extraordinary general shareholders' meetings in the Official Gazette of the Commercial Registry or in one of the more widely circulated newspapers in Spain, on the website of the Spanish Securities and Exchange Commission (Comisión Nacional del Mercado de Valores (the "CNMV")), and on our web site in due time pursuant to the Spanish Corporation Act, being on a general basis at least one month before the relevant meeting. Furthermore, the Board of Directors may publish notices in other media, if deemed appropriate to ensure the public and effective dissemination of the notice meeting.

Each share of Telefónica, S.A. entitles the holder to one vote. However, only registered holders of at least 300 shares are entitled to attend a general shareholders' meeting. Holders of a lesser number of shares may grant a proxy in respect thereof to a shareholder having the right to attend, as well as group together with other shareholders in the same situation until reaching the required number of shares, following which a proxy must be granted by the shareholders so grouped together to one of such shareholders. The grouping must be carried out specifically for each General Shareholders' Meeting and be recorded in writing.

However, under our bylaws, the maximum number of votes that a shareholder may cast is capped at 10% of our total outstanding voting capital. In determining the maximum number of votes that each shareholder may cast, only the shares held by such shareholder are counted, disregarding those that correspond to other shareholders who have appointed such shareholder as his or her proxy, in spite of applying the limit individually to each of the represented shareholders. This cap will also apply to the maximum number of votes that may be collectively or individually cast by two or more shareholder companies belonging to the same group of entities, as well as to the maximum number of votes that may be cast by an individual or corporate shareholder and the entity or entities that are shareholders themselves and which are directly or indirectly controlled by that individual or corporate shareholder. Moreover, in accordance with the Spanish Corporation Act, such cap would become ineffective where the bidder reaches, as a consequence of a tender offer, a percentage equal to or greater than 70% of the share capital carrying voting rights, unless the bidder (or those acting in concert with the bidder) is not subject to equivalent neutralization measures or has not adopted them.

In addition, according to Article 34 of Spanish Royal Decree-Law 6/2000 of June 23 on urgent measures to improve competition in the goods and services markets, individuals and legal entities directly and indirectly holding more than 3% of the total share capital or voting rights of two or more principal operator companies in Spain in, among other markets, the fixed-line and mobile-line telephony markets, may not exercise their voting rights in excess of 3% of the total in more than one company, except with the prior authorization of the Spanish National Markets and Competition Commission (Comisión Nacional de los Mercados o la Competencia (the "CNMC")). Principal operators are defined as one of the five operators with the largest market share in the corresponding market ("Principal Operators"). In addition, no individual or legal entity is allowed to appoint, directly or indirectly, members of the management body of more than one Principal Operator in, among others, the fixed-line or mobile-line telephony markets, except with the prior authorization of the CNMC. Additionally, individuals or legal entities considered Principal Operators are not allowed to exercise more than 3% of the voting rights of another Principal Operator nor to appoint, directly or indirectly, members of the management body of any Principal Operator, except, in both cases, with the prior authorization of the CNMC. Telefónica is considered a Principal Operator for the purposes of Article 34 of Royal Decree-Law 6/2000 of June 23 in the Spanish fixed-line and mobile-line telephony markets.

Any share may be voted by proxy. The proxies may be granted in writing or electronically and are valid only for a single meeting, unless the proxy-holder is the granting shareholder's spouse, ascendant or descendant, or holds a general power of attorney granted in a public instrument with powers to manage all of the assets held by the shareholder granting the proxy in Spain. Under the Deposit Agreement relating to our ADSs, the Depositary accepts voting instructions from holders of ADSs. The Depositary executes such instructions to the extent permitted by law and by the terms governing the shares and ADSs. The Depositary or its nominee, as the case may be, will be entitled to vote by proxy the shares underlying the relevant ADSs.

Only holders of record five days prior to the day on which a general meeting of shareholders is scheduled to be held may attend and vote at the meeting.

According to the Spanish Corporation Act, as amended by Law 31/2014, the general shareholders' meeting will be quorate on first call if the shareholders present, in person or by proxy, hold at least 25% of the subscribed share capital carrying voting rights. On second call, the meeting will be quorate regardless of the capital in attendance.

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However, if the agenda of the meeting includes resolutions on the amendment of the bylaws, including an increase or reduction of share capital, the transformation, merger, split-off, the en bloc assignment of assets and liabilities, the migration of the registered office abroad, the issuance of debentures or the exclusion or limitation of preemptive rights, the required quorum on first call must be met by the attendance of shareholders representing at least 50% of the subscribed share capital carrying voting rights (each a “Special Resolution”). On second call, the attendance of 25% of the subscribed share capital carrying voting rights will suffice.

As a general rule, resolutions at the general shareholder’s meeting will be passed by a simple majority of votes cast at such meeting (i.e., provided that the votes for outnumber the votes against the relevant resolution).

In contrast, in order to approve any Special Resolution, if the capital present or represented at the general shareholders’ meeting exceeds 50% of the subscribed share capital carrying voting rights, the favorable vote of the absolute majority (that is, if the votes in favor exceed 50% of the votes corresponding to capital present and represented at the shareholders’ meeting) will be required. If, on second call, shareholders representing 25% or more of the subscribed share capital carrying voting rights are present or represented but fail to reach the 50% threshold, the favorable vote of at least two-thirds of the share capital present or represented at the meeting will be required.

## Preemptive Rights

Pursuant to the Spanish Corporation Act, shareholders have preemptive rights to subscribe for any new shares in capital increases with issuances of new shares with a charge to monetary contributions and in issuances of debentures convertible into shares. Such rights may be excluded (partially or totally) under special circumstances by virtue of a resolution passed at a general shareholders’ meeting in accordance with Articles 308, 504 and 506 of the Spanish Corporation Act, or by the Board of Directors, if previously authorized at a general shareholders’ meeting in accordance with Article 506 of the Spanish Corporation Act (for capital increases) and Articles 417 and 511 (for issuances of debentures convertible into shares). Such preemptive rights will not be available in the event of an increase in capital to meet the requirements of a convertible bond issue or a merger or demerger of another entity into Telefónica or of all or part of the assets split from another company, in which shares are issued as consideration or, in general, when the increase is carried out as consideration in exchange for non-cash contributions. Such rights are transferable, may be traded on the Automated Quotation System and may be of value to existing shareholders because new shares may be offered for subscription at prices lower than prevailing market prices.

## Form and Transfer

Ordinary shares are in book-entry form and are indivisible. Joint holders must nominate one person to exercise their rights as shareholders, though joint holders are jointly and severally liable for all obligations arising from their status as shareholders. Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A.

Unipersonal (“**Iberclear**”), which manages the clearance and settlement system of the Spanish Stock Exchanges, maintains the central registry of ordinary shares reflecting the number of ordinary shares held by each of its participant entities (*entidades participantes*) as well as the number of such shares held by registered legal owners. Each participant entity in turn maintains a register of the owners of such shares.

Transfers of Telefónica’s ordinary shares quoted on the Spanish Stock Exchanges must be made by book-entry registry or delivery of evidence of title to the buyer through, or with the participation of, a member of the Spanish Stock Exchanges that is an authorized broker or dealer. Transfers of Telefónica’s ordinary shares may also be subject to certain fees and expenses.

### **Reporting Requirements**

According to Royal Decree 1362/2007 of October 19 on the disclosure of significant stakes in listed companies (“**Royal Decree 1362/2007**”), recently modified by Royal Decree 878/2015, of October 2, the acquisition or disposition of shares of Telefónica must be reported within four trading days of the acquisition or disposition to Telefónica and the CNMV, where:

in the case of an acquisition, the acquisition results in that person or group holding a number of voting rights in Telefónica which reaches or surpasses 3% (or 5%, 10%, 15%, 20%, 25%, 30%, 35%, 40%, 45%, 50%, 60%, 70%, 75%, 80% or 90%) of Telefónica’s total number of voting rights; or

in the case of a disposal, the disposition reduces the number of voting rights held by a person or group below a threshold of 3% (or 5%, 10%, 15%, 20%, 25%, 30%, 35%, 40%, 45%, 50%, 60%, 70%, 75%, 80% or 90%) of Telefónica’s total number of voting rights.

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Royal Decree 878/2015 established a new approach for calculating whether these thresholds are reached, surpassed or fell short which requires adding the voting rights corresponding to shares and financial instruments. Royal Decree 878/2015 also expands the definition of financial instruments which should be reported, including financial instruments having a similar economic effect as the shares of a company, whether the instruments are cash or physically settled, including convertible securities, options, forwards, futures, swaps, CFDs or any other type of instrument which grants the holder the right to acquire shares or a right to receive an equivalent cash settlement amount. Additionally, Royal Decree 878/2015 amends the calculation rules of the voting rights attributable to a financial instrument which, among other changes, shall now be calculated on a daily basis.

The reporting requirements referred to above apply not only to the acquisition or transfer of shares, but also when, without an acquisition or transfer of shares, the proportion of voting rights of an individual or legal entity reaches, exceeds or falls below the threshold that triggers the obligation to report as a consequence of a change in the total number of voting rights of Telefónica on the basis of the information reported to the CNMV and disclosed by it, in accordance with the Royal Decree.

Regardless of the actual ownership of the shares, any individual or legal entity with a right to acquire, transfer or exercise voting rights granted by the shares, and any individual or legal entity who owns, acquires or transfers, whether directly or indirectly, other securities or financial instruments which grant a right to acquire shares carrying voting rights (such as transferable securities, options, futures, swaps, forwards and other derivative contracts), will also have an obligation to notify the company and the CNMV of the holding of a significant stake in accordance with the above-mentioned regulations.

Stricter disclosure obligations apply if the person obligated to disclose has residency in a country considered a tax haven by the Spanish authorities, a zero-taxation country or territory or a country or territory that does not share information with the Spanish authorities, in which cases the initial threshold for disclosure is reduced to 1% (and successive multiples of 1%).

Our directors must report to us and the CNMV the percentage and number of voting rights in Telefónica held by them at the time of becoming or ceasing to be a member of the Board of Directors. Furthermore, all members of the Board must report any change in the percentage of voting rights they hold, as a result of any acquisition or disposition of our shares or voting rights, or financial instruments which carry a right to acquire or dispose of shares which have voting rights attached, including any stock-based compensation that they may receive pursuant to any of our compensation plans. Members of our senior management must also report any stock-based compensation that they may receive pursuant to any of our compensation plans or any subsequent amendment to such plans. Royal Decree 1362/2007 (as amended) refers to the definition given by Royal Decree 1333/2005 of November 11, which develops the Spanish Securities Market Act, regarding market abuse, which defines senior management (*directivos*) as those “high-level employees in positions of responsibility with regular access to insider information (*información privilegiada*) related, directly or indirectly, to the issuer and that, furthermore, are empowered to adopt management decisions affecting the future development and business perspectives of the issuer”.

In addition, pursuant to Royal Decree 1333/2005 of November 11 (as amended), any member of our Board and our senior management, or any parties closely related to any of them, as such terms are defined therein, must report to the CNMV any transactions carried out with respect to our shares or derivatives or other financial instruments relating to our shares. The notification of the transaction must include particulars of, among others, the type of transaction, the date of the transaction and the market in which the transactions were carried out, the number of shares traded and the price paid.

These disclosure obligations are primarily regulated by Royal Decree 1362/2007 (as amended) and, since July 3, 2016, by the Regulation (EU) No 596/2014 of the European Parliament and of the Council of April 16, 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, both establish a detailed set of rules on this legal framework (including, *inter alia*, rules determining the persons subject to disclosure obligations, the different types of situations triggering disclosure and corresponding exceptions, specific attribution and aggregation rules, the deadlines to notify the transactions, triggering disclosure obligations and incorporation of notices submitted to the CNMV's public registry).



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**Disclosure of Net Short Positions**

In accordance with Regulation (EU) No. 236/2012 of the European Parliament and of the European Council of March 14, 2012 on short selling and certain aspects of credit default swaps (as further supplemented by several delegated regulations regulating technical aspects necessary for its effective enforceability and to ensure compliance with its provisions), net short positions on shares listed on the Spanish Stock Exchanges equal to, or in excess of, 0.2% of the relevant issuer's share capital and any increases or reductions thereof by 0.1% are required to be disclosed to the CNMV by no later than the first trading day following the transaction. If the net short position reaches 0.5%, and also at every 0.1% above that, the CNMV will disclose the net short position to the public.

Notification is mandatory even if the same position has been already notified to the CNMV in compliance with reporting requirements previously in force in Spain.

The information to be disclosed is set out in Table 1 of Annex I of Delegated Regulation 826/2012, according to the format approved as Annex II of this Regulation. The information will be published, where appropriate, on a web page operated or supervised by the corresponding authority.

Moreover, pursuant to Regulation (EU) No. 236/2012, where the CNMV considers that (i) there are adverse events or developments that constitute a serious threat to financial stability or to market confidence (serious financial, monetary or budgetary problems, which may lead to financial instability, unusual volatility causing significant downward spirals in any financial instrument, etc.); and (ii) the measure is necessary and will not be disproportionately detrimental to the efficiency of financial markets in view of the advantages sought, it may, following consultation with the European Securities and Market Authority ("ESMA"), take any one or more of the following measures:

impose additional notification obligations by either (a) reducing the thresholds for the notification of net short positions in relation to one or several specific financial instruments; and/or (b) requesting the parties involved in the lending of a specific financial instrument to notify any change in the fees requested for such lending; and

restrict short selling activity by either prohibiting or imposing conditions on short selling.

In addition, according to Regulation (EU) No. 236/2012, where the price of a financial instrument has fallen significantly during a single day in relation to the closing price on the previous trading day (10% or more in the case of a liquid share), the CNMV may prohibit or restrict short selling of financial instruments for a period not exceeding the end of the trading day following the trading day on which the fall in price occurs.

Finally, Regulation (EU) No. 236/2012 also vests powers to ESMA in order to take measures similar to the ones described above in exceptional circumstances, when the purpose of these measures is to deal with a threat affecting several EU member states and the competent authorities of these member states have not taken adequate measures to address it.

### **Shareholder Agreements**

Article 531 *et seq.* of the Spanish Corporation Act require parties to disclose those shareholders' agreements in respect of Spanish listed companies that affect the exercise of voting rights at a general shareholders' meeting or contain restrictions or conditions on the transferability of shares or bonds that are convertible or exchangeable into shares. If any shareholders enter into such agreements with respect to Telefónica's shares, they must disclose the execution, amendment or extension of such agreements to Telefónica and the CNMV (together with the relevant clauses of said agreements) and file such agreements with the appropriate Commercial Registry. Failure to comply with these disclosure obligations renders any such shareholders' agreement unenforceable and constitutes a violation of the Spanish Securities Market Act.

### **Acquisition of Own Shares**

Pursuant to Spanish corporate law, we may only repurchase our own shares within certain limits and in compliance with the following requirements:

the repurchase must be authorized by the general shareholders' meeting by a resolution establishing the maximum number of shares to be acquired, the minimum and maximum acquisition price and the duration of the authorization, which may not exceed five years from the date of the resolution; and

the repurchase, including any shares already held by us or a person acting on our behalf, must not bring our net worth below the aggregate amount of our share capital and legal reserves.

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For these purposes, net worth means the amount resulting from the application of the criteria used to draw up the financial statements, subtracting the amount of profits directly imputed to that net worth, and adding the amount of share capital subscribed but not called and the share capital par and issue premiums recorded in our accounts as liabilities. In addition:

- the aggregate par value of the shares directly or indirectly repurchased, together with the aggregate par value of the shares already held by us and our subsidiaries, must not exceed 10% of our share capital; and
- the shares repurchased must be fully paid and must be free of ancillary contributions (*prestaciones accesorias*).

Voting rights attached to treasury shares will be suspended and economic rights (*e.g.*, the right to receive dividends and other distributions and liquidation rights), except the right to receive bonus shares, will accrue proportionately to all of our shareholders. Treasury shares are counted for the purpose of establishing the quorum for shareholders' meetings and majority voting requirements to pass resolutions at shareholders' meetings.

Regulation (EU) No. 596/2014 of April 16, repealing, among others, Directive 2003/6/EC of the European Parliament and the European Council of January 28, on insider dealing and market manipulation establishes rules in order to ensure the integrity of European Community financial markets and to enhance investor confidence in those markets. This regulation maintains an exemption from the market manipulation rules regarding share buyback programs by companies listed on a stock exchange in an EU Member State. Commission Regulation (EC) No. 2273/2003, of December 22, implemented the aforementioned directive with regard to exemptions for buyback programs. Article 5 of this Regulation states that in order to benefit from the exemption, a buyback program must comply with certain requirements established under such Regulation and the sole purpose of the buyback program must be to reduce the share capital of an issuer (in value or in number of shares) or to meet obligations arising from either of the following:

- debt financial instruments exchangeable into equity instruments; or
- employee share option programs or other allocations of shares to employees of the issuer or an associated company.

In addition, on December 19, 2007, the CNMV issued Circular 3/2007 setting out the requirements to be met by liquidity contracts entered into by issuers with financial institutions for the management of its treasury shares to constitute an accepted market practice and, therefore, be able to rely on a safe harbor for the purposes of market abuse regulations.

If an acquisition or series of acquisitions of shares of Telefónica reaches or exceeds or causes Telefónica's and its affiliates' holdings to reach or exceed 1% of Telefónica's voting shares, Telefónica must notify its final holding of treasury stock to the CNMV. If such threshold is reached as a result of a series of acquisitions, such reporting

obligation will only arise after the closing of the acquisition which, taken together with all acquisitions made since the last of any such notifications, causes the Telefónica's and its affiliates holdings to exceed, 1% of Telefónica's voting shares. Sales and other dispositions of Telefónica's treasury stock will not be deducted in the calculation of such threshold. This requirement also applies if the stock is acquired by a majority-owned subsidiary of Telefónica.

Moreover, pursuant to Spanish corporate law, the audited financial statements of a company must include a reference regarding any treasury shares.

At December 31, 2016, we held 141,229,134 shares of treasury stock, representing 2.80339% of our capital stock. At December 31, 2015, we held 141,639,159 shares of treasury stock, representing 2.84690% of our capital stock. As a part of our shareholders' remuneration policy, we have implemented various share buyback programs since 2003. For further description about our shareholders' return, see "Item 8. Financial Information—Dividend Information and Share Buyback Programs."

At our annual general shareholders' meeting held on May 30, 2014, our shareholders extended their prior authorization to the Board of Directors to acquire our shares for an additional five years from the date of such meeting. The authorization also applies to companies under our control. Pursuant to the authorization, the aggregate nominal value of our shares held by us or any of our subsidiaries cannot exceed the limit established by applicable laws (which is, as of the date of this Annual Report, 10% of our outstanding capital).

### **Change of Control Provisions**

Certain antitrust regulations may delay, defer or prevent a change of control of Telefónica or any of its subsidiaries in the event of a merger, acquisition or corporate restructuring. In Spain, the application of both Spanish and European antitrust regulations requires that prior notice of domestic or cross-border merger transactions be given in order to obtain a "non-opposition" ruling from antitrust authorities.

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**Tender Offers**

Tender offers are governed in Spain by the Spanish Securities Markets Act (as amended by Law 6/2007 of April 12) and Royal Decree 1066/2007, of July 27, which have implemented Directive 2004/25/EC of the European Parliament and of the European Council of April 21. Tender offers in Spain may qualify as either mandatory or voluntary offers.

Mandatory public tender offers must be launched for all the shares of the target company or other securities that might directly or indirectly give the right to subscription thereto or acquisition thereof (including convertible and exchangeable bonds) at an equitable price and not subject to any conditions when any person acquires control of a Spanish company listed on the Spanish Stock Exchanges, whether such control is obtained:

· by means of the acquisition of shares or other securities that directly or indirectly give voting rights in such company;

· through agreements with shareholders or other holders of said securities; or

· as a result of other situations of equivalent effect as provided in the regulations (i.e., indirect control acquired through mergers, share capital decreases, target's treasury stock variations or securities exchange or conversion, etc.).

A person is deemed to have obtained the control of a target company, individually or jointly with concerted parties, whenever:

· it acquires, directly or indirectly, a percentage of voting rights equal to or greater than 30%; or

· it has acquired a percentage of less than 30% of the voting rights and appoints, in the 24 months following the date of acquisition of said percentage, a number of directors that, together with those already appointed, if any, represent more than one-half of the members of the target company's board of directors. Regulations also set forth certain situations where directors are deemed to have been appointed by the bidder or persons acting in concert therewith unless evidence to the contrary is provided.

Notwithstanding the above, Spanish regulations establish certain exceptional situations where control is obtained but no mandatory tender offer is required, including, among others:

· subject to the CNMV's approval,

acquisitions or other transactions resulting from the conversion or capitalization of credits into shares of listed companies, the financial feasibility of which is subject to serious and imminent danger, even if the company is not undergoing bankruptcy proceedings, provided that such transactions are intended to ensure the company's financial recovery in the long term; or

in the event of a merger, provided that those acquiring control did not vote in favor of the merger at the relevant general shareholders' meeting of the offeree company and provided also that it can be shown that the primary purpose of the transaction is not the takeover but an industrial or corporate purpose; and

when control has been obtained after a voluntary bid for all of the securities, if either the bid has been made at an equitable price or has been accepted by holders of securities representing at least 50% of the voting rights to which the bid was directed.

For the purposes of calculating the percentages of voting rights acquired, the regulations establish the following rules:

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percentages of voting rights corresponding to (i) companies belonging to the same group of the bidder; (ii) members of the board of directors of the bidder or of companies of its group; (iii) persons acting for the account of or in concert with the bidder (a concert party shall be deemed to exist when two or more persons collaborate under an agreement, be it express or implied, oral or written, in order to obtain control of the offeree company); (iv) voting rights exercised freely and over an extended period by the bidder under proxy granted by the actual holders or owners of such rights in the absence of specific instructions with respect thereto; and (v) shares held by a nominee, such nominee being understood as a third party whom the bidder totally or partially covers against the risks inherent in acquisitions or transfers of the shares or the possession thereof, will be deemed to be held by the bidder (including the voting rights attaching to shares that constitute the underlying asset or the subject matter of financial contracts or swaps when such contracts or swaps cover, in whole or in part, against the risks inherent in ownership of the securities and have, as a result, an effect similar to that of holding shares through a nominee);

both the voting rights arising from the ownership of shares and those enjoyed under a usufruct or pledge or upon any other title of a contractual nature will be counted towards establishing the number of voting rights held;

the percentage of voting rights shall be calculated based on the entire number of shares carrying voting rights, even if the exercise of such rights has been suspended; voting rights attached to treasury shares shall be excluded; and non-voting shares shall be taken into consideration only when they carry voting rights pursuant to applicable law; and

acquisitions of securities or other financial instruments giving the right to the subscription, conversion, exchange or acquisition of shares which carry voting rights will not result in the obligation to launch a tender offer either until such subscription, conversion, exchange or acquisition occurs.

Notwithstanding the foregoing, upon the terms established in the regulations, the CNMV will conditionally dispense with the obligation to launch a mandatory bid when another person or entity, individually or jointly in concert, directly or indirectly holds an equal or greater voting percentage than the potential bidder in the target company.

The price of the mandatory tender offer is deemed equitable when it is at least equal to the highest price paid or agreed by the bidder or by any person acting in concert therewith for the same securities during the 12 months prior to the announcement of the tender offer. When the mandatory tender offer must be made without the bidder having previously acquired the shares over the above-mentioned 12-month period, the equitable price shall not be less than the price calculated in accordance with other rules set forth in the regulations. In any case, the CNMV may change the price so calculated in certain circumstances (extraordinary events affecting the price, evidence of market manipulation, etc.).

Mandatory offers must be launched within one month from the acquisition of the control of the target company.

Voluntary tender offers may be launched when a mandatory offer is not required. Voluntary offers are subject to the same rules established for mandatory offers except for the following:

they may be subject to certain conditions (such as amendments to the bylaws or adoption of certain resolutions by the target company, acceptance of the offer by a minimum number of securities, approval of the offer by the shareholders' meeting of the bidder and any other deemed by the CNMV to be in accordance with law), provided that such conditions can be met before the end of the acceptance period of the offer; and

they may be launched at any price, regardless of whether it is lower than the above-mentioned "equitable price". However, if they are not launched at an equitable price and if the tender offer shares representing at least 50% of the voting rights are tendered in the offer (excluding voting rights already held by the bidder and those belonging to shareholders who entered into an agreement with the bidder regarding the tender offer), the bidder may become obliged to launch a mandatory tender offer.

In any case, by virtue of an amendment to the Spanish Securities Market Act operated by Law 1/2012, of June 22, the price in a voluntary tender offer must be the higher of (i) the equitable price and (ii) the price resulting from an independent valuation report, and must at least consist of cash as an alternative if certain circumstances have occurred during the two years prior to the announcement of the offer (basically, the trading price for the shares being affected by price manipulation practices, market or share prices being affected by natural disasters, *force majeure*, or other exceptional events, or the target company being subject to expropriation or confiscation resulting in a significant impairment of the company's real value).

Spanish regulations on tender offers set forth further provisions, including:



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subject to shareholder approval within 18 months from the date of announcement of the tender offer, the board of directors of a target company will be exempt from the rule prohibiting frustrating action against a foreign bidder whose board of directors is not subject to an equivalent passivity rule;

defensive measures included in a listed company's bylaws and transfer and voting restrictions included in agreements among a listed company's shareholders will remain in place whenever the company is the target of a tender offer, unless the shareholders resolve otherwise (in which case any shareholders whose rights are diluted or otherwise adversely affected will be entitled to compensation at the target company's expense); and

squeeze-out and sell-out rights will apply provided that following a tender offer for all the target's share capital, the bidder holds securities representing at least 90% of the target company's voting capital and the tender offer has been accepted by the holders of securities representing at least 90% of the voting rights other than those held by or attributable to the bidder previously to the offer.

## **Payment of Taxes**

Holders of ordinary shares will be responsible for any taxes or other governmental charges payable on their ordinary shares, including any taxes payable on transfer. The paying agent or the transfer agent, as the case may be, may, and upon instruction from Telefónica, will:

refuse to effect any registration of transfer of such ordinary shares or any split-up or combination thereof until such payment is made; or

withhold or deduct from any distributions on such ordinary shares or sell for the account of the holder thereof any part or all of such ordinary shares (after attempting by reasonable means to notify such holder prior to such sale), and apply, after deduction for its reasonable expenses incurred in connection therewith, the net proceeds of any such sale to payment of such tax or other governmental charge. The holder of such ordinary shares will remain liable for any deficiency.

## **Dividends**

Shareholders vote on final dividend distributions at the shareholders' meeting. Distributable profits are equal to:

net profits for the year; plus

profits carried forward from previous years; plus

distributable reserves; minus

losses carried forward from previous years; minus

amounts allocated to reserves as required by law or by our bylaws.

The amount of distributable profits is based on our unconsolidated financial statements prepared in accordance with Spanish GAAP, which differ from the Consolidated Financial Statements prepared in accordance with IFRS included elsewhere in this Annual Report.

The Board of Directors can approve interim dividend payments without a prior shareholder vote on the issue. However, under those circumstances, the dividend is limited to distributable net profits of the current year and is subject to certain legal requirements.

Unclaimed dividends revert to us five years from their date of payment.

### ***Registration and transfers***

Our shares are in registered book-entry form. Transfers executed through stock exchange systems are implemented pursuant to the stock exchange clearing and settlement procedures carried out by the Spanish clearing institution. Transfers executed outside of stock exchange systems, that is, over the counter, are implemented pursuant to the general legal regime for book-entry transfer, including registration by the Spanish clearing institution.

There are no restrictions with respect to the transfer of our shares.

### ***Liquidation rights***

Under Spanish law, upon our liquidation, the shareholders would be entitled to receive, on a pro rata basis, any assets remaining after the payment of our debts and taxes and liquidation expenses.



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C. Material Contracts

Divestment in Telecom Italia and Termination of Contracts Relating to Such Investment

On June 16, 2014, the Italian shareholders of Telco, S.p.A. (Assicurazioni Generali, S.p.A., Intesa Sanpaolo, S.p.A. Mediobanca, S.p.A.) requested the initiation of the process of demerger of such company, as provided in the relevant shareholders agreement.

The implementation of such demerger process, which was approved by the General Shareholders' Meeting of Telco held on July 9, 2014, was subject to obtaining all the required anti-trust and telecommunications approvals (including in Brazil and Argentina). Once the aforementioned approvals were obtained, the demerger deed was executed on June 17, 2015, becoming effective on June 18, 2015 after its registration in the Madrid Mercantile Registry. As a consequence of the demerger, the Telecom Italia ordinary shares held by Telco – which represented 22.3% of the company's ordinary share capital – were allocated as follows: 14.72% was allocated to Telco TE, S.p.A., a newly created company owned by Telefónica; 4.31% to a newly created company owned by the Generali group; and 1.64% to each of the newly created companies owned by Intesa Sanpaolo and Mediobanca respectively.

Moreover, the shareholders' agreement in force between the shareholders of Telco ceased to have effect on June 18, 2015.

In accordance with the regulatory and competition commitments it had assumed, Telefónica completed the divestment of its entire stake in Telecom Italia, S.p.A. during this period.

Investment in China Unicom

On September 6, 2009, Telefónica and China Unicom entered into a subscription agreement, (the "Subscription Agreement"), pursuant to which each party conditionally agreed to invest the equivalent of 1 billion U.S. dollars in the other party through the acquisition of shares in the other party. Moreover, both parties entered into a strategic alliance agreement which provides for, among other areas for cooperation, joint procurement of infrastructure and client equipment, common development of mobile service platforms, joint provisions of service to multinational customers, roaming, research and development, sharing of best practices and technical, operational and management know-how, joint development of strategic initiatives in the area of network evolution, joint participation in international alliances and exchanges of senior management.

On October 21, 2009, the mutual share exchange pursuant to the Subscription Agreement was implemented through the subscription by Telefónica Internacional of 693,912,264 newly issued shares of China Unicom and a contribution in kind to China Unicom of 40,730,735 shares of Telefónica.

Following the completion of the transaction, we increased our share of China Unicom's voting share capital from 5.38% to 8.06% and obtained the right to appoint a member to its board of directors, while China Unicom became owner of approximately 0.87% of our voting share capital at that date. Subsequently, after a capital reduction carried out by China Unicom, we reached a shareholding equivalent to 8.37% of the company's voting share capital.

Under the Subscription Agreement, we agreed with China Unicom that for a period of one year from completion of the acquisition of the mutual share exchange, we shall not, directly or indirectly, sell, transfer or dispose of any of the China Unicom shares held, directly or indirectly, by us or any of our subsidiaries (save for the transfer of such shares to any member of the Telefónica group). China Unicom has made an analogous undertaking with respect to its participation in our share capital.

In addition, subject to Telefónica or any of its subsidiaries holding in aggregate, directly or indirectly, not less than 5% of the issued share capital of China Unicom from time to time and to the extent not prohibited under applicable law, the articles of association of China Unicom and the Hong Kong Listing Rules, we shall be entitled to nominate one representative to the Board of Directors of China Unicom.

Finally, with effect from completion, and for so long as the strategic alliance agreement is in effect, China Unicom shall not (i) offer, issue or sell any significant number of its ordinary shares (including those held in treasury by the company itself, if any), or any securities convertible into or other rights to subscribe for or purchase a significant number of China Unicom's ordinary shares (including those held in treasury by the company itself, if any), to any of our current major competitors; or (ii) make any significant investment, directly or indirectly, in any of our current major competitors. We have made similar undertakings.

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The strategic alliance agreement between the parties terminates on the third anniversary and automatically renews thereafter for one year terms, subject to either party's right to terminate on six months' notice. Also, the strategic alliance agreement may be terminated by China Unicom if we sell our shares in China Unicom causing us to own less than 5% of the issued share capital of China Unicom or by us if China Unicom sells our shares and ceases to own at least 0.5% of our issued share capital. In addition, the strategic alliance agreement is subject to termination in the event either party is in default and automatically terminates on a change in control of China Unicom.

On January 23, 2011, Telefónica and China Unicom entered into an extension to their already existing strategic alliance agreement (the "**Enhanced Strategic Alliance Agreement**") in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas and through which, upon the terms and conditions set out thereof, each party agreed to invest the equivalent of 500 million U.S. dollars in ordinary shares of the other party toward the alliance. Furthermore, we agreed to propose the appointment of a director nominated by China Unicom.

Pursuant to the Enhanced Strategic Alliance Agreement, Telefónica, through its wholly-owned subsidiary, Telefónica Internacional acquired 282,063,000 ordinary shares of China Unicom through several transactions executed in the period between January 25, 2011, and September 7, 2011, investing an aggregate amount equivalent to approximately 500 million U.S. dollars (equivalent to 358 million euros).

Additionally, on January 28, 2011, China Unicom acquired 21,827,499 Telefónica shares at the agreed price of 17.16 euros per share, giving it ownership of 1.37% of the Company's capital (the arithmetic average of the closing price of Telefónica shares as quoted on the Madrid Stock Exchange for the thirty consecutive trading days ending on January 14, 2011), which represents a total price of 500 million U.S. dollars. In recognition of China Unicom's stake in Telefónica, the Company nominated Mr. Chang Xiaobing, who was designated by China Unicom, to the Board of Directors at the General Shareholders' Meeting held on May 18, 2011.

At December 31, 2011, Telefónica's shareholding in China Unicom amounted to 9.6% of its capital stock.

Since their strategic alliance agreement signed in September 2009, Telefónica and China Unicom have made significant progress in various areas of cooperation. In this respect, we believe that this agreement will enhance this alliance and deepen cooperation between the two companies in the areas of procurement, mobile service platforms, service to multinational customers, wholesale carriers, roaming technology/R&D, international business development, cooperation and sharing of best practices.

On June 10, 2012, Telefónica, S.A. through its 100% subsidiary, Telefónica Internacional, S.A.U., and China United Network Communications Group Company Limited ("**Unicom Parent**") through a 100% owned subsidiary, signed an agreement for the acquisition by this last company of 1,073,777,121 shares of China Unicom -Hong Kong- Limited, owned by Telefónica, equivalent to 4.56% of the issued share capital.

On July 21, 2012, the aforementioned agreement was complemented by a Supplemental Agreement which determined the acquisition of the shares at a price of HK\$10.02 per share, for a total amount of HK\$10,759,246,752.42 (approximately 1,142 million euros). The transaction was completed on July 30, 2012, after obtaining the relevant regulatory authorizations.

On November 10, 2014, Telefónica, through its 100% subsidiary Telefónica Internacional, S.A.U., sold 597,844,100 shares of China Unicom (Hong Kong) Limited (representing 2.5% of the share capital of that company), through a block trade process, at a price of HK\$ 11.14 per share, for a total amount of HK\$ 6,660 million, approximately 687 million euros at the exchange rate as at the date of the sale.

On June 10, 2012, Telefónica, S.A. through its 100% subsidiary, Telefónica Internacional, S.A.U., transferred 361,794,559 shares in China Unicom (representing 1.51% of the latter's issued share capital), through a block trade at a price of HK\$ 7.80 per share, for a total amount of HK\$ 2,822 million, approximately 322 million euros at the exchange rate as at the date of the sale.

Further to such sale, Telefónica maintains its commitment to the strategic alliance with China Unicom.

On July 10, 2016, Telefónica Internacional, S.A.U. (a 100% subsidiary of Telefónica, S.A.) sold 361,794,559 shares of China Unicom (Hong Kong) Limited ("**China Unicom HK**"), representing 1.51% of the share capital of the company, through a block trade process, at a price of 7.80 Hong Kong dollars per share, for a total amount of 2,822 million Hong Kong dollars, approximately 322 million euros.

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On December 31, 2016, Telefónica's shareholding in China Unicom amounts close to 1% of its capital stock, being Mr. César Alierta, former chairman of Telefónica, a member of the Board of Directors of China Unicom, and Mr. Wang Xiaochu, chairman of China Unicom, member of the Board of Telefónica, S.A.

**Agreement related to the Sale of Customer Relationship Management (“CRM”) Business, Atento**

As a result of the sale agreement of Atento by Telefónica, announced on October 12, 2012, and ratified on December 12, 2012, both companies signed a Master Service Agreement which regulates Atento's relationship with the Telefónica Group as a service provider for a period of nine years and which was amended on May 16, 2014, and on November 8, 2016. This period was extended only for Spain and Brazil in November 2016, for two additional years until 2023.

By virtue of this agreement, Atento became Telefónica's preferred Contact Center and Customer Relationship Management (“CRM”) service provider, stipulating annual commitments in terms of turnover which is updated based on inflation and deflation that vary from country to country, pursuant to the volume of services Atento has been providing to the entire Group. Effective January 1, 2017, the minimum volume commitments that Telefónica must comply with have significantly decreased for Brazil.

Failure to meet the annual turnover commitments generally results in the obligation to the counterparty, to pay additional amounts, which would be calculated based on the difference between the actual amount of turnover and the predetermined commitment, applying a percentage based on the Contact Center's business margin to the final calculation.

The Master Agreement sets forth a reciprocal arrangement, whereby Atento assumes similar commitments to subscribe its telecommunications services to Telefónica.

**Agreement for the Acquisition of Global Village Telecom, S.A. and Its Holding Company GVT Participações, S.A. (“GVT”)**

On September 19, 2014, Telefónica, S.A. signed an agreement with Vivendi, S.A., for the acquisition by Telefônica Brasil, S.A. of Global Village Telecom, S.A. and its holding company GVT Participações, S.A. (jointly “GVT”) for a cash consideration of 4,663 million euros (through payment in cash and debt assumption), as well as the delivery of shares representing 12% of the share capital of the new Telefônica Brasil, S.A. (following its integration with GVT).



As part of the agreement, Vivendi, S.A. acquired 1,110 million ordinary shares in Telecom Italia from Telefónica, (which represented, as of such date, 8.2% of Telecom Italia's voting share capital and 5.7% of its total share capital), in exchange for 4.5% of the total share capital of Telefônica Brasil, S.A. (following its integration with GVT).

The cash consideration for the GVT Acquisition was financed through a capital increase of Telefônica Brasil, S.A. which was subscribed by Telefónica, S.A. in proportion to its stake. Telefónica, S.A. financed such subscription via its own capital increase.

On May 28, 2015, once the relevant regulatory approvals were obtained, the Extraordinary General Shareholders' Meeting of Telefônica Brasil, S.A. held on May 28, 2015, approved the acquisition as well as the issue of shares of Telefônica Brasil to Vivendi, S.A., as partial payment of the purchase price of GVT. The acquisition of GVT was therefore completed.

Accordingly, since May 1, 2015, GVT is incorporated in the consolidation perimeter of the Telefónica Group by the global integration method.

#### **Agreement for the divestment of Telefónica's operations in the United Kingdom ("O2 UK")**

On March 24, 2015, Telefónica signed an agreement with Hutchison Whampoa Group for the acquisition by the latter of Telefónica's operations in the United Kingdom (O2 UK) for a price (firm value) of 10,250 million pounds sterling in cash (approximately 14,000 million euros at the exchange rate as of the date of the agreement).

On May 11, 2016, the EC made public its decision to prohibit the transaction under the European Union merger regulations, resulting in the termination of the aforementioned agreement between Telefónica and Hutchison Whampoa Group.

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D. Exchange Controls

Exchange Controls and Other Limitations Affecting Security Holders

***Ownership limitations***

There are no limitations with respect to the ownership of our assets or share capital except those derived from the application of the reciprocity principle as described above.

***Trading by us in our own shares or shares of companies under our control***

For information on the requirements applicable to the trading by us in our own shares or shares of companies under our control, see “—Memorandum and Articles of Association- Description of Our Capital Stock—Acquisition of own shares” above.

***Other restrictions on acquisitions of shares***

For information on reporting requirements and other restrictions “applicable to the acquisition of our shares see “—Memorandum and Articles of Association—Description of Our Capital Stock-Reporting requirements” and “—Trading by in our own shares or shares of companies under our control” above.

Dividend and Liquidation Rights

According to Spanish law and our bylaws, dividends may only be paid out of profits or distributable reserves if the value of our net worth is not, and as a result of such distribution would not be, less than our capital stock. Pursuant to Spanish law, we are required to reserve 10% of our fiscal year net income until the amount in our legal reserve reaches 20% of our capital. Our legal reserve is currently at 20%.

Dividends payable by us to non-residents of Spain ordinarily are subject to a Spanish withholding tax. For the tax implications of dividends to U.S. Holders (as defined below), see “—Taxation.”

Upon our liquidation, our shareholders would be entitled to receive pro rata any assets remaining after the payment of our debts and taxes and expenses of such liquidation. Any change in the rights of shareholders to receive dividends and payment upon liquidation would require an amendment to our bylaws by resolution adopted by a general meeting of shareholders. If there were more than one class of shares, such amendment would also require the approval of each class of shareholders affected by the amendment.

#### Preemptive Rights and Increases of Share Capital

Pursuant to the Spanish Corporations Law, shareholders have preemptive rights to subscribe for any new shares and for bonds convertible into shares. Such rights may not be available under special circumstances if waived by a resolution passed at a general meeting of shareholders in accordance with Article 308 of the Spanish Corporations Law, or the Board of Directors, if authorized (Article 506 of the Spanish Corporation Act). Further, such rights, in any event, will not be available in the event of an increase in capital to meet the requirements of a convertible bond issue or a merger in which shares are issued as consideration. Such rights:

are transferable;

may be traded on the Automated Quotation System; and

may be of value to existing shareholders because new shares may be offered for subscription at prices lower than prevailing market prices.

Absent an exemption from registration, shares issuable upon exercise of rights must be registered under the Securities Act in order to be offered to holders of ADRs. If we decided not to register the shares, the rights would not be distributed to holders of ADRs. Pursuant to the Deposit Agreement, however, holders of ADRs are entitled to receive their proportionate share of the proceeds, if any, from sale by the Depositary of any rights accruing to holders of ADRs.

#### E. Taxation

The following is a general summary of the material Spanish and U.S. federal income tax consequences to U.S. Holders described below of the ownership and disposition of shares or ADSs. This summary is based upon Spanish and U.S. tax laws (including the U.S. Internal Revenue Code of 1986, as amended (the “Code”), final, temporary and

proposed U.S. Treasury regulations, rulings, judicial decisions and administrative pronouncements), and the Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed February 22, 1990 (the “**Treaty**”), all as of the date hereof and all of which are subject to change or changes in interpretation, possibly with retroactive effect. In addition, the summary is based in part on representations of the Depositary and assumes that each obligation provided for in or otherwise contemplated by the Deposit Agreement or any other related agreements will be performed in accordance with its terms.

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As used herein, the term “U.S. Holder” means a beneficial owner of one or more shares or ADSs:

that is, for U.S. federal income tax purposes, one of the following:

- (a) a citizen or individual resident of the United States;
  - (b) a corporation (or other entity taxable as a corporation) created or organized in or under the laws of the United States or any state therein or the District of Columbia; or
  - (c) an estate or trust the income of which is subject to U.S. federal income taxation regardless of its source;
- who is entitled to the benefits of the Treaty;
- who holds the shares or ADSs as capital assets for U.S. federal income tax purposes;
- who owns, directly, indirectly or by attribution, less than 10% of the share capital or voting stock of Telefónica; and
- whose holding is not attributable to a fixed base or permanent establishment in Spain.

This summary does not address all of the tax considerations, including the potential application of the provisions of the Code known as the Medicare contribution tax, that may apply to holders that are subject to special tax rules, such as certain U.S. expatriates, insurance companies, tax-exempt organizations, certain financial institutions, persons subject to the alternative minimum tax, dealers and certain traders in securities, persons holding shares or ADSs as part of a straddle, hedging, conversion or integrated transaction, persons who acquired their shares or ADSs pursuant to the exercise of employee stock options or otherwise as compensation, persons owning shares or ADSs in connection with a trade or business outside of the U.S., partnerships or other entities classified as partnerships for U.S. federal income tax purposes or persons whose functional currency is not the U.S. dollar. Such holders may be subject to U.S. federal income tax consequences different from those set forth below.

If a partnership holds shares or ADSs, the tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. A partner in a partnership that holds shares or ADSs is urged to consult its own tax advisor regarding the specific tax consequences of owning and disposing of the shares or ADSs.

For purposes of the Treaty and U.S. federal income tax, U.S. Holders of ADSs will generally be treated as owners of the underlying shares represented by such ADSs. Accordingly, no gain or loss will be recognized if a U.S. Holder

exchanges ADSs for the underlying shares represented by those ADSs.

The U.S. Treasury has expressed concerns that parties to whom American depositary receipts are released before shares are delivered to the depositary, or intermediaries in the chain of ownership between holders and the issuer of the security underlying the American depositary receipts, may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. holders of American depositary receipts. Such actions would also be inconsistent with the claiming of the reduced rates of tax applicable to dividends received by certain non-corporate U.S. Holders. Accordingly, the availability of foreign tax credits to U.S. Holders of ADSs and the reduced tax rates for dividends received by certain non-corporate U.S. Holders of ADSs, each as described below, could be affected by actions taken by such parties or intermediaries.

This discussion assumes that Telefónica is not, and will not become, a passive foreign investment company (“PFIC”), as discussed below under “—U.S. Federal Income Tax Considerations—Passive foreign investment company rules.”

U.S. Holders of shares or ADSs should consult their own tax advisors concerning the specific Spanish and U.S. federal, state and local tax consequences of the ownership and disposition of shares or ADSs in light of their particular situations as well as any consequences arising under the laws of any other taxing jurisdiction. In particular, U.S. Holders are urged to consult their own tax advisors concerning their eligibility for benefits under the Treaty.

## **Spanish Tax Considerations**

### ***Taxation of dividends***

Under Spanish law, dividends paid by Telefónica to U.S. Holders of ordinary shares or ADSs are subject to Spanish Non-Resident Income Tax, withheld at source, at a rate of 19%. For these purposes, upon distribution of the dividend, Telefónica or its paying agent will withhold an amount equal to the tax due according to the rules set forth above.

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However, under the Treaty, if you are a U.S. Holder, you are entitled to a reduced withholding tax rate of 15%.

To benefit from the Treaty-reduced rate of 15%, you must provide to Telefónica through its paying agent in Spain, before the tenth day following the end of the month in which the dividends were payable, a certificate from the U.S. Internal Revenue Service (“**IRS**”) stating that, to the best knowledge of the IRS, such U.S. Holders are residents of the United States within the meaning of the Treaty and entitled to its benefits.

If this certificate is not provided within this period, you may afterwards apply for a refund of the amount withheld in excess of the rate provided for in the Treaty by following the procedures described in the next section.

*Spanish Refund Procedure*

According to Spanish Regulations on Non-Resident Income Tax, approved by Royal Decree 1776/2004 dated July 30, 2004, as amended, a refund for the amount withheld in excess of the Treaty-reduced rate can be obtained from the relevant Spanish tax authorities. To pursue the refund claim, if you are a U.S. Holder, you are required to file:

- the corresponding Spanish tax form;
- the certificate referred to in the preceding section; and
- evidence of the Spanish Non-Resident Income Tax that was withheld with respect to you.

The refund claim must be filed within four years from the date in which the withheld tax was collected by the Spanish tax authorities.

U.S. Holders are urged to consult their own tax advisors regarding refund procedures and any U.S. tax implications thereof.

*Taxation of capital gains*

For Spanish tax purposes, income obtained from the sale of ADSs or ordinary shares of Telefónica will be treated as capital gains. Spanish non-resident income tax is levied at a rate of 19% on capital gains obtained by persons not residing in Spain for tax purposes who are not entitled to the benefit of any applicable treaty for the avoidance of double taxation.

Notwithstanding the above, capital gains derived from the transfer of shares on an official Spanish secondary stock market by any holder who is resident in a country that has entered into a treaty for the avoidance of double taxation with an “exchange of information” clause (the Treaty contains such a clause) will be exempt from taxation in Spain. If you are a U.S. Holder, under the Treaty capital gains arising from the disposition of ordinary shares or ADSs will not be taxed in Spain. You will be required to establish that you are entitled to the exemption from tax under the Treaty by providing to the relevant Spanish tax authorities a certificate of residence issued by the IRS stating that to the best knowledge of the IRS, you are a U.S. resident within the meaning of the Treaty.

### ***Spanish wealth tax***

Individual U.S. Holders who hold shares or ADSs located in Spain are subject to the Spanish Wealth Tax (Impuesto sobre el Patrimonio) (Spanish Law 19/1991), which imposes tax on property located in Spain on the last day of any year. As of January 1, 2017 a 100% tax allowance has been approved by Royal Legislative Decree 13/2011 dated September, 16, 2011 to any resident or non resident taxpayer.

### ***Inheritance and gift tax***

Transfers of shares or ADSs on death and by gift to individuals are subject to Spanish inheritance and gift taxes (Impuesto sobre Sucesiones y Donaciones), respectively, if the transferee is a resident of Spain for tax purposes, or if the shares or ADSs are located in Spain at the time of death, regardless of the residence of the heir or beneficiary. In this regard, the Spanish tax authorities may determine that all shares of Spanish corporations and all ADSs representing such shares are located in Spain for Spanish tax purposes. The state applicable tax rate, after applying relevant personal, family and wealth factors, generally ranges between 7.65% and 81.6% for individuals.

Gifts granted to corporations non-resident in Spain are subject to Spanish Non-Resident Income Tax at a rate of 19% on the fair market value of the shares as a capital gain. If the donee is a United States resident corporation, the exclusions available under the Treaty described in the section “—Taxation of Capital Gains” above will be applicable.



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*Expenses of Transfer*

Transfers of shares or ADSs will be exempt from any transfer tax (Impuesto sobre Transmisiones Patrimoniales) or value added tax. Additionally, no stamp tax will be levied on such transfers.

**U.S. Federal Income Tax Considerations**

*Taxation of dividends*

Distributions received by a U.S. Holder on shares or ADSs, including the amount of any Spanish taxes withheld therefrom, other than certain pro rata distributions of shares to all shareholders (including ADS holders), will constitute foreign-source dividend income to the extent paid out of Telefónica's current or accumulated earnings and profits (as determined for U.S. federal income tax purposes). Because Telefónica does not maintain calculations of its earnings and profits under U.S. federal income tax principles, it is expected that distributions generally will be reported to U.S. Holders as dividends. The amount of dividend income paid in euro that a U.S. Holder will be required to include in income will equal the U.S. dollar value of the distributed euro, calculated by reference to the exchange rate in effect on the date the payment is received by the Depositary (in the case of ADSs) or by the U.S. Holder (in the case of shares), regardless of whether the payment is converted into U.S. dollars on the date of receipt. If the dividend is converted into U.S. dollars on the date of receipt, a U.S. Holder will generally not be required to recognize foreign currency gain or loss in respect of the dividend income. A U.S. Holder may have foreign currency gain or loss if the dividend is converted into U.S. dollars after the date of its receipt. Gain or loss that a U.S. Holder realizes on a sale or other disposition of euro will be U.S.-source ordinary income or loss. Corporate U.S. Holders will not be entitled to claim the dividends-received deduction with respect to dividends paid by Telefónica. Subject to applicable limitations and the discussion above regarding concerns expressed by the U.S. Treasury, dividends received by certain non-corporate U.S. Holders will be taxable at rates applicable to long-term capital gains. Non-corporate U.S. Holders should consult their own tax advisors to determine whether they are subject to any special rules that limit their ability to be taxed at these favorable rates.

Spanish income taxes withheld from dividends on shares or ADSs at a rate not exceeding the rate provided in the Treaty will be creditable against a U.S. Holder's U.S. federal income tax liability, subject to applicable restrictions and limitations that may vary depending upon the U.S. Holder's circumstances and the discussion above regarding concerns expressed by the U.S. Treasury. Spanish taxes withheld in excess of the rate applicable under the Treaty will not be eligible for credit against a U.S. Holder's federal income tax liability. See "Spanish Tax Considerations—Taxation of dividends" above for a discussion of how to obtain the applicable treaty rate. Instead of claiming a credit, a U.S. Holder may elect to deduct foreign taxes (including the Spanish taxes) in computing its taxable income, subject to generally applicable limitations. An election to deduct foreign taxes (instead of claiming foreign tax credits) applies to all taxes paid or accrued in the taxable year to foreign countries and possessions of the United States. The limitations on foreign taxes eligible for credit are calculated separately with respect to specific classes of income. The rules governing foreign tax credits are complex. Therefore, U.S. Holders should consult their own tax advisors regarding

the availability of foreign tax credits in their particular circumstances.

***Taxation upon sale or other disposition of shares or ADSs***

A U.S. Holder will generally recognize U.S. source capital gain or loss on the sale or other disposition of shares or ADSs. Any such gain or loss will be long-term capital gain or loss if the U.S. Holder has held such shares or ADSs for more than one year. The amount of the U.S. Holder's gain or loss will be equal to the difference between such U.S. Holder's tax basis in the shares or ADSs sold or otherwise disposed of and the amount realized on the sale or other disposition, as determined in U.S. dollars.

As discussed under "Spanish Tax Considerations—Taxation of capital gains" above, gain realized by a U.S. Holder on the sale or other disposition of shares or ADSs will be exempt from Spanish tax on capital gains under the Treaty. If a U.S. Holder is eligible for the exemption from Spanish tax on capital gains but does not follow appropriate procedures for obtaining the exemption, such holder will not be entitled to credit the amount of Spanish tax on capital gains paid against its U.S. federal income tax liability. U.S. Holders should consult their own tax advisors regarding the potential Spanish tax consequences of a sale or other disposition of shares or ADSs and the procedures available for an exemption from such tax.

***Passive foreign investment company rules***

Telefónica believes that it was not a PFIC for U.S. federal income tax purposes for its 2016 taxable year. However, because PFIC status depends upon the composition of a company's income and assets and the market value of its assets (including, among others, less than 25% owned equity investments) from time to time, there can be no assurance that Telefónica will not be considered a PFIC for any taxable year. If Telefónica were treated as a PFIC for any taxable year during which a U.S. Holder owned a share or ADS, certain adverse tax consequences could apply to the U.S. Holder.

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In general, if Telefónica were treated as a PFIC for any taxable year during which a U.S. Holder owned a share or ADS, gain recognized by a U.S. Holder on a sale or other disposition of such share or ADS would be allocated ratably over the U.S. Holder's holding period for the share or ADS. The amounts allocated to the taxable year of the sale or other disposition and to any year before Telefónica became a PFIC would be taxed as ordinary income. The amount allocated to each other taxable year would be subject to tax at the highest rate in effect for individuals or corporations, as appropriate, and an interest charge would be imposed on the resulting tax liability. The same treatment would apply to any distribution in respect of shares or ADSs to the extent it exceeds 125% of the average of the annual distributions on shares or ADSs received by the U.S. Holder during the preceding three years or the U.S. Holder's holding period, whichever is shorter. Certain elections may be available that would result in alternative treatments (such as mark-to-market treatment) of the shares or ADSs.

In addition, if Telefónica were treated as a PFIC in a taxable year in which it pays a dividend or in the prior taxable year, the favorable dividend rates discussed above with respect to dividends paid to certain non-corporate U.S. Holders would not apply.

If Telefónica were a PFIC for any taxable year during which a U.S. Holder owned our shares or ADSs, the U.S. Holder will generally be required to file IRS Form 8621 with its annual U.S. federal income tax return.

***Information reporting and backup withholding***

Payments of dividends and sales proceeds that are made within the United States or through certain U.S.-related financial intermediaries generally are subject to information reporting and may be subject to backup withholding unless the U.S. Holder is a corporation or other exempt recipient or, in the case of backup withholding, the U.S. Holder provides a correct taxpayer identification number and certifies that it is not subject to backup withholding. The amount of any backup withholding from a payment to a U.S. Holder will be allowed as a credit against the U.S. Holder's U.S. federal income tax liability and may entitle such U.S. Holder to a refund, provided that the required information is timely furnished to the IRS.

Certain U.S. Holders who are individuals and certain specified entities, may be required to report information relating to stock of a non-U.S. person, subject to certain exceptions (including an exception for stock held through a U.S. financial institution). U.S. Holders are urged to consult their tax advisors regarding the application, if any, of this legislation to their ownership of shares or ADSs.

F. Dividends and Paying Agents

Not Applicable.

#### G. Statements by Experts

Not Applicable.

#### H. Documents on Display

#### Where You Can Find More Information

We file Annual Reports on Form 20-F and furnish periodic reports on Form 6-K to the SEC. You may read and copy any of these reports at the SEC's public reference room in Washington, D.C. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our SEC filings are also available to the public from commercial document retrieval services. Some of our SEC filings are also available at the website maintained by the SEC at "<http://www.sec.gov>."

Our ADSs are listed on the New York Stock Exchange under the symbol "TEF." You may inspect any periodic reports and other information filed with or furnished to the SEC by us at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

As a foreign private issuer, we are exempt from the rules under the Exchange Act which prescribe the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act.

We are subject to the informational requirements of the Spanish securities commission and the Spanish Stock Exchanges, and we file reports and other information relating to our business, financial condition and other matters with the Spanish securities commission and the Spanish Stock Exchanges. You may read such reports, statements and other information, including the annual and biannual financial statements, at the public reference facilities maintained in Madrid and Barcelona. Some of our Spanish securities commission filings are also available at the website maintained by the CNMV at <http://www.cnmv.es>.

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We have appointed Citibank, N.A. to act as Depositary for the Telefónica ADSs. Citibank will, as provided in the Deposit Agreement, arrange for the mailing of summaries in English of such reports and communications to all record holders of the ADSs of Telefónica. Any record holder of Telefónica ADSs may read such reports and communications or summaries thereof at Citibank's office located at 388 Greenwich Street, 14th Floor, New York, New York 10013.

I. Subsidiary Information

Not applicable.

Item 11. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various financial market risks as a result of: (i) our ordinary business activity, (ii) debt incurred to finance our business, (iii) our investments in companies, and (iv) other financial instruments related to the above commitments.

The main market risks affecting us are as follows:

*a) Exchange rate risk*

Exchange rate risk arises primarily from (i) our international presence, through our investments and businesses in countries that use currencies other than the euro (primarily in Latin America, but also in the United Kingdom), and (ii) debt denominated in currencies other than that of the country where the business is conducted or the home country of the company incurring such debt.

*b) Interest rate risk*

Interest rate risk arises primarily from changes in interest rates affecting (i) financial expenses on floating rate debt (or short-term debt likely to be renewed), due to changes in interest rates and (ii) the value of long-term liabilities at fixed interest rates.

*c) Share price risk*

Share price risk arises primarily from changes in the value of our equity investments that may be bought, sold or otherwise involved in transactions, from changes in the value of derivatives associated with such investments, from changes in the value of our treasury shares and from equity derivatives.

We are also exposed to liquidity risk if a mismatch arises between our financing needs (including operating and financial expense, investment, debt redemptions and dividend commitments) and our sources of finance (including revenues, divestments, credit lines from financial institutions and capital market transactions). The cost of financing could also be affected by movements in credit spreads (over benchmark rates) demanded by lenders.

Furthermore, we are exposed to “country risk” (which overlaps with market and liquidity risks). This refers to the possible decline in the value of assets, cash flows generated or cash flows returned to the parent company as a result of political, economic or social instability in the countries where we operate, especially in Latin America.

We seek to actively manage these risks through the use of derivatives (primarily on exchange rates, interest rates and share prices) and by incurring debt in local currencies, where appropriate, with a view to stabilizing cash flows, our income statement and, to a lesser extent, part of the value of our investments. In this way, we attempt to protect our solvency, facilitate financial planning and take advantage of investment opportunities.

We manage our exchange rate risk and interest rate risk in terms of net financial debt and net financial debt plus commitments as calculated by us. We believe that these parameters are more appropriate to understanding our debt position. Net financial debt and net financial debt plus commitments take into account the impact of our cash balance and cash equivalents including derivatives positions with a positive value linked to liabilities. Neither net financial debt nor net financial debt plus commitments as calculated by us should be considered as a substitute for gross financial debt (the sum of current and non-current interest-bearing debt) as a measure of our leverage. For a more detailed description on reconciliation of net debt and net financial debt to gross financial debt, see “Item 5. Operating and Financial Review and Prospects—Presentation of Financial Information—Non-GAAP financial information—Net financial debt and net financial debt plus commitments.”

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For a more detailed description on quantitative and qualitative disclosures about market risks see Note 16 to our Consolidated Financial Statements.

## Item 12. Description of Securities Other Than Equity Securities

## D. American Depositary Shares

The Depositary of our ADR program is Citibank, N.A., and the address of its principal executive office is 388 Greenwich Street, 14th Floor, New York, New York 10013.

Our ADSs are listed on the New York Stock Exchange under the symbol “TEF.” Each ADS represents the right to receive one ordinary share of capital stock of 1.00 euros nominal value each, of Telefónica, S.A. The Depositary issues ADSs in the form of certificated ADSs (American Depositary Receipts, or ADRs) or uncertificated ADSs pursuant to the Deposit Agreement.

Under the terms of the Deposit Agreement, as of the date of this Annual Report, an ADS holder may have to pay to the Depositary the services fees specified in the table below:

| Category   | Depositary Actions  | Associated Fee / By Whom Paid   |
|--|---|---|
| (a) Depositing or substituting the underlying shares | Issuance of ADSs upon the deposit of shares   | Up to 5.00 dollars for each 100 ADSs (or portion thereof) evidenced by the new ADSs delivered (charged to person depositing the shares or receiving the ADSs)(1)  |
| (b) Receiving or distributing dividends              | Distribution of cash dividends or other cash distributions; distribution of share dividends or other free share distributions; distribution of securities other than ADSs or rights to purchase additional ADSs | Up to 5.00 dollars for each 100 ADSs (or portion thereof) held (in the case of cash distributions, deducted from the relevant distribution; in the case of all other distributions, billed to the relevant holder)(2) |
|  | Distribution or sale of securities  |   |

|  |   |   |
|--|---|---|
| (c) Selling or exercising rights   |   | Up to 5.00 dollars for each 100 ADSs (or portion thereof) held (billed to the relevant holder)  |
| (d) Withdrawing an underlying security   | Acceptance of ADSs surrendered for withdrawal of deposited securities | Up to 5.00 dollars for each 100 ADSs (or portion thereof) evidenced by the ADSs surrendered (charged to person surrendering or to person to whom withdrawn securities are being delivered)(1) |
| (e) Transferring, splitting or grouping receipts                               | Transfers   | Up to 1.50 dollars per ADS so presented (charged to person presenting certificate for transfer)   |
| (f) General depositary services, particularly those charged on an annual basis | Other services performed by the Depositary in administering the ADSs  | Up to 5.00 dollars for each 100 ADSs (or portion thereof) held on the applicable record date (billed to person holding ADSs on applicable record date established by the Depositary)(2)       |



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| Category                       | Depositary Actions  | Associated Fee / By Whom Paid   |
|--------------------------------|---|---|
|                                | Certain fees and expenses incurred by the depositary bank and certain taxes and governmental charges in connection with:  |   |
|                                | <ul style="list-style-type: none"> <li>· compliance with foreign exchange control regulations or any law or regulation relating to foreign investment;</li> <li>· the Depositary or its custodian's compliance with applicable law, rule or regulation;</li> </ul>  |   |
| (g) Expenses of the Depositary | <ul style="list-style-type: none"> <li>· stock transfer or other taxes and other governmental charges;</li> <li>· cable, telex, facsimile transmission/delivery;</li> <li>· expenses of the Depositary in connection with the conversion of foreign currency into U.S. dollars (which are paid out of such foreign currency);</li> <li>· any other charge payable by Depositary or its agents.</li> </ul> | Expenses payable at the sole discretion of the Depositary (billed or deducted from cash distributions to person holding ADSs on applicable record date established by the Depositary) |

(1) In the case of ADSs issued by the Depositary into DTC or presented to the Depositary via DTC, the ADS issuance and cancellation fees will be payable to the Depositary by DTC Participant(s) receiving the ADSs from the Depositary or the DTC Participant(s) surrendering the ADSs to the Depositary for cancellation, as the case may be, on behalf of the beneficial owner(s) and will be charged by the DTC Participant(s) to the account(s) of the applicable beneficial owner(s) in accordance with the procedures and practices of the DTC participant(s) as in effect at the time.

(2) For ADSs held through DTC, the Depositary fees for distributions other than cash and the Depositary service fee are charged by the Depositary to the DTC Participants in accordance with the procedures and practices prescribed by DTC from time to time and the DTC Participants in turn charge the amount of such fees to the beneficial owners for whom they hold ADSs.

The Depositary has agreed to reimburse or pay on behalf of Telefónica, S.A., certain reasonable expenses related to our ADS program and incurred by us in connection with the program (such as NYSE listing fees, legal and accounting fees incurred in connection with the preparation of Form 20-F and ongoing SEC compliance and listing requirements, distribution of proxy materials, investor relations expenses, etc.). The Depositary has covered all such expenses incurred by us during 2016 for an amount of 5.7 million dollars. The amounts the Depositary reimbursed or paid are not perforce related to the fees collected by the depositary from ADS holders.

As part of its service to us, the Depositary has agreed to waive certain expenses for the standard costs associated with the administration of our ADS program for the year ended December 31, 2016.

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Part II

Item 13. Defaults, Dividend Arrearages and Delinquencies

None.

Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds

Not applicable.

Item 15. Controls and Procedures

**Disclosure Controls and Procedures**

Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this Form 20-F, have concluded that, as of such date, our disclosure controls and procedures were effective.

**Management's Annual Report on Internal Control over Financial Reporting**

The management of Telefónica is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act. Telefónica's internal control system is designed to provide reasonable assurance as to the reliability of financial reporting and the preparation of the published financial statements under generally accepted accounting principles.

Any internal control system, no matter how well designed, has inherent limitations, including the possibility of human error and the circumvention or overriding of the controls and procedures, which may not prevent or detect misstatements.

Telefónica management assessed the effectiveness of Telefónica's internal control over financial reporting as of December 31, 2016. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO 2013 framework) in Internal Control – Integrated Framework. Based on its assessment and those criteria, Telefónica management believes that at December 31, 2016, Telefónica's internal control over financial reporting is effective.

#### **Report of the Independent Registered Public Accounting Firm**

Telefónica's independent registered public accounting firm, Ernst & Young, S.L., has issued a report on the effectiveness of the company's internal control over financial reporting. The report is included on page F-2.

#### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting during the period covered by this Annual Report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Item 16. [Reserved]

Item 16A. Audit Committee Financial Expert

Our Board of Directors has determined that Mr. José Javier Echenique Landiribar, Mr. Antonio Massanell Lavilla and Mr. Ignacio Moreno Martínez meet the requirements of an “audit committee financial expert” as such term is defined by the SEC.

Item 16B. Code of Ethics

Telefónica is governed by a code of business conduct and ethics called the Telefónica Business Principles. The Business Principles are binding on all employees globally, including senior officers, in their daily operations and on the Company in its relations with its stakeholders.

The standards set forth in the Telefónica Business Principles cover ethical issues such as honesty and trust, respect for the law, integrity and the respect of human rights, as well as how these ethical principles should be implemented in our relationships with our stakeholders: employees, customers, shareholders, suppliers and the communities we work in. Issues covered, amongst other, are professional development, health and safety, communications and advertising, corporate governance, risk management, anti-corruption, conflicts of interest, environmental protection, privacy and data protection, etc.

The Telefónica Business Principles are available and open to consultation for employees on the Telefónica Intranet site as well as for the general public on the Telefónica external website ([https://www.telefonica.com/en/web/about\\_telefonica/strategy/business-principles](https://www.telefonica.com/en/web/about_telefonica/strategy/business-principles) ).

In 2016, the Company reinforced the description of its anti-corruption principles in the Integrity section of its Business Principles. No waivers were granted in 2016.

For more information, please see “Item 16G. Corporate Governance - Code of Ethics.”

Item 16C. Principal Accountant Fees and Services

Please see Note 21(d) to our Consolidated Financial Statements.

### **The Audit and Control Committee's Pre-Approval Policies and Procedures**

The engagement of any service rendered by our external auditor or any of its affiliates must always have the prior approval of our Audit and Control Committee. Such Committee has developed a Pre-approval Policy regarding the engagement of professional services by our external auditor, in accordance with the Spanish Audit Law and the Sarbanes-Oxley Act. This Policy establishes the obligation to obtain prior approval from our Audit and Control Committee for any service to be rendered by our external auditor to Telefónica or any of its subsidiaries.

This Policy sets forth restrictions on engaging our external auditor for the performance of non-audit services, according to which the engagement of our external auditor for the provision of such services is only permitted when there is no other firm available to provide the needed services at a comparable cost and with a similar level of quality. Moreover, this Policy prohibits the engagement of our external auditor for the provision of certain type of services that would be considered as "prohibited services."

In addition, the Audit and Control Committee oversees the total amount of fees paid to our external auditor for the provision of non-audit services in order to assure that such fees do not exceed a certain percentage of the total amount of fees paid for the provision of audit services.

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## Item 16D. Exemptions from the Listing Standards for Audit Committees

Not applicable.

## Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The number of shares of treasury stock at December 31, 2016, amounted to 141,229,134 (141,639,159 at December 31, 2015). These treasury shares are directly owned by Telefónica, S.A.

| Year ended<br>December 31, 2016 |                                  |                                     |  |
|---------------------------------|----------------------------------|-------------------------------------|--|
| Period of Fiscal Year           | Total Number of Shares Purchased | Average Price Paid per Share (euro) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs(1) |
| January 1 to January 31         | 34,250,000                       | 9.48                                | 410,444  |
| February 1 to February 28       | 24,500,000                       | 9.04                                | 425,748  |
| March 1 to March 31             | 6,724,616                        | 9.87                                | 344,950  |
| April 1 to April 30             | 3,916,005                        | 9.42                                | 495,945  |
| May 1 to May 31                 | 500,000                          | 9.72                                | 362,111  |
| June 1 to June 30               | 1,264,787                        | 7.78                                | 640,012  |
| July 1 to July 31               | 250,000                          | 8.36                                | 167,480  |
| August 1 to August 31           | 250,000                          | 8.83                                | 22,644   |
| September 1 to September 30     | -                                | -                                   | -  |
| October 1 to October 31         | -                                | -                                   | -  |
| November 1 to November 30       | -                                | -                                   | -  |
| December 1 to December 31       | 5,431,889                        | 0.00                                | -  |
| <b>Total</b>                    | <b>77,087,297</b>                | <b>8.67</b>                         | <b>2,869,334</b>   |

(1) Under employee share plans a maximum of 2,869,334 shares could be assigned to employees participating in

voluntary plans. See Note 19 to our Consolidated Financial Statements.

For a more detailed description of our plans or programs, see “Item 8. Financial Information—Dividend Information and Shareholders’ Return” and Note 19 to our Consolidated Financial Statements.

#### Item 16F. Change in Registrant’s Certifying Accountant

On April 8, 2016, the Board of Directors of Telefónica, S.A., at the recommendation of its Audit and Control Committee and following a transparent competitive process, resolved to propose to the Ordinary General Shareholders’ Meeting of the Company, the appointment of PricewaterhouseCoopers Auditores, S.L. as the independent registered public accounting firm of Telefónica, S.A. and its consolidated group of companies for the years ending December 31, 2017, 2018 and 2019. This selection was approved by the shareholders at the annual shareholders’ meeting held on May 12, 2016. The appointment was registered in the Commercial Registry of Madrid on August 23, 2016 on page M-6164, volume 25.212, book 0, section 8, folio 181 record 1853.

As a consequence, Ernst & Young, S.L. was released as the independent registered public accounting firm of the Company as of February 23, 2017. The change of auditors was made pursuant to prevailing corporate governance practice and not the result of Ernst & Young, S.L.’s resignation, dismissal or declination to stand for re-election.

The reports of Ernst & Young, S.L. on the audits related to the Consolidated Financial Statements and the effectiveness of internal control over financial reporting for the past two fiscal years did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. There was no disagreement whatsoever relating to the years ended December 31, 2016, 2015 and 2014, and the period from January 1, 2017 through February 23, 2017 with Ernst & Young, S.L. on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement, if not resolved to the satisfaction of the Ernst & Young, S.L. would have caused them to make reference to the subject matter of the disagreement in connection with their reports.



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We have provided a copy of the above statements to Ernst & Young, S.L. and requested that Ernst & Young, S.L. furnish us with a letter addressed to the SEC stating whether or not they agree with the above disclosure. A copy of that letter, dated February 23, 2017, is filed as an exhibit to this Annual Report.

Item 16G. Corporate Governance

Significant Differences in Corporate Governance Practices

*Corporate governance guidelines*

In Spain, companies with securities listed on a Spanish Stock Exchange are expected to follow the Good Governance Code of Listed Companies (the “**Code**”) published in February 2015, which contains corporate governance and shareholder disclosure recommendations. Spanish listed companies are required by law to publish an Annual Report on Corporate Governance and a Report on the Compensation Policy of the Board of Directors. Additionally, Spanish listed companies are required to publish their corporate governance information on their websites. We base our corporate governance procedures on the recommendations of the Code. As part of our corporate governance procedures, we have adopted regulations for our Board of Directors that govern, among other things, director qualification standards, responsibilities, compensation, access to management information, the Board of Directors’ purpose and each of our Board Committee’s purpose and responsibilities. Moreover, we have a Regulation of the General Shareholders’ Meeting that aims to reinforce its transparency, providing shareholders with a framework guaranteeing and facilitating exercise of their rights. The Annual Report on Corporate Governance published by us provides a detailed explanation of our corporate governance procedures and explains the role and duties of our Board of Directors and Board Committees. Our Annual Report on Corporate Governance and the Report on the Compensation Policy of the Board of Directors of Telefónica, S.A. are available on our website at [www.telefonica.com](http://www.telefonica.com). None of the information contained on our website is incorporated in this Annual Report.

*Committees*

We have had an Audit and Control Committee since 1997. Our Audit and Control Committee is composed of five non-executive directors, all of whom are deemed Rule 10A-3 independent by our Board of Directors. The functions, composition and competencies of this Committee are regulated by the Board of Directors’ Regulations and are similar to those required by the New York Stock Exchange. The Audit and Control Committee shall consist of not less than three directors appointed by our Board of Directors. All Committee members shall be external directors. When appointing such members, our Board of Directors shall take into account the appointees’ knowledge and experience in matters of accounting, auditing and risk management.

We have had a Nominating, Compensation and Corporate Governance Committee since 1997, which is composed of five external directors. The functions, composition and competencies of this Committee are regulated by the Board of Directors' Regulations and are very similar to those required by the NYSE. The Nominating, Compensation and Corporate Governance Committee shall consist of not less than three directors appointed by the Board of Directors. All members of the Committee must be external directors and the majority thereof must be independent. The chairman of the Nominating, Compensation and Corporate Governance Committee, who shall in all events be an independent director, shall be appointed from among its members.

Additionally we have a Regulation and Institutional Affairs Committee, a Service Quality and Customer Service Committee, and an Innovation and Strategy Committee. The functions, composition and competencies are regulated by the Board of Directors' Regulations.

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***Independence of the Board***

As of the date of this Annual Report, we have 18 directors, out of which nine have been deemed independent by our Board of Directors attending to the director's classification contained in Good Governance Code of Listed Companies. All our directors, with the exception of the Chairman, 17, are non-executive directors. We, in accordance with the Code, assess the independence of our directors. Among other things, independent directors: (i) shall not be, past employees or executive directors of any of the Group companies, unless three or five years have elapsed, respectively, (ii) shall not receive any payment or other form of compensation from us or our group on top of their directors' fees, unless the amount involved is not significant, (iii) shall not be partners, now or on the past three years, in the external auditor or in the firm responsible for the audit report, (iv) shall not be executive directors or senior officers of another company where one of our executive directors or senior officers is an external director, (v) shall not have material business dealings with us or any other company in our group, (vi) shall not be spouses, nor partners maintaining an analogous affective relationship, nor close relative of any of our executive directors or senior officers and (vii) shall not stand in any of the situations listed in (i), (v) or (vi) above in relation to a significant shareholder or a shareholder with board representation.

The classification of each director shall be explained by the Board of Directors to the shareholders at the General Shareholders' Meeting at which the appointment thereof must be made or ratified. Furthermore, such classification shall be reviewed annually by our Board of Directors after verification by the Nominating, Compensation and Corporate Governance Committee, and reported in the Annual Corporate Governance Report.

***Internal Audit Function***

We have an Internal Audit Department responsible for internal audit matters and for ensuring the efficiency of the internal audit control process of our different units. This Internal Audit Department reports directly to the Audit and Control Committee, thus supporting the adequate performance of all its functions.

***Non-Executive Director Meetings***

Pursuant to the NYSE listing standards, non-executive directors of U.S.-listed companies must meet on a regular basis without management present and the company must disclose a method for any interested parties to communicate directly with the non-executive directors. As a group, our non-executive directors do not meet formally without management present. Nevertheless, each of the Audit and Control Committee, the Nominating, Compensation and Corporate Governance Committee, the Institutional Affairs Committee, and the Strategy and Innovation Committee is composed exclusively of non-executive directors, thus giving each of these committees, the chance to analyze and discuss any matter related to our management, within its respective area of responsibility.

In addition, since May 2013, we have a lead independent director who acts as “Coordinating Independent Director”, who our By-laws grant the right to have a say on key elements of governance structure that most companies in Spain and around the world, reserve to the Board of Directors.

According to our By-laws (Art. 32) the independent director who acts as “Coordinating Independent Director”, shall carry out the following duties and tasks:

- a) Coordinate the work of the External Directors that the Company has appointed, in defense of the interests of all the shareholders of the Company, and echo the concerns of such Directors.
- b) Request the Chairman of the Board of Directors to call meetings of the Board where appropriate in accordance with the rules of corporate governance.
- c) Request, consequently, the inclusion of certain matters in the agenda of the meetings of the Board of Directors.
- d) Oversee the evaluation by the Board of Directors of the Chairman thereof.

### ***Whistleblowing***

We have procedures in place that allow any employee to anonymously and confidentially report instances of fraud, alterations of financial information or specific risks to Telefónica and its subsidiaries.

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*Code of Ethics*

The NYSE listing standards require U.S. companies to adopt a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. In 2004 we adopted, as required by the Sarbanes-Oxley Act, a code of ethics that applied to our principal executive officer, principal financial officer and to our senior financial officers. In December 2006, we adopted a code of business conduct and ethics, the “Telefónica Business Principles”, which apply to all Telefónica Group employees. In March 2008, we decided to modify such Business Principles in order to incorporate within them all components of the code of ethics definition in Section 406 of Sarbanes Oxley Act, and consequently our code of ethics for senior officers was replaced by such Business Principles. These Principles were further modified in 2010 in order to include a new principle of privacy and data protection and in 2016 to reinforce certain anti-corruption principles.

We also have an Internal Code of Conduct for securities markets issues to prevent insider trading misconduct and to control possible conflicts of interest. In addition, the Regulations of the Board of Directors set out in detail our directors’ main obligations relating to conflicts of interest concerning business opportunities, misappropriation of our assets, confidentiality and non-competition.

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Part III

Item 17. Financial Statements

We have responded to Item 18 in lieu of responding to this Item.

Item 18. Financial Statements

Please see pages F-4 through F-169.

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Item 19. Exhibits

| Exhibit<br>Number | Description  |
|-------------------|--|
| 1.1               | Amended and Restated bylaws (English translation)  |
| 4.1               | Subscription Agreement, dated September 6, 2009 between Telefónica, S.A. and China Unicom (Hong Kong) Limited*   |
| 4.2               | Enhanced Strategic Alliance Agreement dated January 23, 2011 between Telefónica, S.A. and China Unicom (Hong Kong) Limited **  |
| 4.3               | Share Purchase Agreement for the Sale and Purchase of Shares in China Unicom (Hong Kong) Limited, dated June 10, 2012 and Supplemental Agreement, dated July 21, 2012, between Telefónica, Internacional S.A.U. and a 100% owned subsidiary of China United Network Communications Group Company Limited ***   |
| 4.4               | Agreement for the Sale and Purchase of Customer Relationship Management business, Atento, dated October 11, 2012 ****  |
| 4.5               | Stock Purchase Agreement and Other Covenants, dated September 18, 2014, by and among Vivendi, S.A., Société d'Investissements et de Gestion 72 S.A. and Société d'Investissements et de Gestion 108 SAS, as the sellers, Telefônica Brasil S.A., as purchaser, GVT Participações S.A., as target, Global Village Telecom S.A. and Telefónica, S.A. (1) ***** |
| 4.6               | Long Term Incentive Plan Terms *****   |
| 4.7               | Agreement for the sale and purchase of the entire issued share capital of Telefónica Europe plc. between Telefónica, S.A., Hutchison 3G UK Investments Limited and Hutchison 3G UK Holdings (CI) Limited dated March 24, 2015 (1) *****  |
| 8.1               | Subsidiaries of Telefónica (see Note 1 to the Consolidated Financial Statements and Appendix VI thereto)   |
| 12.1              | Certification of José María Álvarez-Pallete López, Chief Executive Officer of Telefónica, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 12.2              | Certification of Ángel Vilá Boix, Chief Strategy and Finance Officer of Telefónica, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 13.1              | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 15.1              | Consent of Independent Registered Public Accounting Firm   |
| 15.2              | Letter of Ernst & Young, S.L. dated February 23, 2017 regarding change in the Group's independent registered public accounting firm.   |
| *                 | Incorporated by reference to Telefónica's Schedule 13D/A filed on September 17, 2009.  |
| **                | Incorporated by reference to Telefónica's Schedule 13D filed on February 8, 2011.  |
| ***               | Incorporated by reference to Telefónica's Schedule 13 D/A filed on June 13, 2012 and Schedule 13 D/A filed on August 1, 2012, respectively.  |
| ****              | Incorporated by reference to Telefónica's Annual Report on Form 20-F for the fiscal year ended December 31, 2012.  |

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\*\*\*\*\* Incorporated by reference to Telefónica's Annual Report on Form 20-F for the fiscal year ended December 31, 2014.

\*\*\*\*\* Incorporated by reference to Telefónica's Annual Report on Form 20-F for the fiscal year ended December 31, 2015.

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(1) Confidential treatment has been requested with respect to certain portions of this agreement. Confidential portions have been redacted and separately filed with the SEC.

We agree to furnish to the SEC upon request, copies of the instruments defining the rights of the holders of our long-term debt and of our subsidiaries' long-term debt.

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and has duly caused and authorized the undersigned to sign this Annual Report on its behalf.

TELEFÓNICA, S.A.

By: /s/ José María Álvarez-Pallete López  
Name: José María Álvarez-Pallete López  
Title: Chief Executive Officer

TELEFÓNICA, S.A.

By: /s/ Ángel Vilá Boix  
Name: Ángel Vilá Boix  
Title: Chief Strategy and Finance Officer  
Date: February 23, 2017

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2016

Consolidated Financial Statements

(Consolidated Annual Accounts)

Telefónica, S.A. and subsidiaries composing the Telefónica Group.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of

Telefónica, S.A.

We have audited Telefónica, S.A.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). Telefónica, S.A.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on Telefónica, S.A.'s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Telefónica, S.A. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial position of Telefónica, S.A. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2016 and our report dated February 23, 2017 expressed an unqualified opinion thereon.

ERNST & YOUNG, S.L.

/s/ Alicia Martínez Durán  
Alicia Martínez Durán

Madrid, Spain

February 23, 2017

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of

Telefónica, S.A.

We have audited the accompanying consolidated statements of financial position of Telefónica, S.A. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2016. These consolidated financial statements are the responsibility of Telefónica, S.A.'s Directors. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Telefónica, S.A. and subsidiaries as of December 31, 2016 and 2015, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Telefónica S.A.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 23, 2017 expressed an unqualified opinion thereon.

ERNST & YOUNG, S.L.

/s/ Alicia Martínez Durán  
Alicia Martínez Durán

Madrid, Spain

February 23, 2017

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## Consolidated Statements of financial position

| Millions of euros   | NOTES       | 2016           | 2015<br>(*)         |
|---|-------------|----------------|---------------------|
| <b>ASSETS</b>   |             |                |                     |
| <b>A) NON-CURRENT ASSETS</b>  |             | 103,667        | 101,614             |
| Intangible assets   | (Note 6)    | 20,518         | 21,149              |
| Goodwill  | (Note 7)    | 28,686         | 27,395              |
| Property, plant and equipment   | (Note 8)    | 36,393         | 33,910              |
| Investments accounted for by the equity method  | (Note 9)    | 76             | 80                  |
| Non-current financial assets  | (Note 13)   | 9,765          | 10,405              |
| Deferred tax assets   | (Note 17)   | 8,229          | 8,675               |
| <b>B) CURRENT ASSETS</b>  |             | 19,974         | 18,715              |
| Inventories   |             | 1,055          | 1,456               |
| Trade and other receivables   | (Note 11)   | 10,675         | 10,226              |
| Tax receivables   | (Note 17)   | 1,533          | 1,341               |
| Current financial assets  | (Note 13)   | 2,954          | 3,053               |
| Cash and cash equivalents   | (Note 13)   | 3,736          | 2,615               |
| Non-current assets and disposal groups classified as held for sale                          | 0           | 21             | 24                  |
| <b>TOTAL ASSETS (A+B)</b>   |             | <b>123,641</b> | <b>120,329</b>      |
|   | <b>NOTE</b> | <b>2016</b>    | <b>2015<br/>(*)</b> |
| <b>EQUITY AND LIABILITIES</b>   |             |                |                     |
| <b>A) EQUITY</b>  |             | 28,385         | 25,436              |
| Equity attributable to equity holders of the parent and other holders of equity instruments | (Note 12)   | 18,157         | 15,771              |
| Equity attributable to non-controlling interests  | (Note 12)   | 10,228         | 9,665               |
| <b>B) NON-CURRENT LIABILITIES</b>   |             | 59,805         | 60,509              |
| Non-current financial liabilities   | (Note 13)   | 45,612         | 47,117              |
| Non-current trade and other payables  | (Note 14)   | 1,925          | 2,388               |
| Deferred tax liabilities  | (Note 17)   | 2,395          | 2,550               |
| Non-current provisions  | (Note 15)   | 9,873          | 8,454               |
| <b>C) CURRENT LIABILITIES</b>   |             | 35,451         | 34,384              |
| Current financial liabilities   | (Note 13)   | 14,749         | 12,970              |
| Current trade and other payables  | (Note 14)   | 16,150         | 17,134              |
| Current tax payables  | (Note 17)   | 2,332          | 2,241               |
| Current provisions  | (Note 15)   | 2,220          | 2,022               |
| Liabilities associated with non-current assets held for sale                                |             | –              | 17                  |
| <b>TOTAL EQUITY AND LIABILITIES (A+B+C)</b>   |             | <b>123,641</b> | <b>120,329</b>      |

(\*) Amended data: comparative information as of December 31, 2015 was amended in order to cease to present the assets and liabilities of Telefónica United Kingdom as held for sale (see Notes 2 and 23).

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated statements of financial position.



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| Consolidated income statements  | Notes            | 2016           | 2015 (*)       | 2014 (*)       |
|---|------------------|----------------|----------------|----------------|
| Millions of euros   |                  |                |                |                |
| <b>INCOME STATEMENTS</b>  |                  |                |                |                |
| Revenues  | (Note 18)        | 52,036         | 54,916         | 50,377         |
| Other income  | (Note 18)        | 1,763          | 2,011          | 1,707          |
| Supplies  |                  | (15,242)       | (16,547)       | (15,182)       |
| Personnel expenses  | (Note 18)        | (8,098)        | (10,349)       | (7,098)        |
| Other expenses  | (Note 18)        | (15,341)       | (16,802)       | (14,289)       |
| Depreciation and amortization   | (Note 18)        | (9,649)        | (9,704)        | (8,548)        |
| <b>OPERATING INCOME</b>   |                  | <b>5,469</b>   | <b>3,525</b>   | <b>6,967</b>   |
| Share of loss of investments accounted for by the equity method                           | (Note 9)         | (5)            | (10)           | (510)          |
| Finance income  |                  | 1,770          | 2,076          | 992            |
| Exchange gains  |                  | 5,489          | 6,504          | 4,110          |
| Finance costs   |                  | (4,476)        | (4,417)        | (3,511)        |
| Exchange losses   |                  | (5,002)        | (6,772)        | (4,413)        |
| <b>Net financial expense</b>  | <b>(Note 16)</b> | <b>(2,219)</b> | <b>(2,609)</b> | <b>(2,822)</b> |
| <b>PROFIT BEFORE TAX</b>  |                  | <b>3,245</b>   | <b>906</b>     | <b>3,635</b>   |
| Corporate income tax  | (Note 17)        | (846)          | (155)          | (383)          |
| <b>PROFIT FOR THE YEAR</b>  |                  | <b>2,399</b>   | <b>751</b>     | <b>3,252</b>   |
| Attributable to equity holders of the Parent  |                  | 2,369          | 616            | 3,001          |
| Attributable to non-controlling interests   | (Note 12)        | 30             | 135            | 251            |
| Basic and diluted earnings per share attributable to equity holders of the parent (euros) | (Note 18)        | 0.42           | 0.07           | 0.58           |

(\*) Amended data: comparative information was amended to cease to present the results of Telefónica United Kingdom as discontinued operations (see Notes 2 and 23).

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated income statements.

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| Consolidated statements of comprehensive income   | 2016  | 2015    | 2014    |
|---|-------|---------|---------|
| Millions of euros   | (*)   | (*)     | (*)     |
| Profit for the year   | 2,399 | 751     | 3,252   |
| Other comprehensive income (loss)   |       |         |         |
| (Losses) gains on measurement of available-for-sale investments   | (77)  | 415     | (45)    |
| Income tax impact   | 22    | (123)   | 7       |
| Reclassification of losses (gains) included in the income statement (Note 16)   | 136   | (539)   | –       |
| Income tax impact   | (19)  | 139     | –       |
|   | 62    | (108)   | (38)    |
| Gains (Losses) on hedges  | 498   | (14)    | (507)   |
| Income tax impact   | (120) | (37)    | 127     |
| Reclassification of (Gains) losses included in the income statement (Note 16)   | 54    | 207     | 163     |
| Income tax impact   | (14)  | (58)    | (49)    |
|   | 418   | 98      | (266)   |
| Share of (losses) gains recognized directly in equity of associates and others  | (8)   | 17      | (27)    |
| Income tax impact   | 3     | (4)     | 3       |
| Reclassification of losses included in the income statement   | –     | –       | 103     |
| Income tax impact   | –     | –       | (24)    |
|   | (5)   | 13      | 55      |
| Translation differences (Note 12)   | 3,152 | (6,762) | (2,810) |
| Total other comprehensive income (loss) recognized in the period (Items that may be reclassified subsequently to profit or loss)      | 3,627 | (6,759) | (3,059) |
| Actuarial (losses) gains and impact of limit on assets for defined benefit pension plans  | (378) | 94      | (173)   |
| Income tax impact   | 90    | (32)    | 38      |
|   | (288) | 62      | (135)   |
| Total other comprehensive (loss) income recognized in the period (Items that will not be reclassified subsequently to profit or loss) | (288) | 62      | (135)   |
| Total comprehensive income (loss) recognized in the year  | 5,738 | (5,946) | 58      |
| Attributable to:  |       |         |         |
| Equity holders of the parent and other holders of equity instruments  | 4,630 | (4,535) | (258)   |
| Non-controlling interests   | 1,108 | (1,411) | 316     |
|   | 5,738 | (5,946) | 58      |

(\*) Amended data in order to cease to present the total comprehensive income of Telefónica United Kingdom as discontinued operations (see Notes 2 and 23).

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated statements of comprehensive income.

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STATEMENTS  
OF CHANGES IN  
EQUITY

Attributable to equity holders of the parent and other holders of equity instruments

| Millions of euros   | Share capital | Share premium | Treasury Shares | Other equity instruments | Legal reserve | Retained earnings | Available-for-sale investments | Hedges | Equity of associates and others | Translation differences | Total   |
|---|---------------|---------------|-----------------|--------------------------|---------------|-------------------|--------------------------------|--------|---------------------------------|-------------------------|---------|
| Financial position at December 31, 2015 (*)                                       | 4,975         | 3,227         | (1,656)         | 6,803                    | 984           | 18,475            | (53)                           | (231)  | 36                              | (16,789)                | 15,000  |
| Profit for the year   | —             | —             | —               | —                        | —             | 2,369             | —                              | —      | —                               | —                       | 2,369   |
| Other comprehensive income (loss) for the year                                    | —             | —             | —               | —                        | —             | (267)             | 62                             | 422    | (5)                             | 2,049                   | 2,209   |
| Total comprehensive income (loss) for the year                                    | —             | —             | —               | —                        | —             | 2,102             | 62                             | 422    | (5)                             | 2,049                   | 4,578   |
| Dividends paid (Note 12)  | 137           | —             | —               | —                        | 1             | (2,544)           | —                              | —      | —                               | —                       | (2,414) |
| Net movement in treasury shares   | —             | —             | (637)           | —                        | —             | —                 | —                              | —      | —                               | —                       | (637)   |
| Acquisitions and disposals of non-controlling interests and business combinations | —             | —             | —               | —                        | —             | —                 | —                              | —      | —                               | —                       | —       |
| Capital reduction (Note 12)   | (74)          | —             | 813             | —                        | —             | (739)             | —                              | —      | —                               | —                       | —       |
| Undated Deeply Subordinated Securities (Note 12)                                  | —             | —             | —               | 1,000                    | —             | (255)             | —                              | —      | —                               | —                       | 745     |
| Other movements   | —             | —             | —               | —                        | —             | 54                | —                              | —      | —                               | —                       | 54      |
| Financial position at December 31, 2016   | 5,038         | 3,227         | (1,480)         | 7,803                    | 985           | 17,093            | 9                              | 191    | 31                              | (14,740)                | 18,239  |

(\*) Amended data: comparative information as of December 31, 2015 was amended in order to cease to present Telefónica United Kingdom as discontinued operations (see Notes 2 and 23).

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated statements of changes in equity.

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Attributable to equity holders of the parent and other holders of equity instruments

| Millions of euros  | Share capital | Share premium | Treasury Shares | Other equity instruments | Legal reserve | Retained earnings | Available-for-sale investments | Hedges | Equity of associates and others | Translation differences | Total |
|--|---------------|---------------|-----------------|--------------------------|---------------|-------------------|--------------------------------|--------|---------------------------------|-------------------------|-------|
| Financial position at December 31, 2014  | 4,657         | 460           | (1,586)         | 6,351                    | 984           | 22,656            | 55                             | (334)  | 24                              | (12,132)                | 21,1  |
| Profit for the year (*)  | –             | –             | –               | –                        | –             | 616               | –                              | –      | –                               | –                       | 616   |
| Other comprehensive income (loss) for the year (*)   | –             | –             | –               | –                        | –             | 43                | (108)                          | 103    | 12                              | (5,201)                 | (5,15 |
| Total comprehensive income (loss) for the year (*)   | –             | –             | –               | –                        | –             | 659               | (108)                          | 103    | 12                              | (5,201)                 | (4,55 |
| Dividends paid (Note 12)   | 111           | –             | –               | –                        | –             | (2,360)           | –                              | –      | –                               | –                       | (2,24 |
| Net movement in treasury shares  | –             | –             | (1,511)         | –                        | –             | (75)              | –                              | –      | –                               | –                       | (1,58 |
| Acquisitions and disposals of non-controlling interests and business combinations (Note 5) | –             | –             | 555             | –                        | –             | (1,297)           | –                              | –      | –                               | 628                     | (114  |
| Capital increase (Note 12)   | 281           | 2,767         | –               | –                        | –             | (41)              | –                              | –      | –                               | –                       | 3,00  |
| Capital reduction (Note 12)  | (74)          | –             | 886             | –                        | –             | (812)             | –                              | –      | –                               | –                       | –     |
| Undated Deeply Subordinated Securities (Note 12)   | –             | –             | –               | 452                      | –             | (247)             | –                              | –      | –                               | (84)                    | 121   |
| Other movements  | –             | –             | –               | –                        | –             | (8)               | –                              | –      | –                               | –                       | (8)   |
| Financial position at December 31, 2015 (*)  | 4,975         | 3,227         | (1,656)         | 6,803                    | 984           | 18,475            | (53)                           | (231)  | 36                              | (16,789)                | 15,7  |
| Financial position at December 31, 2013  | 4,551         | 460           | (544)           | 2,466                    | 984           | 22,517            | 94                             | (37)   | (31)                            | (9,275)                 | 21,1  |

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|  |       |     |         |       |     |         |      |       |    |          |         |
|--|-------|-----|---------|-------|-----|---------|------|-------|----|----------|---------|
| Profit for the year  | -     | -   | -       | -     | -   | 3,001   | -    | -     | -  | -        | 3,001   |
| Other comprehensive income (loss) for the year   | -     | -   | -       | -     | -   | (121)   | (39) | (297) | 55 | (2,857)  | (3,257) |
| Total comprehensive income (loss) for the year   | -     | -   | -       | -     | -   | 2,880   | (39) | (297) | 55 | (2,857)  | (258)   |
| Dividends paid (Note 12)   | 106   | -   | -       | -     | -   | (2,138) | -    | -     | -  | -        | (2,032) |
| Net movement in treasury shares  | -     | -   | (1,042) | -     | -   | (113)   | -    | -     | -  | -        | (1,155) |
| Acquisitions and disposals of non-controlling interests and business combinations (Note 5) | -     | -   | -       | -     | -   | (307)   | -    | -     | -  | -        | (307)   |
| Undated Deeply Subordinated Securities (Note 12)   | -     | -   | -       | 3,885 | -   | (129)   | -    | -     | -  | -        | 3,756   |
| Other movements  | -     | -   | -       | -     | -   | (54)    | -    | -     | -  | -        | (54)    |
| Financial position at December 31, 2014  | 4,657 | 460 | (1,586) | 6,351 | 984 | 22,656  | 55   | (334) | 24 | (12,132) | 21,126  |

(\* ) Amended data: comparative information of the year 2015 was amended in order to cease to present Telefónica United Kingdom as discontinued operations (see Notes 2 and 23)

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated statements of changes in equity.

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## Consolidated statements of cash flows

Millions of euros

|  | Notes     | 2016     | 2015 (*) | 2014 (*) |
|--|-----------|----------|----------|----------|
| Cash received from operations  | (Note 20) | 63,514   | 67,582   | 61,522   |
| Cash paid from operations  | (Note 20) | (47,384) | (50,833) | (45,612) |
| Net payments of interest and other financial expenses net of dividends received                              | (Note 20) | (2,143)  | (2,445)  | (2,530)  |
| Taxes paid   | (Note 20) | (649)    | (689)    | (1,187)  |
| Net cash flow provided by operating activities   | (Note 20) | 13,338   | 13,615   | 12,193   |
| (Payments on investments)/proceeds from the sale in property, plant and equipment and intangible assets, net | (Note 20) | (9,187)  | (10,256) | (8,865)  |
| Proceeds on disposals of companies, net of cash and cash equivalents disposed                                | (Note 20) | 767      | 354      | 3,615    |
| Payments on investments in companies, net of cash and cash equivalents acquired                              | (Note 20) | (54)     | (3,181)  | (5,020)  |
| Proceeds on financial investments not included under cash equivalents  | (Note 20) | 489      | 1,142    | 302      |
| Payments on financial investments not included under cash equivalents  | (Note 20) | (265)    | (426)    | (247)    |
| (Payments)/proceeds on placements of cash surpluses not included under cash equivalents                      |           | 42       | (557)    | 217      |
| Government grants received   |           | –        | 7        | 30       |
| Net cash flow used in investing activities   | (Note 20) | (8,208)  | (12,917) | (9,968)  |
| Dividends paid   | (Note 20) | (2,906)  | (2,775)  | (2,328)  |
| Proceeds from share capital increase   | (Note 20) | –        | 4,255    | 814      |
| (Payments)/proceeds of treasury shares and other operations with shareholders                                | (Note 20) | (660)    | (1,772)  | (1,241)  |
| Operations with other equity holders   | (Note 20) | 656      | 83       | 3,713    |
| Proceeds on issue of debentures and bonds, and other debts   | (Note 20) | 5,693    | 1,602    | 4,453    |
| Proceeds on loans, borrowings and promissory notes   | (Note 20) | 10,332   | 8,784    | 4,290    |
| Cancellation of debentures and bonds, and other debts  | (Note 20) | (6,873)  | (3,805)  | (5,116)  |
| Repayments of loans, borrowings and promissory notes   | (Note 20) | (8,506)  | (9,858)  | (8,604)  |
| Financed operating payments and investments in property, plant and equipment and intangible assets payments  | (Note 20) | (1,956)  | (126)    | (22)     |
| Net cash used in financing activities  | (Note 20) | (4,220)  | (3,612)  | (4,041)  |
| Effect of changes in exchange rates  |           | 185      | (1,000)  | (1,616)  |
| Effect of changes in consolidation methods and others  |           | 26       | –        | (16)     |
| Net increase (decrease) in cash and cash equivalents during the year   |           | 1,121    | (3,914)  | (3,448)  |

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|   |              |       |       |       |
|---|--------------|-------|-------|-------|
| CASH AND CASH EQUIVALENTS AT JANUARY 1  |              | 2,615 | 6,529 | 9,977 |
| CASH AND CASH EQUIVALENTS AT DECEMBER 31  | (Note<br>13) | 3,736 | 2,615 | 6,529 |
| RECONCILIATION OF CASH AND CASH EQUIVALENTS WITH THE<br>STATEMENT OF FINANCIAL POSITION |              |       |       |       |
| BALANCE AT JANUARY 1  |              | 2,615 | 6,529 | 9,977 |
| Cash on hand and at banks   |              | 1,278 | 4,912 | 7,834 |
| Other cash equivalents  |              | 1,337 | 1,617 | 2,143 |
| BALANCE AT DECEMBER 31  | (Note<br>13) | 3,736 | 2,615 | 6,529 |
| Cash on hand and at banks   |              | 2,077 | 1,278 | 4,912 |
| Other cash equivalents  |              | 1,659 | 1,337 | 1,617 |

(\*) Amended data: comparative information was amended in order to cease to present Telefonica United Kingdom as discontinued operations (see Notes 2 and 23).

The accompanying Notes 1 to 24 and Appendices I to VI are an integral part of these consolidated statements of cash flows.

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Telefónica, S.A. and subsidiaries composing the Telefónica Group

Notes to the consolidated financial statements (consolidated annual accounts) for the year ended December 31, 2016

Note 1. Background and general information

Telefónica, S.A. and its subsidiaries and investees (“Telefónica”, “the Company”, the “Telefónica Group” or “the Group”) make up an integrated and diversified telecommunications group operating mainly in Europe and Latin America. The Group’s activity is centered around services of wireline and wireless telephony, broadband, internet, data traffic, Pay TV and other digital services.

The parent company of the Group is Telefónica, S.A., a public limited company incorporated on April 19, 1924 for an indefinite period. Its registered office is at calle Gran Vía 28, Madrid (Spain).

Appendix I lists the main companies composing the Telefónica Group, their corporate purpose, country, functional currency, share capital, the Group’s effective shareholding and their method of consolidation.

As a multinational telecommunications company which operates in regulated markets, the Group is subject to different laws and regulations in each of the jurisdictions in which it operates, pursuant to which permits, concessions or licenses must be obtained in certain circumstances to provide the various services. In addition, certain wireline and wireless telephony services are provided under regulated rate and price systems. Key regulatory issues, and concessions and licenses held by the Telefónica Group are detailed in Appendix VI.

The website [www.telefonica.com](http://www.telefonica.com) provides more information about the organizational structure of the Group, the sectors in which it operates and the products it offers.



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Note 2. Basis of presentation of the consolidated financial statements

The accompanying consolidated financial statements were prepared from the accounting records of Telefónica, S.A. and of each of the companies comprising the Telefónica Group, whose separate financial statements were prepared in accordance with the generally accepted accounting principles prevailing in the various countries in which they are located, and for purposes of these consolidated financial statements are presented in accordance with the International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), which for the purposes of the Telefónica Group are not different from those adopted by the European Union, to give a true and fair view of the consolidated equity and financial position at December 31, 2016, and of the consolidated results of operations, changes in consolidated equity and the consolidated cash flows obtained and used in the year then ended. The euro is the Group's reporting currency. The figures in these consolidated financial statements are expressed in millions of euros, unless otherwise indicated, and therefore may be rounded.

The accompanying consolidated financial statements for the year ended December 31, 2016 were approved by the Company's Board of Directors at its meeting on February 22, 2017 for submission for approval at the General Shareholders' Meeting, which is expected to occur without modification.

Note 3 contains a detailed description of the most significant accounting policies used to prepare these consolidated financial statements.

Materiality criteria

These consolidated financial statements do not include any information or disclosures that, not requiring presentation due to their qualitative significance, have been determined as immaterial or of no relevance pursuant to the concepts of *materiality* or *relevance* defined in the IFRS conceptual framework, insofar as the Telefónica Group's consolidated financial statements, taken as a whole, are concerned.

Recognition of Telefónica's operation in the United Kingdom

On March 24, 2015, Telefónica, S.A. reached an agreement with Hutchison Whampoa Group for the acquisition of Telefónica's operations in United Kingdom. In accordance with IFRS 5, companies under the sale agreement were classified as a disposal group held for sale at that date, and their operations qualified as discontinued operations in the consolidated financial statements for the year ended December 31, 2015.

On May 11, 2016 the European Commission made public its decision to prohibit the transaction. Following this decision, the Board of Directors of Telefónica at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, following the submission of the consolidated financial information of the second quarter of 2016, Telefónica's operations in United Kingdom were no longer presented as discontinued operations and their assets and liabilities ceased to be classified as held for sale. Thus, items are presented line by line in the consolidated financial statements.

Comparative financial statements have been amended accordingly with respect to those published in the consolidated financial statements for the year 2015. The impacts of this classification change are described in Note 23.

#### Comparative information and main changes in the consolidation scope

For comparative purposes, the accompanying consolidated financial statements for 2016 include the figures for 2015, and in the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows, and the notes thereto for the year then ended, they also include those of 2014.

The main events and changes in the consolidation scope affecting comparability of the consolidated information for 2016 and 2015 (see Appendix I for a detail of the consolidation scope and the changes during the year) are as follows:

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*a) Acquisition of 100% stake in GVT*

Once the pertinent regulatory authorizations were obtained, Telefônica Brasil, S.A. acquired from Vivendi, S.A. the 100% of the share capital of Global Village Telecom, S.A. and its holding company GVT Participações, S.A. (collectively “GVT”).

Consequently, the Group consolidates GVT from May 1, 2015 using the full consolidation method. The main impacts are detailed in Note 5.

*b) Acquisition of 56% stake in Distribuidora de Televisión Digital, S.A. (DTS)*

Once the pertinent regulatory authorizations were obtained, on April 30, 2015 Telefónica, through its subsidiary Telefónica de Contenidos, S.A.U. acquired 56% of the share capital of Distribuidora de Televisión Digital, S.A. (DTS) from Promotora de Informaciones, S.A. (PRISA).

Following the transaction, the Telefónica Group holds 100% of the share capital of DTS, which was incorporated in the consolidation perimeter from April 30, 2015 under the full consolidation method, in the Telefónica Spain segment. The 44% stake in DTS held prior to the transaction was accounted for by the equity method. The main impacts of this transaction are explained in Note 5.

*c) Individual Suspension Plan*

In 2015 Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U. and Telefónica Soluciones de Informática y Comunicaciones de España, S.A.U. signed the 1st Collective Agreement of Related Companies (CEV), wholly backed by the largest labor unions. This agreement considered, among other elements, a plan of measures for individual suspension of the employment relationship in 2016 and 2017, applying principles of voluntariness, universality, non-discrimination and social responsibility. In December 2016, the Collective Agreement of Related Companies was extended until 2018, by virtue of the provisions of this same agreement (see Note 15).

The expense relating to the present value of the payment flows to meet the commitments resulting from the extension of this program was recognized in 2016. A total of 789 million euros was recorded for the Individual Suspension Plan in 2016 (2,896 million euros in 2015).



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Note 3. Accounting policies

As stated in Note 2, the Group's consolidated financial statements have been prepared in accordance with IFRSs and interpretations issued by the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRIC) as endorsed by the European Commission for use in the European Union (IFRSs – EU).

Accordingly, only the most significant accounting policies used in preparing the accompanying consolidated financial statements, in light of the nature of the Group's activities, are set out below, as well as the accounting policies applied where IFRSs permit a policy choice, and those that are specific to the sector in which the Group operates.

a) Hyperinflationary economies

Venezuela is considered as a hyperinflationary economy since 2009. The inflation rates used to prepare the financial information are the “Indice Nacional de Precios al Consumidor de Venezuela”, published by the Central Bank of Venezuela, or the best estimate in case the final index is not available. On an annual basis, these rates are 511.1%, 190.8% and 64.1% for 2016, 2015 and 2014, respectively.

The exchange rate used to translate inflation-adjusted bolivar-denominated items is the exchange rate as of the closing date of each reporting period, amounting to 673.762 bolivars per U.S. dollar (DICOM), 198.699 bolivars per U.S. dollar (SIMADI) and 49.988 bolivars per U.S. dollar (SICAD II) as of December 31, 2016, 2015 and 2014, respectively.

b) Translation methodology

The income statements and statements of cash flows of the Group's foreign subsidiaries (except Venezuela) were translated into euros at the average exchange rates for the year.

c) Goodwill

After initial recognition, goodwill is carried at cost, less any accumulated impairment losses. Goodwill is recognized as an asset denominated in the currency of the company acquired and is tested for impairment annually or more frequently, if there are certain events or changes indicating the possibility that the carrying amount may not be fully

recoverable. The potential impairment loss is determined by assessing the recoverable amount of the cash generating unit (or group of cash generating units) to which the goodwill is allocated from the acquisition date.

d) Intangible assets

Intangible assets are carried at acquisition or production cost, less any accumulated amortization or any accumulated impairment losses.

Intangible assets are amortized on a straight-line basis according to the following:

Expenditures incurred in developing new products to be available for sale or use within the Group's own network, and whose future economic viability is reasonably certain ("Development costs"), are amortized on a straight-line basis over the period during which the related development project is expected to generate economic benefits, upon its completion.

Licenses granted to the Telefónica Group by various public authorities to provide telecommunications services and the value allocated to licenses held by certain companies at the time they were included in the Telefónica Group ("Service concession arrangements and licenses") are amortized on a straight-line basis over the duration of related licenses from the moment commercial operation begins.

The allocation of acquisition costs attributable to customers acquired in business combinations, as well as the acquisition value of this type of assets in a third-party transaction for consideration ("Customer base") are amortized on a straight-line basis over the estimated period of the customer relationship. The term length is between 5 to 14 years, based on the customer segment (residential, business, etc.) and the business model (prepaid, postpaid, etc.).

Software is amortized on a straight-line basis over its useful life, generally estimated to be between two and five years.

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## e) Property, plant and equipment

Property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment in value.

Cost includes, among others, direct labor used in installation and the allocable portion of the indirect costs required for the related asset. The latter two items are recorded as revenue under the concept “Own work capitalized” of the line item “Other income”.

Interest and other financial expenses incurred and directly attributable to the acquisition or construction of qualifying assets are capitalized. Qualifying assets for the Telefónica Group are those assets that require a period of at least 18 months to bring the assets to the condition necessary for their intended use or sale.

The Group’s subsidiaries depreciate their property, plant and equipment, from the time they can be placed in service, amortizing the cost of the assets, net of their residual values on a straight-line basis over the assets’ estimated useful lives, which are calculated in accordance with technical studies that are revised periodically in light of technological advances and the rate of dismantling, as follows:

|  | Years of estimated<br>useful life |
|--|-----------------------------------|
| Buildings  | 25 – 40                           |
| Plant and machinery  | 10 – 15                           |
| Telephone installations, networks and subscriber equipment | 5 – 20                            |
| Furniture, tools and other items                           | 2 – 10                            |

## f) Impairment of non-current assets

Non-current assets, including goodwill and intangible assets are assessed at each reporting date for indicators of impairment. Whenever such indicators exist, or in the case of assets which are subject to an annual impairment test, the recoverable amount is estimated. An asset’s recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future post-tax cash flows deriving from the use of the asset or its cash generating unit, as applicable, are discounted to their present value using a post-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset, whenever the result obtained is the same that would be obtained by discounting pre-tax cash flows at a pre-tax discount rate.

The Group bases the calculation of impairment on the business plans of the various cash generating units to which the assets are allocated. The projected cash flows, based on strategic business plans, cover a period of five years. Starting with the sixth year, an expected constant growth rate is applied.

g) Lease agreements

The determination of whether an arrangement is, or contains a lease is based on the substance of the agreement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset and the agreement conveys a right to the use of the asset.

Leases where the lessor does not transfer substantially all the risks and benefits of ownership of the asset are classified as operating leases.

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards incidental to ownership of the leased item to the Group.

h) Investment in associates and joint arrangements

The Group assesses whether it has significant influence not only on the basis of its ownership percentage but also on the existence of qualitative factors such representation on the board of directors of the investee, its participation in decision-making processes, interchange of managerial personnel and access to technical information.

The Group assesses rights and obligations agreed to by the parties to a joint arrangement and, when relevant, other facts and circumstances in order to determine whether the joint arrangement in which it is involved is a joint venture or a joint operation.



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i) Financial assets and liabilities

Financial investments

All regular way purchases and sales of financial assets are recognized in the statement of financial position on the trade date, i.e. the date that the Company commits to purchase or sell the asset.

Financial assets which the Group intends to hold for an indefinite period of time and could be sold at any time in response to needs for liquidity requirements or in response to changes in market conditions are classified as available-for-sale. These investments are presented as non-current assets, unless it is probable and feasible that they will be sold within 12 months.

Derivative financial instruments and hedge accounting

The accounting treatment of any gain or loss resulting from changes in the fair value of a derivative depends on whether the derivative in question meets all the criteria for hedge accounting and, if appropriate, on the nature of the hedge.

Changes in fair value of derivatives that qualify as fair value hedging instruments are recognized in the income statement, together with changes in the fair value of the hedged asset or liability attributable to the risk being hedged.

Changes in the fair value of derivatives that qualify and have been designated as cash flows hedges, which are highly effective, are recognized in equity. The ineffective portion is recognized immediately in the income statement. Fair value changes from hedges that relate to firm commitments or forecast transactions that result in the recognition of non-financial assets or liabilities are included in the initial carrying amount of those assets or liabilities. Otherwise, changes in fair value previously recognized in equity are recognized in the income statement in the period in which the hedged transaction affects profit or loss.

An instrument designated to hedge foreign currency exposure from a net investment in a foreign operation is accounted for in a similar manner to cash flow hedges.

When the Group chooses not to apply hedge accounting criteria, gains or losses resulting from changes in the fair value of derivatives are taken directly to the income statement. In this respect, transactions used to reduce the exchange rate risk of income contributed by foreign subsidiaries are not treated as hedging transactions.

j) Inventories

Materials stored for use in investment projects and inventories for consumption and replacement are valued at the lower of weighted average cost and net realizable value.

k) Pensions and other employee obligations

Provisions required to cover the accrued liability for defined-benefit pension plans are determined using “the projected unit credit” actuarial valuation method. The calculation is based on demographic and financial assumptions determined at a country level, and in consideration of the macroeconomic environment. The discount rates are determined based on high quality market yield curves. Plan assets are measured at fair value.

Provisions for post-employment benefits (e.g. early retirement or other) are calculated individually based on the terms agreed with the employees. In some cases, these may require actuarial valuations based on both demographic and financial assumptions.

l) Revenue and expenses

The Telefónica Group revenues are derived principally from providing the following telecommunications services: traffic, connection fees, regular (normally monthly) network usage fees, interconnection, network and equipment leasing, handset sales and other digital services such as Pay TV and value-added services or maintenance. Products and services may be sold separately or bundled in promotional packages.

Revenues from calls carried on Telefónica’s networks (traffic) entail an initial call establishment fee plus a variable call rate, based on call length, distance and type of service. Both wireline and wireless traffic is recognized as revenue as service is provided. For prepaid calls, the amount of unused traffic generates a deferred revenue presented in “Trade and other payables” on the statement of financial position. Prepaid cards generally expire within 12 months and any deferred revenue from prepaid traffic is recognized directly in the income statement when the card expires as the Group has no obligation to provide service after expiry date.



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Revenues from traffic sales and services at a fixed rate over a specified period of time (flat rate) are recognized on a straight-line basis over the term covered by the rate paid by the customer.

Connection fees arising when customers connect to the Group's network are deferred and recognized in the income statement throughout the average estimated customer relationship period, which varies by type of service. All related costs, except those related to network expansion, as well as administrative expenses and overhead, are recognized in the income statement as incurred.

Installation fees are taken to the income statement on a straight-line basis over the related period. Equipment leases and other services are taken to profit or loss as they are consumed.

Interconnection revenues from wireline-wireless and wireless-wireline calls and other customer services are recognized in the period in which the calls are made.

Revenues from handset and equipment sales are recognized once the sale is considered complete, i.e., generally when delivered to the end customer.

For bundled packages that include multiple elements sold in the wireline, wireless, internet and television businesses it is determined whether it is necessary to separate the separately identifiable elements and apply the corresponding revenue recognition policy to each element. Total package revenue is allocated among the identified elements based on their respective fair values (i.e. the fair value of each element relative to the total fair value of the package).

As connection or initial activation fees, or upfront non-refundable fees, are not separately identifiable elements in these types of packages, any revenues received from the customer for these items are allocated to the remaining elements.

Additionally, when allocating the package revenue to the elements, amounts contingent upon delivery of undelivered elements are not allocated to delivered elements.

All expenses related to bundled promotional packages are recognized in the income statement as incurred.

m) Use of estimates

The key assumptions concerning the future and other relevant sources of uncertainty in estimates at the reporting date that could have a significant impact on the consolidated financial statements within the next financial year are discussed below.

A significant change in the facts and circumstances on which these estimates and related judgments are based could have a material impact on the Group's results and financial position. Accordingly, sensitivity analyses are disclosed for the most relevant situations (see notes 7 and 15).

#### Property, plant and equipment, intangible assets and goodwill

The accounting treatment of investments in property, plant and equipment and intangible assets entails the use of estimates to determine the useful life for depreciation and amortization purposes and to assess fair value at their acquisition dates for assets acquired in business combinations.

Determining useful life requires making estimates in connection with future technological developments and alternative uses for assets. There is a significant element of judgment involved in making technological development assumptions, since the timing and scope of future technological advances are difficult to predict.

The decision to recognize an impairment loss involves developing estimates that include, among others, an analysis of the causes of the potential impairment, as well as its timing and expected amount. Furthermore, additional factors, such as technological obsolescence, the suspension of certain services and other circumstantial changes, which highlight the need to evaluate a possible impairment, are taken into account.

The Telefónica Group evaluates its cash-generating units' performance regularly to identify potential goodwill impairments. Determining the recoverable amount of the cash-generating units to which goodwill is allocated also entails the use of assumptions and estimates and requires a significant element of judgment.

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Deferred income taxes

The Group assesses the recoverability of deferred tax assets based on estimates of future earnings, and of all the options available to achieve an outcome, it considers the most efficient one in tax terms within the legal framework the Group is subject to. Such recoverability ultimately depends on the Group's ability to generate taxable earnings over the period for which the deferred tax assets remain deductible. This analysis is based on the estimated schedule for reversing deferred tax liabilities, as well as estimates of taxable earnings, which are sourced from internal projections that are continuously updated to reflect the latest trends.

The recognition of tax assets and liabilities depends on a series of factors, including estimates as to the timing and realization of deferred tax assets and the projected tax payment schedule. Actual Group company income tax receipts and payments could differ from the estimates made by the Group as a result of changes in tax legislation or unforeseen transactions that could affect tax balances.

Provisions

The amount of the provision is determined based on the best estimate of the outflow of resources required to settle the obligation, bearing in mind all available information at the statement of financial position date, including the opinions of independent experts such as legal or financial counsel.

Given the uncertainties inherent in the estimates used to determine the amount of provisions, actual outflows of resources may differ from the amounts recognized originally on the basis of the estimates.

Revenue recognition

*Connection fees*

Connection fees generated when customers connect to the Group's network are deferred and recognized as revenue over the average estimated customer relationship period.

The estimate of the average customer relationship period is based on the recent history of customer churn. Potential changes in estimates could lead to changes in both the amount and timing of the future recognition of revenues.

*Bundled offers*

Bundled offers that combine different elements are assessed to determine whether it is necessary to separate the different identifiable components and apply the corresponding revenue recognition policy to each element. Total package revenue is allocated among the identified elements based on their respective fair values.

Determining fair values for each identified element requires estimates that are complex due to the nature of the business.

A change in estimates of fair values could affect the apportionment of revenue among the elements and, as a result, the date of recognition of revenues.

Exchange rate and inflation rates used to translate the financial statements of our Venezuelan subsidiaries

As of December 31, 2016, there are multiple exchange mechanisms and three published exchange rates legally available for translation of the financial statements of the Venezuelan subsidiaries.

We review, on a regular basis, the economic conditions in Venezuela and the specific circumstances of our Venezuelan operations. Assessment of the exchange rate that best reflects the economics of Telefónica's business activities in Venezuela relies on several factors and is performed considering all the information available at the closing date, and entails the use of assumptions and estimates and significant management judgment.

Due to inherent uncertainties in the estimates required to determine the appropriate exchange rate for the conversion of BsF-denominated financial statements, actual cash flows denominated in such currency may differ from the amounts currently recognized on the basis of our estimates, as a result of changes in currency laws or changes in exchange mechanisms or published exchange rates that may have a material impact on the conversion rate used for our Venezuelan subsidiaries' financial statements, affecting the net monetary position of assets (liabilities) denominated in BsF.

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In addition to this, Venezuela is considered as a hyperinflationary economy since 2009. Telefónica recognizes the effects of inflation by restating the financial information of its Venezuelan operation using the “Indice Nacional de Precios al Consumidor de Venezuela” issued by the Central Bank of Venezuela, or the best estimate in case the final index is not available.

Significant management judgment is required to determine the appropriate inflation rate where the official rate is not available. The estimates and underlying assumptions are based on careful consideration of factors that are considered to be relevant and rely on all the information available at the closing date. Actual results may differ from these estimates as a result of changes in circumstances and assumptions about future developments in Venezuela due to evolving market conditions, uncertainty about currency and operating restrictions or other circumstances arising beyond the control of the Company.

n) New IFRS and interpretations of the IFRS Interpretations Committee (IFRIC)

The accounting policies applied in the preparation of the consolidated financial statements for the year ended December 31, 2016 are consistent with those used in the preparation of the Group’s consolidated annual financial statements for the year ended December 31, 2015, except for the adoption, on January 1, 2016, of new amendments to standards published by the International Accounting Standards Board (IASB) and adopted by the European Union for application in Europe, noted below:

· Improvements to IFRS 2012-2014

The annual improvements projects provide a vehicle for making non-urgent but necessary amendments to IFRSs, with the aim of removing inconsistencies and clarifying wording. These improvements do not have a significant impact on the results or financial position of the Group.

· Amendments to IFRS 11, Accounting for Acquisitions of Interests in Joint Operations

The amendments to IFRS 11 require that a joint operator accounting for the acquisition of an interest in a joint operation, in which the activity of the joint operation constitutes a business, must apply the relevant IFRS 3 Business Combinations principles for business combination accounting. These amendments do not have any impact on the Group as there has been no interest acquired in a joint operation during the period.

· Amendments to IAS 16 and IAS 38, Clarification of Acceptable Methods of Depreciation and Amortization



The amendments clarify the principle in IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets that revenue reflects a pattern of economic benefits that are generated from operating a business (of which the asset is a part) rather than the economic benefits that are consumed through use of the asset. As a result, a revenue-based method cannot be used to depreciate property, plant and equipment and may only be used in very limited circumstances to amortise intangible assets. These amendments do not have any impact to the Group given that the Group does not use a revenue-based method to depreciate its noncurrent assets.

· Amendments to IAS 1, Disclosure Initiative

The amendments to IAS 1 clarify, rather than significantly change, existing IAS 1 requirements. The amendments clarify:

o The materiality requirements in IAS 1.

o That specific line items in the statement(s) of profit or loss and OCI and the statement of financial position may be disaggregated.

o That entities have flexibility as to the order in which they present the notes to financial statements.

o That the share of OCI of associates and joint ventures accounted for using the equity method must be presented in aggregate as a single line item, and classified between those items that will or will not be subsequently reclassified to profit or loss.

Furthermore, the amendments clarify the requirements that apply when additional subtotals are presented in the statement of financial position and the statement(s) of profit or loss and OCI. The Group has considered these amendments in the preparation of these consolidated financial statements.

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·Amendments to IFRS 10, IFRS 12 and IAS 28, Investment Entities: Applying the Consolidation Exception

The amendments address issues that have arisen in applying the investment entities exception under IFRS 10 Consolidated Financial Statements. These amendments have not been endorsed by the EU for use in Europe, but they do not have any impact on the Group as the Group does not apply the consolidation exception.

New standards and amendments to standards issued but not effected as of December 31, 2016

At the date of preparation of the consolidated financial statements, the following IFRSs and amendments had been published, but their application was not mandatory:

| <b>Standards and amendments</b>                       |  | <b>Mandatory application: annual periods beginning on or after</b> |
|---|--|--|
| Amendments to IAS 7                                   | <i>Disclosure Initiative</i><br><i>Recognition of Deferred Tax</i>                           | January 1, 2017  |
| Amendments to IAS 12                                  | <i>Assets for Unrealised Losses</i>  | January 1, 2017  |
| IFRS 9  | <i>Financial instruments</i>   | January 1, 2018  |
| IFRS 15   | <i>Revenues from Contracts with Customers</i>  | January 1, 2018  |
| Clarifications to IFRS 15                             | <i>Revenues from Contracts with Customers (issued on 12 April 2016)</i>                      | January 1, 2018  |
| Amendments to IFRS 2                                  | <i>Classification and Measurement of Share-based Payment Transactions</i>                    | January 1, 2018  |
| Amendments to IFRS 4                                  | <i>Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts</i>                 | January 1, 2018  |
| Amendments to IAS 40                                  | <i>Transfers of Investment Property</i>  | January 1, 2018  |
| IFRIC 22  | <i>Foreign Currency Transactions and Advance Consideration</i>                               | January 1, 2018  |
| <i>Improvements to IFRS Standards 2014-2016 Cycle</i> |  | January 1, 2017/2018   |
| IFRS 16   | <i>Leases</i>  | January 1, 2019  |
| Amendments to IFRS 10 and IAS 28                      | <i>Sale or Contribution of Assets between an Investor and its Associate or Joint Venture</i> | Deferred<br>Indefinitely   |

Based on the analyses made to date, the Group estimates that the adoption of many of these standards, amendments and interpretations will not have a significant impact on the consolidated financial statements in the initial period of application. However, the following issued but not yet effective standards are expected to have a significant impact on the consolidated financial statements at the time of their adoption and prospectively.

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*IFRS 15 Revenues from Contracts with Customers*

IFRS 15 sets out the requirements for recognizing revenue from contracts with customers. The Group is currently assessing the impact of the application of this new standard on its contracts. A number of expected impacts has been identified in connection with the following aspects, among others:

In accordance with the current accounting policy, for bundled packages that combine multiple wireline, wireless, data, internet or television goods or services, the total package revenue is allocated among the identified elements based on their respective fair values. In these cases, portions of the total consideration that are contingent upon delivery of undelivered elements are not allocated to delivered elements. Instead, under IFRS 15, revenue will be allocated to each element based on their standalone selling prices in relation to the total consideration of the package. Revenue will be recognized when (or as) the obligation is satisfied, regardless of whether there are undelivered items. As a consequence, the adoption of these new requirements will result in an acceleration of revenues recognized from the sale of handsets and other equipment, generally recognized at the moment of delivery to the end customer, to the detriment of ongoing service revenue over subsequent periods. To the extent that the packages are marketed at a discount, the difference between the revenue from the sale of equipment and the consideration received from the customer upfront will be recognized as a *contract asset* on the statement of financial position.

Under the current accounting policy, all expenses directly related with obtaining a contract (sales commissions and other third party acquisition costs) are expensed when incurred. However, IFRS 15 will require these costs of acquiring a contract to be recognized as an asset when incurred, to be expensed over the associated contract period. Likewise, certain contract fulfilment costs which are currently expensed when incurred, will be deferred under IFRS 15 where they are related to a performance obligation that that is satisfied over time.

Compared to the current revenue standard, IFRS 15 sets out more detailed requirements on how to account for contract modifications. Certain changes must be accounted for as a retrospective change, while other modifications must be accounted for prospectively as separate contracts or resulting in a reallocation of revenues amongst identified performance obligations.

The Group is progressing in the process of implementing the new requirements, but due to the significant number of transactions affected, the high volume and dispersion of the information involved and the complexity of estimations, quantifying reasonably the implications of this standard is not possible at present. However, considering the current commercial offers as well as the volume of contracts affected, the Group expects that the changes introduced by IFRS 15 would have a significant impact on the Group's financial statements on first-time adoption. IFRS 15 allows for two transition methods, namely the full retrospective method and the modified retrospective method. It is also possible to elect to apply certain practical solutions at the moment of first application of the standard on the determination of the contracts to be accounted for under the new standard; so depending on the transition method chosen, the impacts of the first application will be different. In addition to this, the Group's consolidated financial statements will include more quantitative disclosures for revenue related accounts.

*IFRS 9 Financial Instruments*

IFRS 9 is applicable to financial assets and financial liabilities, and covers requirements for classification, measurement, impairment and de-recognition of financial assets and financial liabilities, together with a new hedge accounting model. The Group expects the key changes to be related to documentation of policies and hedging strategies, as well as the estimation of expected losses on all financial assets. Changes introduced by IFRS 9 will affect the recognition and measurement of financial assets and derivative financial instruments from January 1, 2018. The Group is undertaking the process of implementing the new requirements, but due to the significant items potentially affected and the complexity of estimations, quantifying reasonably the implications of this standard is not possible at present.

#### *IFRS 16 Leases*

IFRS 16 requires lessees to recognize assets and liabilities arising from all leases (except for short-term leases and leases of low-value assets) in the statement of financial position.

The Group acts as a lessee on a very significant number of lease agreements over different assets, such as third-party towers, circuits, office buildings and stores and land where the towers are located, mainly. A significant portion of these contracts is accounted for as operating lease under the current lease standard, with lease payments being recognized generally on a straight-line basis over the contract term.

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The Group is currently in the process of estimating the impact of this new standard on such contracts. This analysis includes the estimation of the lease term, based on the non-cancellable period and the periods covered if the option to extend the lease is exercised, where exercise is reasonably certain, which will depend, to a large extent, on the expected use of the Group's own assets jointly with the underlying leased assets. In addition to this, the Group will make assumptions to calculate the discount rate, which will mainly be based on the incremental borrowing rate of interest for the estimated term. In addition to the mentioned estimations, the standard allows for two transition methods: retrospectively for all periods presented, or using a modified retrospective approach where the cumulative effect of adoption is recognized at the date of initial application. Also, certain practical expedients are available on first-time application in connection with the lease liability measurement, discount rates, impairment, leases that finish within the twelve months subsequent to the date of first application, initial direct costs, and term of the lease. Therefore, the impacts of the first application will depend on the transition method used.

Due to the different alternatives available, together with the complexity of the estimations and the significant number of lease contracts, the Group has not yet completed the implementation process, so at present it is not possible to make a reasonable estimation of the impact of initial application of the new requirements. However, based on the volume of contracts affected, although it has not quantified the impact, the Group expects that the changes introduced by IFRS 16 would have a significant impact on its financial statements from the date of adoption, including the recognition on the balance sheet of right of use assets and a corresponding lease obligation in connection with a significant number of contracts that are classified as operating leases under the current lease standard. Also, amortization of the right of use assets and recognition of interest costs on the lease obligation on the statements of income will replace amounts recognized as lease expense under the current lease standard. Classification of lease payments in the statement of cash flows will also be affected by the requirements under the new lease standard.

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Note 4. Segment information

The organizational structure approved by the Board of Directors of Telefónica, S.A. on February 26, 2014 is made up of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (formed by the Group's operators in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay).

As described in Note 2, Telefónica United Kingdom is no longer presented as disposal group held for sale and discontinued operation. Therefore, the segment information for 2015 and 2014 has been amended with respect to the information presented in the 2015 consolidated financial statements.

These segments include the information relating to wireline, wireless, cable, data, internet and television businesses and other digital services in accordance with each location. The results, assets and liabilities of the segments include the new companies that operate the towers business. Consequently the impacts of the intercompany sales of towers have been eliminated. "Other companies and eliminations" includes the companies belonging to the transverse areas as well as other Group companies and eliminations in the consolidation process.

Segment reporting takes into account the impact of the purchase price allocation to assets acquired and the liabilities assumed for the companies included in each segment. The assets and liabilities presented in each segment are those managed by the heads of each segment, irrespective of their legal structure.

The Group manages borrowing activities and taxes centrally. Therefore, it does not disclose the related assets, liabilities, revenue and expenses by reportable segments. In addition, revenue and expenses arising from intra-group invoicing for the use of the trademark and management services have been eliminated from the operating results of each Group segment. These adjustments have no impact on the Group's consolidated results.

Inter-segment transactions are carried out at market prices.

Operating income before depreciation and amortization (OIBDA) is calculated by excluding solely depreciation and amortization from operating income. OIBDA is used to track the performance of the business and to establish operating and strategic targets of the Telefónica Group companies. OIBDA is a commonly reported measure and is widely used among analysts, investors and other interested parties in the telecommunications industry, although not a measure explicitly defined in IFRS, and therefore, may not be comparable to similar indicators used by other companies. OIBDA should not be considered as a substitute for operating income.



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The following table presents income and CapEx information (capital expenditures in intangible assets and property, plant and equipment, see Notes 6 and 8) regarding the Group's operating segments:

| Millions of euros                   | Telefónica       |                           |                    |                   |                            |                                  | Total Group |
|-------------------------------------|------------------|---------------------------|--------------------|-------------------|----------------------------|----------------------------------|-------------|
|                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other companies and eliminations |             |
| Revenues                            | 12,713           | 6,861                     | 7,503              | 11,097            | 12,579                     | 1,283                            | 52,036      |
| External revenues                   | 12,410           | 6,822                     | 7,460              | 11,067            | 12,337                     | 1,940                            | 52,036      |
| Inter-segment revenues              | 303              | 39                        | 43                 | 30                | 242                        | (657)                            | –           |
| Other operating income and expenses | (8,246)          | (5,152)                   | (5,709)            | (7,383)           | (9,102)                    | (1,326)                          | (36,918)    |
| OIBDA                               | 4,467            | 1,709                     | 1,794              | 3,714             | 3,477                      | (43)                             | 15,118      |
| Depreciation and amortization       | (1,830)          | (1,090)                   | (2,211)            | (2,038)           | (2,190)                    | (290)                            | (9,649)     |
| Operating income                    | 2,637            | 619                       | (417)              | 1,676             | 1,287                      | (333)                            | 5,469       |
| Capital expenditures (CapEx)        | 1,847            | 931                       | 1,108              | 2,138             | 2,613                      | 291                              | 8,928       |

## 2015 (\*)

| Millions of euros                   | Telefónica       |                           |                    |                   |                            |                                  | Total Group |
|-------------------------------------|------------------|---------------------------|--------------------|-------------------|----------------------------|----------------------------------|-------------|
|                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other companies and eliminations |             |
| Revenues                            | 12,402           | 7,837                     | 7,888              | 11,060            | 14,387                     | 1,342                            | 54,916      |
| External revenues                   | 12,194           | 7,787                     | 7,874              | 11,027            | 14,147                     | 1,887                            | 54,916      |
| Inter-segment revenues              | 208              | 50                        | 14                 | 33                | 240                        | (545)                            | –           |
| Other operating income and expenses | (10,066)         | (5,908)                   | (6,030)            | (7,487)           | (10,031)                   | (2,165)                          | (41,687)    |
| OIBDA                               | 2,336            | 1,929                     | 1,858              | 3,573             | 4,356                      | (823)                            | 13,229      |
| Depreciation and amortization       | (1,898)          | (1,196)                   | (2,128)            | (1,916)           | (2,241)                    | (325)                            | (9,704)     |
| Operating income                    | 438              | 733                       | (270)              | 1,657             | 2,115                      | (1,148)                          | 3,525       |
| Capital expenditures (CapEx)        | 1,827            | 883                       | 2,230              | 2,105             | 3,060                      | 356                              | 10,461      |

(\*) Amended data (see Note 2).



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2014 (\*)

| Millions of euros                   | Telefónica       |                           |                    |                   |                            |                                  | Total Group |
|-------------------------------------|------------------|---------------------------|--------------------|-------------------|----------------------------|----------------------------------|-------------|
|                                     | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other companies and eliminations |             |
| Revenues                            | 12,023           | 7,062                     | 5,522              | 11,231            | 13,155                     | 1,384                            | 50,377      |
| External revenues                   | 11,832           | 7,021                     | 5,500              | 11,200            | 13,013                     | 1,811                            | 50,377      |
| Inter-segment revenues              | 191              | 41                        | 22                 | 31                | 142                        | (427)                            | –           |
| Other operating income and expenses | (6,352)          | (5,318)                   | (4,789)            | (7,688)           | (9,087)                    | (1,628)                          | (34,862)    |
| OIBDA                               | 5,671            | 1,744                     | 733                | 3,543             | 4,068                      | (244)                            | 15,515      |
| Depreciation and amortization       | (1,805)          | (1,121)                   | (1,426)            | (1,762)           | (2,034)                    | (400)                            | (8,548)     |
| Operating income                    | 3,866            | 623                       | (693)              | 1,781             | 2,034                      | (644)                            | 6,967       |
| Capital expenditures (CapEx)        | 1,732            | 755                       | 849                | 2,933             | 2,842                      | 337                              | 9,448       |

(\*) Amended data (see Note 2).

The following table presents segment assets, liabilities and investments accounted for by the equity method:

2016

| Millions of euros                              | Telefónica       |                           |                    |                   |                            |                                  | Total Group |
|--|------------------|---------------------------|--------------------|-------------------|----------------------------|----------------------------------|-------------|
|  | Telefónica Spain | Telefónica United Kingdom | Telefónica Germany | Telefónica Brazil | Telefónica Hispano-américa | Other companies and eliminations |             |
| Investments accounted for by the equity method | 1                | 6                         | –                  | 2                 | 1                          | 66                               | 76          |
| Fixed assets                                   | 15,559           | 9,771                     | 15,825             | 27,522            | 15,126                     | 1,794                            | 85,597      |
| Total allocated assets                         | 22,353           | 12,025                    | 18,835             | 35,192            | 21,694                     | 13,542                           | 123,641     |
| Total allocated liabilities                    | 13,009           | 3,907                     | 6,078              | 9,636             | 13,002                     | 49,624                           | 95,256      |

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2015 (\*)

| Millions of euros                                 | Telefónica<br>Spain | Telefónica<br>United<br>Kingdom | Telefónica<br>Germany | Telefónica<br>Brazil | Telefónica<br>Hispano-<br>américa | Other companies and<br>eliminations | Total<br>Group |
|---|---------------------|---------------------------------|-----------------------|----------------------|-----------------------------------|-------------------------------------|----------------|
| Investments accounted for<br>by the equity method | 2                   | 6                               | –                     | 2                    | 2                                 | 68                                  | 80             |
| Fixed assets                                      | 15,393              | 11,570                          | 16,780                | 22,169               | 14,504                            | 2,038                               | 82,454         |
| Total allocated assets                            | 21,349              | 14,745                          | 19,913                | 28,308               | 21,623                            | 14,391                              | 120,329        |
| Total allocated liabilities                       | 13,411              | 4,781                           | 6,471                 | 7,911                | 14,384                            | 47,935                              | 94,893         |

(\*) Amended data (see Note 2).

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The composition of segment revenues, detailed by the main countries in which the Group operates, is as follows:

| Millions of euros<br>Country                    | 2016  |        |                     | 2015 (*) |        |                     | 2014 (*) |        |                     | Total |         |        |
|---|-------|--------|---------------------|----------|--------|---------------------|----------|--------|---------------------|-------|---------|--------|
|   | Fixed | Mobile | Other and<br>elims. | Fixed    | Mobile | Other and<br>elims. | Fixed    | Mobile | Other and<br>elims. |       |         |        |
| Spain   | 9,795 | 4,149  | (1,231)             | 12,713   | 9,359  | 4,337               | (1,294)  | 12,402 | 8,543               | 4,556 | (1,076) | 12,023 |
| United Kingdom                                  | -     | 6,861  | -                   | 6,861    | -      | 7,837               | -        | 7,837  | -                   | 7,062 | -       | 7,062  |
| Germany   | 981   | 6,498  | 24                  | 7,503    | 1,043  | 6,832               | 13       | 7,888  | 1,138               | 4,375 | 9       | 5,522  |
| Brazil  | 4,428 | 6,669  | -                   | 11,097   | 4,154  | 6,906               | -        | 11,060 | 3,613               | 7,618 | -       | 11,231 |
| Hispanoamérica                                  | 3,732 | 8,882  | (35)                | 12,579   | 4,070  | 10,347              | (30)     | 14,387 | 3,604               | 9,578 | (27)    | 13,155 |
| Argentina                                       | 1,133 | 1,867  | -                   | 3,000    | 1,376  | 2,539               | -        | 3,915  | 1,055               | 2,008 | -       | 3,063  |
| Chile   | 925   | 1,238  | -                   | 2,163    | 928    | 1,292               | -        | 2,220  | 842                 | 1,247 | -       | 2,089  |
| Peru  | 1,126 | 1,373  | -                   | 2,499    | 1,200  | 1,566               | -        | 2,766  | 1,077               | 1,427 | -       | 2,504  |
| Colombia  | 548   | 861    | -                   | 1,409    | 566    | 942                 | -        | 1,508  | 629                 | 1,090 | -       | 1,719  |
| Mexico  | -     | 1,410  | -                   | 1,410    | -      | 1,783               | -        | 1,783  | -                   | 1,649 | -       | 1,649  |
| Venezuela and Central<br>America                | -     | 1,344  | -                   | 1,344    | -      | 1,379               | -        | 1,379  | -                   | 1,420 | -       | 1,420  |
| Remaining operators and<br>segment eliminations | -     | 789    | (35)                | 754      | -      | 846                 | (30)     | 816    | 1                   | 737   | (27)    | 711    |
| Other and inter-segment<br>eliminations         | -     | -      | -                   | 1,283    | -      | -                   | -        | 1,342  | -                   | -     | -       | 1,384  |
| Total Group                                     | -     | -      | -                   | 52,036   | -      | -                   | -        | 54,916 | -                   | -     | -       | 50,377 |

(\*) Amended data (see Note 2).

Note: In the countries of the Telefónica Hispanoamérica segment with separate fixed and mobile operating companies, the intercompany revenues have not been considered.

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Note 5. Business combinations and acquisitions of non-controlling interests

**Business combinations****Finalization of the purchase price allocation of GVT**

On September 19, 2014 Telefónica S.A. signed an agreement with Vivendi, S.A. for the acquisition by Telefónica Brasil, S.A. of Global Village Telecom, S.A. and its holding company GVT Participações, S.A. (jointly "GVT") for a cash consideration of 4,663 million euros (through payment in cash and debt assumption), as well as delivery of shares representing 12% of the share capital of the new Telefónica Brasil, S.A. resulting from the integration with GVT.

Once the pertinent regulatory authorizations were obtained, the Extraordinary General Shareholders Meeting of Telefónica Brasil, S.A. held on 28 May, 2015, approved the acquisition.

At the date of authorization for issue of the 2015 consolidated financial statements of the Telefónica Group the purchase price allocation was provisional. In 2016 the preliminary allocation was reviewed within the twelve-month period from the acquisition date, without any change in the fair value of the assets acquired and liabilities assumed.

The table below sets out the consideration transferred, the fair values of the assets and liabilities identified at the acquisition date, and the goodwill generated.

|  |         |
|--|---------|
| Millions of euros                                  |         |
| Gross cash consideration (date of agreement)       | 4,663   |
| Contingent consideration                           | 102     |
| Fair value of 12% of Telefónica Brasil transferred | 2,476   |
| Consideration transferred                          | 7,241   |
| Price adjustment for net debt and hedges           | (2,168) |
| Intangible assets                                  | 835     |
| Customer relationships                             | 751     |
| Other intangible assets                            | 84      |
| Property, plant and equipment                      | 2,374   |
| Deferred tax assets                                | 182     |
| Accounts receivable                                | 282     |
| Other assets                                       | 256     |

|                           |         |
|---------------------------|---------|
| Cash and cash equivalents | 116     |
| Financial debt            | (2,102) |
| Trade and other payables  | (202)   |
| Provisions                | (208)   |
| Other liabilities         | (217)   |
| Fair value of net assets  | 1,316   |
| Goodwill (Note 7)         | 3,757   |

The sale and purchase agreement contemplated a contingent consideration regarding a legal deposit set up by GVT. In September 2014, GVT requested the cancellation of the deposit and the return of the amount deposited. The amount recovered based on a final ruling will be returned to Vivendi. The ultimate date for this is up to 15 years. The fair value of the contingent consideration on the acquisition date was 344 million Brazilian reais (102 million euros on acquisition date), subject to discount.

In accordance with IFRS 3, contingent liabilities at fair value were recognized at the acquisition date, amounting to 513 million Brazilian reais (153 million euros on acquisition date). These contingent liabilities amounted to 578 million Brazilian reais (168 million euros) at December 31, 2016.

Table of Contents**Finalization of the purchase price allocation of DTS**

Once the relevant competence authorizations were obtained, on April 30, 2015 the acquisition by Telefónica of 56% of the share capital of Distribuidora de Televisión Digital, S.A. (DTS) owned by PRISA was completed.

Following the resolution of the adjustments to the purchase price in April 2016, Telefónica paid 29 million euros, resulting on a total consideration of 725 million euros. As a result, the goodwill at December 31, 2015 was amended (see Note 7).

At the date of authorization for issue of the 2015 consolidated financial statements of the Telefónica Group the purchase price allocation was provisional. In 2016 the preliminary allocation was reviewed within the twelve-month period from the acquisition date, without any change in the fair value of the assets acquired and liabilities assumed.

The table below sets out the total consideration, the fair values of the assets and liabilities identified at acquisition date, and the goodwill generated.

Millions of euros

|                                      |            |
|--------------------------------------|------------|
| <b>Cash payment 56% stake</b>        | <b>725</b> |
| <b>Fair value of the prior stake</b> | <b>739</b> |
| Intangible assets                    | 378        |
| Customer relationships               | 362        |
| Other intangible assets              | 16         |
| Property, plant and equipment        | 91         |
| Deferred tax assets                  | 454        |
| Trade and other receivables          | 137        |
| Other assets                         | 213        |
| Financial debt                       | (350)      |
| Trade and other payables             | (367)      |
| Other liabilities                    | (66)       |
| Fair value of net assets             | <b>490</b> |
| Goodwill (Note 7)                    | <b>974</b> |

**Finalization of the purchase price allocation of E-Plus**

On October 1, 2014, following the share capital increase by Telefónica Deutschland to finance the purchase of E-Plus, the latter was finally acquired by Telefónica Deutschland.

The purchase price allocation in the consolidated financial statements as of December 31, 2014 was provisional. In 2015 the preliminary purchase price allocation was reviewed within the twelve-month period and recorded retrospectively to the acquisition date on the basis of a final valuation.

An agreement on the final purchase price was reached with KPN in December 2015. The original purchase price was reduced overall by 134 million euros. 30 million euros of this figure was adjusted against goodwill within the twelve-month period. A sufficiently secure agreement on the final purchase price was not reached at the end of the aforementioned twelve-month period foreseen in the accounting regulation, therefore estimates based on partial agreements and expert opinions were used in order to determine the purchase price for the final goodwill calculation. The remaining amount, 104 million euros, was recognised in “other operating income” as it arose after the twelve-month period since the date of acquisition (see Note 18).

The table below sets out the consideration transferred, the fair values of the assets and liabilities identified at the acquisition date, and the goodwill generated:

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| Millions of euros  | Final fair values at acquisition date |
|--|---------------------------------------|
| Intangible assets  | 4,182                                 |
| Customer relationships                                   | 2,857                                 |
| Frequency usage rights                                   | 1,057                                 |
| Rest of intangible assets                                | 268                                   |
| Property, plant and equipment                            | 1,742                                 |
| Inventories  | 21                                    |
| Trade and other receivables                              | 677                                   |
| Other financial assets                                   | 19                                    |
| Other non-financial assets                               | 93                                    |
| Cash and cash equivalents                                | 396                                   |
| Deferred revenue   | (220)                                 |
| Provisions   | (254)                                 |
| Interest-bearing debt                                    | (528)                                 |
| Current trade and other payables                         | (709)                                 |
| Fair value of net assets                                 | 5,419                                 |
| Goodwill   | 2,014                                 |
| Cash payment   | 4,906                                 |
| Fair value of the T. Deutschland shares purchased by KPN | 2,527                                 |
| Purchase price   | 7,433                                 |
| Purchase price adjustments outside measurement period    | (104)                                 |
| Final purchase price                                     | 7,329                                 |

**Transactions with non-controlling interests****2016**

No material transactions with non-controlling interests were carried out that were significant for the Group in 2016.

**2015****Acquisition from Vivendi of 4.5% of Telefónica Brasil**

On June 24, 2015 in accordance with the commitments undertaken in the acquisition agreement with GVT, Telefónica proceeded to deliver (through its fully-owned subsidiary Telco TE, S.p.A.) 1,110 million ordinary shares in Telecom Italia, S.p.A. representing 8.2% of the voting equity of Telecom Italia, S.p.A. (equivalent to 5.7% of its share capital)



to Vivendi, S.A. and received from Vivendi, S.A. all of the ordinary shares and part of the preference shares of Telefônica Brasil, S.A. which Vivendi, S.A. had received from the sale of GVT, which jointly represent 4.5% of the share capital of Telefônica Brasil, S.A. The fair value of the Telecom Italia, S.p.A. shares delivered to Vivendi as part of the consideration has been calculated on the basis of their market price at the date of the approval of the operation, amounting to 1,264 million euros. The difference between the aforementioned value and the valuation of the minority interest in Telefônica Brasil had an adverse effect on “Equity attributable to the parent Company” in the amount of 277 million euros.

After the acquisition of the 4.5% stake of Telefônica Brasil, S.A. from Vivendi, S.A., the stake of Telefónica Group increased to 70.13% (70.22% considering Telefônica Brasil, S.A. treasury shares).

#### **Agreement with Vivendi for the exchange of shares of Telefônica Brasil for treasury shares of Telefónica, S.A.**

In September 2015, after the regulatory approval from CADE, Telefónica delivered to Vivendi 46.0 million of its treasury shares representing 0.95 % of its share capital with an effect on treasury shares and in retained earnings in the amount of 555 million euros and 69 million euros, respectively (see Note 12), in exchange for 58.4 million preferred shares of Telefônica Brasil, S.A. (received by Vivendi, S.A. in the context of the acquisition of GVT Participações, S.A.) representing approximately 3.5% of the share capital of Telefônica Brasil, S.A.

After the acquisition the stake of Telefónica Group increased to 73.6%.

Under this agreement, Vivendi, S.A. committed, among other obligations: (i) to refrain from selling the Telefónica shares during specified periods (lock up), and (ii) to comply with certain restrictions that, in case of sale, and once the lock up periods have lapsed, would ensure an orderly sale of such shares.

#### **2014**

No material transactions with non-controlling interests were carried out that were significant for the Group in 2014, except for those related to E-Plus acquisition (see Note 12.h).

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## Note 6. Intangible assets

The composition of and movements in net intangible assets in 2016 and 2015 are as follows:

## 2016

| Millions of euros                                     | Balance at<br>12/31/2015 | Additions | Amortization | Disposals | Transfers<br>and others | Translation<br>differences and<br>hyperinflation<br>adjustments | Inclusion<br>of<br>companies | Balance at<br>12/31/2016 |
|---|--------------------------|-----------|--------------|-----------|-------------------------|---|------------------------------|--------------------------|
| Service<br>concession<br>arrangements<br>and licenses | 11,881                   | 340       | (1,230)      | (15)      | (2)                     | 620   | –                            | 11,594                   |
| Software  | 2,722                    | 836       | (1,686)      | (16)      | 866                     | 170   | –                            | 2,892                    |
| Customer base   | 3,932                    | –         | (632)        | –         | –                       | 135   | –                            | 3,435                    |
| Trademarks  | 978                      | 1         | (87)         | –         | –                       | 20  | –                            | 912                      |
| Other intangible<br>assets                            | 147                      | 32        | (63)         | 1         | 7                       | 2   | 1                            | 127                      |
| Intangible assets<br>in process                       | 1,489                    | 471       | –            | 2         | (390)                   | (14)  | –                            | 1,558                    |
| Total intangible<br>assets                            | 21,149                   | 1,680     | (3,698)      | (28)      | 481                     | 933   | 1                            | 20,518                   |

## 2015

| Millions of euros                                     | Balance at<br>12/31/2014 | Additions | Amortization | Disposals | Transfers<br>and others | Translation<br>differences and<br>hyperinflation<br>adjustments | Inclusion<br>of<br>companies | Balance at<br>12/31/2015 |
|---|--------------------------|-----------|--------------|-----------|-------------------------|---|------------------------------|--------------------------|
| Service<br>concession<br>arrangements<br>and licenses | 13,346                   | 387       | (1,290)      | –         | 805                     | (1,367)   | –                            | 11,881                   |
| Software  | 2,905                    | 759       | (1,560)      | (15)      | 773                     | (216)   | 76                           | 2,722                    |
| Customer base   | 3,499                    | –         | (612)        | –         | 135                     | (203)   | 1,113                        | 3,932                    |
| Trademarks  | 1,133                    | –         | (92)         | –         | 3                       | (84)  | 18                           | 978                      |
| Other intangible<br>assets                            | 297                      | 60        | (79)         | (4)       | (132)                   | (3)   | 8                            | 147                      |
| Intangible assets<br>in process                       | 1,047                    | 1,580     | –            | –         | (1,124)                 | (14)  | –                            | 1,489                    |
| Total intangible<br>assets                            | 22,227                   | 2,786     | (3,633)      | (19)      | 460                     | (1,887)   | 1,215                        | 21,149                   |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

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The gross cost, accumulated amortization and impairment losses of intangible assets at December 31, 2016 and 2015 are as follows:

## Balance at 12/31/2016

| Millions of euros                            | Gross cost | Accumulated amortization | Impairment losses | Intangible assets |
|--|------------|--------------------------|-------------------|-------------------|
| Service concession arrangements and licenses | 21,843     | (10,249)                 | –                 | 11,594            |
| Software                                     | 16,361     | (13,466)                 | (3)               | 2,892             |
| Customer base                                | 7,253      | (3,818)                  | –                 | 3,435             |
| Trademarks                                   | 2,017      | (1,105)                  | –                 | 912               |
| Other intangible assets                      | 1,135      | (1,003)                  | (5)               | 127               |
| Intangible assets in process                 | 1,558      | –                        | –                 | 1,558             |
| Intangible assets                            | 50,167     | (29,641)                 | (8)               | 20,518            |

## Balance at 12/31/2015 (\*)

| Millions of euros                            | Gross cost | Accumulated amortization | Impairment losses | Intangible assets |
|--|------------|--------------------------|-------------------|-------------------|
| Service concession arrangements and licenses | 21,218     | (9,337)                  | –                 | 11,881            |
| Software                                     | 14,445     | (11,720)                 | (3)               | 2,722             |
| Customer base                                | 7,182      | (3,250)                  | –                 | 3,932             |
| Trademarks                                   | 2,053      | (1,075)                  | –                 | 978               |
| Other intangible assets                      | 1,143      | (991)                    | (5)               | 147               |
| Intangible assets in process                 | 1,491      | –                        | (2)               | 1,489             |
| Intangible assets                            | 47,532     | (26,373)                 | (10)              | 21,149            |

(\*) Amended data (see Note 2).

Outstanding among “Additions” of service concession arrangements and licenses in 2016 is the acquisition of an LTE block of 2x15 MHz in the 700 MHz band by Telefónica Peru for 284 million euros. The acquired frequency has immediate availability and will allow enhancing LTE coverage and capacity across the country.

During exercise 2016, the investment effort also reflects the acquisition of 7 LTE Regional blocks of 2x10 MHz in the 2.5 GHz band by Telefónica Brazil for 48 million euros.

Outstanding among “Additions” of intangible assets in process in 2015 was the acquisition by Telefónica Germany of LTE blocks for 1,198 million euros:

- 700 MHz: two blocks of 2x10 MHz
- 900 MHz: two blocks of 2x10 MHz
- 1800 MHz: two blocks of 2x10 MHz

The acquired frequencies at 900 MHz and 1,800 MHz can be used from January 1, 2017. The use of the acquired frequencies at 700 MHz is expected from the date they are vacated by the broadcasting companies.

During 2015, the acquisition of LTE licenses was recorded in Argentina (196 million euros), Ecuador (127 million euros), Spain (49 million euros), Mexico (8 million euros) and Chile (6 million euros).

“Inclusion of companies” in 2015 mainly corresponds to the acquisitions of GVT and DTS (see Note 5).

The spectrum licenses in the 800 MHz and 900 MHz acquired by Telefónica Móviles España in 2011 for 793 million euros were transferred from “Intangible assets in process” to “Service concession arrangements and licenses in 2015” since they are available for the company from February 4 and March 31, 2015, respectively.

Details of the principal concessions and licenses with which the Group operates are provided in Appendix VI.

The impact of the monetary adjustments due to hyperinflation in Venezuela is included under “Translation differences and hyperinflation adjustments”.

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## Note 7. Goodwill

The movement in this heading assigned to each Group segment was the following:

| 2016                      |                        |              |            |   |                        |
|---------------------------|------------------------|--------------|------------|---|------------------------|
| Millions of euros         | Balance at<br>12/31/15 | Acquisitions | Write-offs | Translation differences and hyperinflation<br>adjustments | Balance at<br>12/31/16 |
| Telefónica Spain          | 4,306                  | –            | –          | –   | 4,306                  |
| Telefónica Brazil         | 9,345                  | –            | –          | 2,220   | 11,565                 |
| Telefónica Germany        | 4,787                  | –            | –          | –   | 4,787                  |
| Telefónica United Kingdom | 5,621                  | –            | –          | (797)   | 4,824                  |
| Telefónica Hispanoamérica | 3,187                  | –            | (215)      | 68  | 3,040                  |
| Others                    | 149                    | 26           | (13)       | 2   | 164                    |
| Total                     | 27,395                 | 26           | (228)      | 1,493   | 28,686                 |

| 2015                           |                        |              |            |   |                        |
|--------------------------------|------------------------|--------------|------------|---|------------------------|
| Millions of euros              | Balance at<br>12/31/14 | Acquisitions | Write-offs | Translation differences and hyperinflation<br>adjustments | Balance at<br>12/31/15 |
| Telefónica Spain (*)           | 3,332                  | 974          | –          | –   | 4,306                  |
| Telefónica Brazil              | 8,407                  | 3,757        | –          | (2,819)   | 9,345                  |
| Telefónica Germany             | 4,787                  | –            | –          | –   | 4,787                  |
| Telefónica United Kingdom (**) | 5,296                  | –            | –          | 325   | 5,621                  |
| Telefónica Hispanoamérica      | 3,365                  | –            | –          | (178)   | 3,187                  |
| Others                         | 250                    | 7            | (104)      | (4)   | 149                    |
| Total (*) (**)                 | 25,437                 | 4,738        | (104)      | (2,676)   | 27,395                 |

(\*) After the final resolution of the acquisition price of DTS, the goodwill was amended according to IFRS 3 (see Note 5).

(\*\*) In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

Additions in 2016 relate to the acquisitions of Nova Casiopea and Saluspot (see Appendix I).

After analyzing the most recent business plan approved in October 2016 by the Board of Directors of Telefónica, S.A., and as a result of applying the inflation index (estimated inflation in 2016 in Venezuela was more than 500%) to its assets, which included goodwill, an impairment loss of 124 million euros was recognized on the total goodwill assigned to Telefónica Venezuela, with a balancing entry in “Other expenses” (see Note 18). At the end of 2015, it was

expected that a certain turning point would be reached in Venezuela in 2016 within the macroeconomic (a lower fall in output and a stabilization of the inflation rate). However, the scenario has become more complex in 2016, when the economic situation, according to several analysts, although there are no official figures, points towards a further drop in GDP with regard to 2015, whilst inflation was above both the level of 2015, and that which was forecast 12 months ago.

Likewise, in 2016 an impairment loss of 91 million euros was also recognized in relation to the goodwill of Telefónica Móviles México, with a balancing entry in “Other expenses” (see Note 18). The economic uncertainty and resultant financial volatility associated with the change of president in the United States of America and the changing competitive environment in the Mexican telecommunications market, have led to a slowdown in the growth forecast in the business plan and a set of efficiency ratios that have improved more slowly than in previous years. This uncertainty makes it advisable a more conservative medium-term outlook to be taken in the valuation parameters.

A decrease of 13 million euros was also recognized in 2016 in relation to the sale of Televisión Federal, S.A. (see Note 18).

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The amount in “Acquisitions” of the Telefónica Spain segment for 2015 corresponds to the acquisition of DTS (see Note 5). The amount for Telefónica Brazil corresponds to the acquisition of GVT (see Note 5).

Write-offs in 2015 related to the partial adjustment of the goodwill generated on the acquisition of Telefónica Digital Inc., with a balancing entry in “Other expenses” (see Note 18).

In order to test for impairment, goodwill has been allocated to the different cash-generating units (CGUs), which are grouped into the following reportable operating segments:

|                                       | 12/31/2016    | 12/31/2015    |
|---------------------------------------|---------------|---------------|
| <b>Telefónica Spain (*)</b>           | <b>4,306</b>  | <b>4,306</b>  |
| <b>Telefónica Brazil</b>              | <b>11,565</b> | <b>9,345</b>  |
| <b>Telefónica Germany</b>             | <b>4,787</b>  | <b>4,787</b>  |
| <b>Telefónica United Kingdom (**)</b> | <b>4,824</b>  | <b>5,621</b>  |
| <b>Telefónica Hispanoamérica</b>      | <b>3,040</b>  | <b>3,187</b>  |
| Chile                                 | 1,022         | 933           |
| Peru                                  | 813           | 766           |
| Mexico                                | 368           | 532           |
| Argentina                             | 217           | 255           |
| Others Telefónica Hispanoamérica      | 620           | 701           |
| <b>Others</b>                         | <b>164</b>    | <b>149</b>    |
| <b>TOTAL (*)(**)</b>                  | <b>28,686</b> | <b>27,395</b> |

(\*) Modified data at December 2015 to reflect the final cost of DTS participation (see Note 5).

(\*\*) Amended data in 2015 (see Note 2).

Goodwill is tested for impairment at the end of the year using the strategic plans of the various cash-generating units to which the goodwill is assigned, approved by the Board of Directors. The strategic plans cover a period of four years, including the closing year. Therefore, in order to complete the five years of cash flows after the closing year, an additional two-year normalization period is added to the strategic plan based on the operating variables until the terminal parameters are reached; the consensus of analysts' forecasts is used as a reference.

The process of preparing the CGUs' strategic plans takes into consideration the current condition of each CGU's market, analyzing the macroeconomic, competitive, regulatory and technological climate together with each CGU's competitive positioning and growth opportunities given market projections, as well as the operators' ability to set them apart from the competition. A growth target is therefore defined for each CGU and the operating resources and fixed asset investments that need to be assigned in order to reach this growth target are estimated. In addition, premises are defined for boosting operating efficiency, in line with the strategic transformation initiatives defined, with a view to increasing operating cash flow over the life of the plan. In this process, the Group has also assessed the level of fulfillment of the strategic plans in the past.

**Main assumptions used in calculating value in use**

Value in use is calculated for the various CGUs based on the aforementioned approved business plans. Subsequently, certain variables are taken into account such as the OIBDA margin and the Capital Expenditure ratio (expressed as a percentage of revenue), which are considered the key operating variables to measure the business performance and to set financial targets. Finally, the discount rates and the perpetuity growth rates are taken into account.

In terms of revenue, the plan is in line with the average three-year estimates made by analysts, which include a trend towards stability or improvement. This trend is supported by service revenue which, leveraging the distinctiveness and quality of the Group's products and services thanks to the investments made, includes growth in the high-value customer base and monetization of the growing data consumption in rational markets, although it is highly competitive in certain segments.

Revenue therefore reflects, in the case of Spain, the growth in penetration and revenue of customers converging on a high quality network; in Germany, the strong growth of high-value mobile data customers; in Brazil, the strength of Telefónica's leadership driven by its leadership and quality and capturing integration synergies; and in the United Kingdom, the drive of mobile data.



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Following is a description of the principal variables considered for each CGU with significant goodwill (Brazil, Spain, United Kingdom and Germany).

*OIBDA margin and long-term Capital Expenditure (CapEx) ratio*

The values obtained, described in the previous paragraphs, are compared with the available data on competitors in the geographic markets where Telefónica Group operates. With regard to Europe, the long-term OIBDA margin for operations in Spain is 42% whilst in Germany (30.5%) and the United Kingdom (26%), it is below this figure. The long-term OIBDA margin is therefore in line with analysts' forecasts over a three year horizon, with Spain estimated at 43%, Germany at 29% and the United Kingdom at 25%.

Respect to the ratio of CapEx over revenues, over the term of the strategic plan, the Group's European operators invest at a percentage of revenue aligned with the range for peers in the region. However, the valuations performed for the impairment tests for Spain, Germany and United Kingdom take into account the opinions of Telefónica Group's analysts for Spain and United Kingdom, and Telefónica Deutschland's analysts for Germany with regard to investment needs (around 13% for the three countries).

The OIBDA margin for Brazil is in line with the average of analysts' three year forecasts for peers in emerging markets, at approximately 36%, and also considers analysts' long-term opinions about Brazil. Over the term of the strategic plan, the operator will invest a percentage at the lower end of the range for its peers. However, this is also in line with the investment needs identified by analysts (17%).

There were no significant changes in the operating indicators compared to the previous year.

*Discount rate*

The discount rate, applied to measure the cash flows, is the weighted average cost of capital (WACC), determined by the weighted average cost of equity and debt according the finance structure established for each CGU.

This rate is calculated using the capital asset pricing model (CAPM), which takes into account the asset's systemic risk, and the impact of risks on cash flows not generated internally, such as country risk, business-specific credit risk, currency risk and price risk specific to the financial asset.

The most significant components of WACC are summarized as follows:

**Risk-Free Rate:** understood as the interest rate offered by long-term sovereign bonds. The rate is determined using current market data and estimates of equilibrium levels (according to standard econometric models) between which the interest rates should fall, thus adjusting the return in low rates as a result of the high influence on term premiums of public debt purchased by central banks.

**Political Risk Premium:** incorporates the insolvency risk inherent to the country due to political and/or financial events, the calculation of which is based on the quoted prices of credit default swaps for each country or, failing this, the EMBI+ index, published by JP Morgan, based on the information available and the liquidity conditions of these swaps.

**Equity Risk Premium (ERP),** which measures the additional risk required for equity assets with a return greater than risk-free assets, is determined using a combination of historical approaches (*expost*), backed by external publications and studies of various past returns, and prospective approaches (*exante*), based on market publications, taking into account the medium- and long-term profit expectations based on the degree of maturity and development of each country.

**Beta Coefficient:** is a multiplier of the equity risk premium, considered to be systematic risk. It is estimated based on a series of historical share prices of comparable companies listed on the stock exchange, thus determining the correlation between the return on the companies' shares and the return on the general index that is representative of the stock exchange of the country where said company is listed.

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The main underlying data used in these calculations are obtained from independent and renowned public external information sources.

The after-tax discount rates applied to the cash flow projections in 2016 and 2015 for the main CGUs are as follows:

| Discount rate in local currency | 2016  | 2015                |
|---------------------------------|-------|---------------------|
| <b>Spain</b>                    | 6.2%  | 6.1%                |
| <b>Brazil</b>                   | 11.3% | 11.9%               |
| <b>United Kingdom</b>           | 7.1%  | n.a. <sup>(1)</sup> |
| <b>Germany</b>                  | 5.7%  | 5.3%                |

<sup>(1)</sup> At December 31, 2015, the value in use of Telefónica United Kingdom was calculated based on the expected sale price following the agreement reached with Hutchison (see Note 2).

The cost of capital for Telefónica United Kingdom is considered to have greater market risk, due to the increase in volatility of British equity securities as a result of *Brexit*, however, this risk is in line with the estimates given by analysts.

With regard to Mexico, the after-tax discount rates increased from 9.05% in 2015 to 9.86% in 2016 as a result of the financial volatility associated with the change of president in the United States of America.

*Perpetuity growth rate*

Cash flow projections as from the sixth year are calculated using an expected constant growth rate (g), considering the consensus estimates among analysts for each business and country, based on the maturity of the industry and technology, and the degree of development of each country. Each indicator is compared to the forecasted long-term real and nominal GDP growth of each country and growth data from external sources, adjusted for any specific characteristics of the business.

The perpetuity growth rates applied to the cash flow projections in 2016 and 2015 for the main CGUs are as follows:

| Perpetuity growth rate | 2016 | 2015 |
|------------------------|------|------|
| in local currency      |      |      |
| <b>Spain</b>           | 0.8% | 0.7% |

|                       |                          |
|-----------------------|--------------------------|
| <b>Brazil</b>         | 5.0% 5.0%                |
| <b>United Kingdom</b> | 0.8% n.a. <sup>(1)</sup> |
| <b>Germany</b>        | 1.0% 1.0%                |

<sup>(1)</sup> At December 31, 2015, the value in use of Telefónica United Kingdom was calculated based on the expected sale price following the agreement reached with Hutchison (see Note 2).

There were no significant changes in the perpetuity growth rates for 2016 compared to those used in 2015 (Europe remains below 1% and Brazil around 5%).

In the case of Brazil, the perpetuity growth rate is in line with the Brazilian Central Bank's medium-term inflation target (4.5%, within a range of  $\pm 1.5$  p.p.) and is aligned with the analyst consensus for the Strategic Plan horizon (around 5%) and below the forecast nominal GDP growth rate (which oscillates around 7%). A conservative outlook has been maintained, in line with analysts' expectations.

#### **Sensitivity to changes in assumptions**

The Group carries out a sensitivity analysis of the impairment test by considering reasonable changes in the main assumptions used in such test. For each CGU with significant goodwill (Brazil, Spain, United Kingdom and Germany) the following maximum increases or decreases, expressed in percentage points (p.p.), were assumed:

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Changes in key assumptions, Spain

|                             | United Kingdom Brazil |          |         |
|-----------------------------|-----------------------|----------|---------|
| In percentage points (p.p.) | Germany               |          |         |
| <b>Financial variables</b>  |                       |          |         |
| Discount rate               | +/- 0.5               | +/- 0.5  | +/- 1   |
| Perpetuity growth rates     | +/- 0.25              | +/- 0.25 | +/- 0.5 |
| <b>Operating variables</b>  |                       |          |         |
| OIBDA Margin                | +/- 2                 | +/- 1.5  | +/- 2   |
| Ratio of CapEx/Revenues     | +/- 1                 | +/- 0.75 | +/- 1   |

In the case of Telefónica Brazil, with a 100 b.p. increase in WACC, the carrying amount of the CGU would be nearly the same as its recoverable amount as of December 31, 2016.

The sensitivity analysis revealed no significant risks for the other main CGUs. In Spain, United Kingdom and Germany there is a comfortable gap between the recoverable value and the carrying amount.

In the case of Telefónica México, a 50 b.p. increase in WACC could result in a negative impact for additional goodwill impairment of around 235 million euros, while with a 50 b.p. decrease in the perpetuity growth rate the negative impact would be around 190 million euros. On the other hand, a decrease of 1 p.p. in OIBDA margin could result in a negative impact of approximately 170 million euros, and with an increase of 0.5 p.p. in the CapEx ratio the negative impact would be around 85 million euros.

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## Note 8. Property, plant and equipment

The composition of and movement in the items comprising net “Property, plant and equipment” in 2016 and 2015 were the following:

2016

| Millions of euros                   | Balance at<br>12/31/15 | Additions | Depreciation | Disposals | Transfers<br>and others | Translation<br>differences<br>and<br>hyperinflation<br>adjustments | Exclusion of<br>companies | Balance at<br>12/31/16 |
|-------------------------------------|------------------------|-----------|--------------|-----------|-------------------------|--|---------------------------|------------------------|
| Land and<br>buildings               | 4,851                  | 59        | (386)        | (36)      | 198                     | 173  | (1)                       | 4,858                  |
| Plant and<br>machinery              | 24,682                 | 1,325     | (5,034)      | (22)      | 4,464                   | 1,369  | (14)                      | 26,770                 |
| Furniture, tools<br>and other items | 1,412                  | 190       | (531)        | (19)      | 344                     | 30   | –                         | 1,426                  |
| PP&E in progress                    | 2,965                  | 5,674     | –            | (12)      | (5,365)                 | 89   | (12)                      | 3,339                  |
| Total PP&E                          | 33,910                 | 7,248     | (5,951)      | (89)      | (359)                   | 1,661  | (27)                      | 36,393                 |

2015

| Millions of euros                   | Balance at<br>12/31/14 | Additions | Depreciation | Disposals | Transfers<br>and others | Translation<br>differences<br>and<br>hyperinflation<br>adjustments | Inclusion<br>of<br>companies | Balance at<br>12/31/15 |
|-------------------------------------|------------------------|-----------|--------------|-----------|-------------------------|--|------------------------------|------------------------|
| Land and<br>buildings               | 5,065                  | 59        | (488)        | (39)      | 382                     | (220)  | 92                           | 4,851                  |
| Plant and<br>machinery              | 23,637                 | 1,624     | (5,008)      | (54)      | 4,381                   | (2,123)  | 2,225                        | 24,682                 |
| Furniture, tools<br>and other items | 1,311                  | 234       | (575)        | (27)      | 456                     | (101)  | 114                          | 1,412                  |
| PP&E in progress                    | 3,143                  | 5,758     | –            | (5)       | (5,696)                 | (270)  | 35                           | 2,965                  |
| Total PP&E                          | 33,156                 | 7,675     | (6,071)      | (125)     | (477)                   | (2,714)  | 2,466                        | 33,910                 |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

The gross cost, accumulated depreciation and impairment losses of property, plant and equipment at December 31, 2016 and 2015 are as follows:

Balance at December 31, 2016

| Millions of euros                | Gross cost | Accumulated depreciation | Impairment losses | PP&E   |
|----------------------------------|------------|--------------------------|-------------------|--------|
| Land and buildings               | 11,930     | (7,069)                  | (3)               | 4,858  |
| Plant and machinery              | 99,945     | (73,021)                 | (154)             | 26,770 |
| Furniture, tools and other items | 7,288      | (5,852)                  | (10)              | 1,426  |
| PP&E in progress                 | 3,350      | –                        | (11)              | 3,339  |
| Total PP&E                       | 122,513    | (85,942)                 | (178)             | 36,393 |

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Balance at December 31, 2015 (\*)

| Millions of euros                | Gross cost | Accumulated depreciation | Impairment losses | PP&E   |
|----------------------------------|------------|--------------------------|-------------------|--------|
| Land and buildings               | 11,515     | (6,661)                  | (3)               | 4,851  |
| Plant and machinery              | 91,172     | (66,362)                 | (128)             | 24,682 |
| Furniture, tools and other items | 6,816      | (5,392)                  | (12)              | 1,412  |
| PP&E in progress                 | 2,982      | –                        | (17)              | 2,965  |
| Total PP&E                       | 112,485    | (78,415)                 | (160)             | 33,910 |

(\*) Amended data (see Note 2).

Investment by Telefónica Spain in property plant and equipment in 2016 and 2015 amounted to 1,610 and 1,575 million euros, respectively. Rapid fiber optic roll out, exceeding 17 million premises passed in 2016, together with investments in LTE network, with a 96% population coverage, and transport network modernization.

Investment by Telefónica United Kingdom in property plant and equipment in 2016 and 2015 amounted to 776 and 759 million euros, respectively. The investment has been focused on increasing LTE coverage, achieving 95% population coverage by year-end 2016, and also pursuing the improvement of network capacity and quality of customer experience.

Investment by Telefónica Germany in property plant and equipment in 2016 and 2015 amounted to 742 and 739 million euros, respectively. LTE roll out has been the company's main focus, achieving a coverage of 79% by year-end 2016, and network consolidation activities, which are allowing to enhance customer experience and to capture integration synergies.

Investment by Telefónica Brazil in property plant and equipment in 2016 and 2015 amounted to 1,782 and 1,824 million euros, respectively. The investment was mainly dedicated to extend the coverage and capacity of 4G and 3G mobile networks, as well as improving network quality, and the deployment and connection of fiber network in the fixed business.

Investment by Telefónica Hispanoamérica in property plant and equipment in 2016 and 2015 amounted to 2,165 and 2,562 million euros, respectively. This investment has been mainly focused on improving the coverage and capacity of 3G and 4G networks, the roll out of ultra-broadband fixed capabilities (fiber / HFC) and the quality enhancement in broadband and TV services.

“Inclusion of companies” in 2015 mainly corresponds to GVT and DTS (see Note 5).



The impact of the monetary adjustments due to hyperinflation in Venezuela is included under “Translation differences and hyperinflation adjustments”.

Telefónica Group companies have purchased insurance policies to reasonably cover the possible risks to which their property, plant and equipment used in operations are subject, with suitable limits and coverage. In addition, as part of its commercial activities and network roll-out, the Group maintains several property acquisition commitments. The timing of scheduled payments in this regard is disclosed in Note 18.

Property, plant and equipment deriving from finance leases amounted to 476 million euros at December 31, 2016 (557 million euros at December 31, 2015). The most significant finance leases are disclosed in Note 22.

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## Note 9. Associates and joint ventures

The breakdown of items related to associates and joint ventures recognized in the consolidated statements of financial position and income statements is as follows:

Millions of euros

|   | 12/31/2016 | 12/31/2015 (*) |
|---|------------|----------------|
| Investments accounted for by the equity method                                  | 76         | 80             |
| Loans to associates and joint ventures  | 16         | 21             |
| Receivables from associates and joint ventures for current operations (Note 11) | 28         | 33             |
| Financial debt, associates and joint ventures                                   | 9          | 399            |
| Payables to associates and joint ventures (Note 14)                             | 497        | 806            |

(\*) Amended data (see Note 2).

Millions of euros

|   | 2016 | 2015 (*) | 2014 (*) |
|---|------|----------|----------|
| Share of (loss) of investments accounted for by the equity method | (5)  | (10)     | (510)    |
| Revenue from operations with associates and joint ventures        | 213  | 217      | 472      |
| Expenses from operations with associates and joint ventures       | 32   | 85       | 503      |
| Financial income with associates and joint ventures               | —    | —        | 49       |
| Financial expenses with associates and joint ventures             | 2    | 17       | 16       |

(\*) Amended data (see Note 2).

The table above includes the transactions with the companies of the Telecom Italia Group until the classification of the investment in Telco, S.p.A. as available-for-sale financial asset at the end of 2014. In 2015 Telefónica sold its stake in Telecom Italia, S.p.A., according to the regulatory and competition commitments assumed (see Note 13).

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The detail of the movement in investments in associates in 2016 and 2015 was the following:

|  | Millions of<br>euros |
|--|----------------------|
| Investments accounted for by the equity method         |                      |
| Balance at 12/31/14                                    | 788                  |
| Additions  | 57                   |
| Translation differences and other comprehensive income | (5)                  |
| Income (loss)  | (10)                 |
| Dividends  | (11)                 |
| Transfers and other                                    | (739)                |
| Balance at 12/31/15                                    | 80                   |
| Additions  | 17                   |
| Translation differences and other comprehensive income | 2                    |
| Income (loss)  | (5)                  |
| Dividends  | (13)                 |
| Transfers and other                                    | (5)                  |
| Balance at 12/31/16                                    | 76                   |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

Additions in 2016 included 7 million euros related to The Smart Steps Data Technology Company (see Note 10).

On April 30, 2015 the acquisition of the 56% of DTS Distribuidora de Televisión Digital, S.A. was completed (see Note 5). From this transaction, DTS and its subsidiaries are incorporated to the Telefónica Group consolidation perimeter under full consolidation method. Until April 30, 2015, the previous stake held by Telefónica Group (44%) was registered under equity method. This movement was registered in “Transfers and other” for 739 million euros.

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Note 10. Related parties

**Significant shareholders**

The significant shareholders of the Company are Bilbao Vizcaya Argentaria, S.A. (BBVA), Blackrock, Inc. and Caja de Ahorros y Pensiones de Barcelona (“la Caixa”) with stakes in Telefónica, S.A. of 6.33%, 5.22% and 5.15%, respectively.

During 2016 the Group did not carry out any significant transactions with Blackrock, Inc., other than the dividends paid corresponding to its stake.

A summary of significant transactions between the Telefónica Group and the companies of BBVA and those of la Caixa, carried out at market prices, is as follows:

| Millions of euros  | BBVA | La Caixa |
|--|------|----------|
| 2016   |      |          |
| Finance costs  | 36   | 2        |
| Receipt of services  | 5    | 4        |
| Purchase of goods  | –    | 65       |
| Other expenses   | 1    | –        |
| Total costs  | 42   | 71       |
| Finance income   | 22   | –        |
| Contracts of management  | 1    | –        |
| Dividends received <sup>(1)</sup>                                | 15   | N/A      |
| Services rendered  | 40   | 66       |
| Sale of goods  | 3    | 42       |
| Other income   | 11   | –        |
| Total revenue  | 92   | 108      |
| Finance arrangements: loans and capital contributions (borrower) | 396  | 45       |
| Finance arrangements: loans and capital contributions (lender)   | –    | 10       |
| Guarantees   | 314  | 50       |
| Commitments  | –    | 84       |
| Finance arrangements: loans and capital contributions (lessee)   | 244  | 203      |
| Dividends  | 243  | 185      |
| Factoring operations   | 533  | 250      |

<sup>(1)</sup> At December 31, 2016, Telefónica holds a 0.67% stake in the share capital of Banco Bilbao Vizcaya Argentaria, S.A. (see Note 13.a).

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Millions of euros

2015(\*)

|  | BBVA | La Caixa |
|--|------|----------|
| Finance costs  | 24   | 1        |
| Leases   | 1    | –        |
| Receipt of services  | 5    | 13       |
| Purchase of goods  | 1    | 53       |
| Total costs  | 31   | 67       |
| Finance income   | 15   | 1        |
| Contracts of management  | 1    | –        |
| Dividends received <sup>(1)</sup>                                | 16   | N/A      |
| Services rendered  | 35   | 52       |
| Sale of goods  | 6    | 64       |
| Other income   | 17   | –        |
| Total revenue  | 90   | 117      |
| Finance arrangements: loans and capital contributions (borrower) | 534  | 422      |
| Finance arrangements: loans and capital contributions (lender)   | –    | 6        |
| Guarantees   | 317  | 39       |
| Commitments  | 1    | 79       |
| Finance arrangements: loans and capital contributions (lessee)   | 54   | 50       |
| Dividends  | 212  | 113      |
| Factoring operations   | 164  | 150      |

<sup>(1)</sup> At December 31, 2015, Telefónica held a 0.69% stake in the share capital of Banco Bilbao Vizcaya Argentaria, S.A. (see Note 13.a).

(\*)Amended data (see Note 2).

In addition, the nominal value of outstanding derivatives held with BBVA and la Caixa in 2016 amounted to 18,047 and 392 million euros, respectively (19,824 million euros held with BBVA and 1,241 million euros held with la Caixa in 2015). As explained in Derivatives policy in Note 16, this figure is inflated by the use in some cases of several levels of derivatives applied to the nominal value of a single underlying. The fair value of these same derivatives in the statement of financial position is 988 and -35 million euros, respectively, in 2016 (948 and -26 million euros, respectively, in 2015). Additionally, at December 31, 2016 there were collateral guarantees on derivatives with BBVA amounting to 240 million euros.

## Other related parties

The most significant balances and transactions with associates and joint ventures are detailed in Note 9.

During the financial year to which these accompanying consolidated financial statements refer, the Directors and senior executives did not perform any transactions with Telefónica, S.A. or any Telefónica Group company other than those in the Group's normal trading activity and business.

Telefónica contracted a civil liability insurance scheme (D&O) for Directors, managers and staff with similar functions in the Telefónica Group, with standard conditions in these type of insurance and a premium attributable to 2016 of 2,088,500 euros. This scheme provides coverage for Telefónica, S.A. and its subsidiaries, in certain cases.

Compensation and other benefits paid to members of the Board of Directors and senior executives are detailed in Note 21.f and Appendix II of these consolidated financial statements.

A representative from Telefónica remains on China Unicom's board of directors, and vice versa (see Note 13). In addition, Telefónica maintains an industrial alliance with this company. On December 18, 2015 a joint venture with China Unicom was incorporated, for the development of Big Data services in China using "Smart Steps" technology, developed by Telefónica. Telefónica's stake in this company is 45% through Telefónica Digital España, S.L.; China Unicom Broadband Online Limited Corp. owns the remaining 55% stake. In 2016, Telefónica paid 7 million euros for its shareholding in the company (see Note 9). The company is already commercially operative and obtained turnover equivalent to 4 million euros in 2016.

Certain Telefónica Group subsidiaries have performed transactions with the Inditex Group in 2016, transactions related to the Group's ordinary course of business, concerning telecommunications and related services, amounting to 36 million euros.

A member of Telefónica, S.A.'s Board of Directors in 2015 was also board member of Abertis Infraestructuras, S.A., parent of Abertis. Telefónica has signed agreements with Abertis, through its subsidiary On Tower Telecom Infraestructuras, S.A. (previously Abertis Tower, S.A.), by virtue of which Telefónica Spain has sold mobile phone at a price of 44 million euros in 2015, generating a gain of 38 million euros in 2015. Additionally, in 2015, an agreement was signed through which On Tower Telecom Infraestructuras S.A. leases certain space in the aforesaid infrastructures for Telefónica Móviles España, S.A.U. to install its communications equipment. In 2016, this company is no longer considered as a related party.

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## Note 11. Trade and other receivables

The breakdown of this consolidated statement of financial position heading at December 31, 2016 and 2015 is as follows:

| Millions of euros                                       | 12/31/2016 | 12/31/2015 (*) |
|---|------------|----------------|
| Trade receivables billed                                | 8,620      | 8,466          |
| Trade receivables unbilled                              | 3,003      | 2,829          |
| Impairment of trade receivables                         | (2,795)    | (2,787)        |
| Receivables from associates and joint ventures (Note 9) | 28         | 33             |
| Other receivables                                       | 418        | 564            |
| Short-term prepayments                                  | 1,401      | 1,121          |
| Total   | 10,675     | 10,226         |

(\*) Amended data (see Note 2).

Public-sector net trade receivables at December 31, 2016 and 2015 amounted to 331 million euros and 360 million euros, respectively.

The movement in impairment of trade receivables in 2016 and 2015 is as follows:

|   | Millions of euros |
|---|-------------------|
| Impairment provision at December 31, 2014 | 2,757             |
| Allowances                                | 968               |
| Amounts applied                           | (888)             |
| Inclusion of companies                    | 146               |
| Translation differences and other         | (196)             |
| Impairment provision at December 31, 2015 | 2,787             |
| Allowances                                | 915               |
| Amounts applied                           | (1,044)           |
| Translation differences and other         | 137               |
| Impairment provision at December 31, 2016 | 2,795             |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

The balance of trade receivables billed and receivables from associates and joint ventures net of impairment losses at December 31, 2016 amounted to 5,853 million euros (5,712 million euros at December 31, 2015), of which 3,672 million euros were not yet due (3,365 million euros at December 31, 2015).

Net balance of trade receivables billed of 260 million euros and 265 million euros are over 360 days due at December 31, 2016 and 2015, respectively.

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Note 12. Equity

**a) Share capital and share premium**

**2016**

On October 11, 2016, the deed of a share capital decrease was registered, cancelling 74,627,988 of own shares, reducing the company's share capital by 74,627,988 euros.

On December 7, 2016, the deed of a share capital increase of 137,233,781 euros ordinary shares with a par value of 1 euro each were issued, with a charge to reserves; as part of the scrip dividend shareholder remuneration deal. Share capital amounts to 5,037,804,990 euros subsequent to this increase.

At December 31, 2016, Telefónica, S.A.'s share capital amounted to 5,037,804,990 euros and consisted of 5,037,804,990 fully paid ordinary shares of a single series, par value of 1 euro, all recorded by the book-entry system and traded on the Spanish electronic trading system ("Continuous Market"), where they form part of the "Ibex 35" Index, on the four Spanish Stock Exchanges (Madrid, Barcelona, Valencia and Bilbao) and listed on the London and Buenos Aires Stock Exchanges, and on the New York and Lima Stock Exchanges, through American Depositary Shares ('ADSs').

**2015**

On April 20, 2015, the public deed evidencing the share capital increase granted by Telefónica, S.A. was registered with the Commercial Registry of Madrid for a nominal value of 281,213,184 euros recorded as "share capital". The difference with the effective amount issued, amounting 3,048,350,914.56 euros was recorded as Share premium.

On July 24, 2015, the public deed of the share capital reduction was registered, cancelling 74,076,263 of the own shares, reducing the company's share capital by 74,076,263 euros.

On December 10, 2015, the public deed of a share capital increase of 110,857,946 euros was executed, during which 110,857,946 ordinary share with a par value of 1 euro each were issued, with a charge to reserves, as part of the scrip dividend shareholder remuneration deal. Share capital amounts to 4,975,199,197 euros subsequent to this increase.

### **Authorizations by Shareholders' Meeting**

With respect to authorizations given regarding share capital, on June 12, 2015, authorization was given at the Annual Shareholders' Meeting of Telefónica, S.A. for the Board of Directors, at its discretion and in accordance with the Company's needs, to increase the Company's capital, once or several times, within a maximum period of five years from that date, up to a maximum nominal increase of 2,469,208,757 euros, equivalent to half of Telefónica, S.A.'s share capital at that date, by issuing and placing new shares, -with or without a share premium, and, in all cases, in exchange for cash, expressly considering the possibility that the new shares may not be fully subscribed. The Board of Directors was also empowered to exclude, partially or fully, pre-emptive subscription rights under the terms of Section 506 of the Spanish Enterprises Act. However, the power to exclude preemptive rights is limited to 20% of the Company's share capital on the date of adoption of this resolution.

Furthermore, on May 30, 2014, shareholders voted to authorize the acquisition by the Board of Directors of Telefónica, S.A. treasury shares, up to the limits and pursuant to the terms and conditions established at the Shareholders' Meeting, within a maximum period of five years from that date. However, it specified that in no circumstances could the par value of the shares acquired, added to that of the treasury shares already held by Telefónica, S.A. and by any of its controlled subsidiaries, exceed the maximum legal percentage at any time (currently 10% of Telefónica, S.A.'s share capital).

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In addition, at the May 30, 2014 Shareholders' Meeting of Telefónica, S.A., authorization was given for the Board of Directors to issue debentures, bonds, notes and other fixed-income securities and hybrid instruments, including preferred shares at one or several times within a maximum period of five years from that date. These securities may be in the form of debentures, bonds, promissory notes or any other kind of fixed-income security, or debt instruments of similar category or hybrid instruments whatever may be the forms admitted in law, plain or, in the case of debentures, bonds and hybrid instruments convertible into shares of the Company and/or exchangeable for shares of any of the Group companies, or any other company. This delegation also includes warrants or other similar securities that might give the right to directly or indirectly subscribe or acquire shares of the Company, whether newly issued or outstanding, and which may be paid for by physical delivery or by offset. The aggregated amount of the issuance(s) of securities approved under this delegation of powers may not exceed, at any given time, the sum of 25,000 million euros or the equivalent in another currency. For promissory notes, the outstanding balance of promissory notes issued under this authorization will be calculated for purposes of the aforementioned limit. Also for purposes of the foregoing limit, in the case of warrants, the sum of the premiums and exercise prices of the warrants for each issuance that is approved under this delegation shall be taken into account.

## **b) Dividends**

### **Dividends distribution in 2016 and capital increase**

Approval was given at the Shareholder's Meeting of Telefónica S.A. of May 12, 2016 to pay a dividend with a charge to unrestricted reserves of a fixed gross 0.40 euros per outstanding share carrying dividend rights. The dividend was paid in full on May 19, 2016, and the total amount paid was 1,906 million euros.

On November 11, 2016 the Executive Commission of Telefónica, S.A.'s Board of Directors approval to pay a scrip dividend amounting to approximately 0.35 euros per share consisting of the assignment of free allotment rights with an irrevocable purchase commitment by the Company, and a subsequent capital increase with a charge to reserves by such amount as may be determined pursuant to the terms and conditions of the resolution, by means of the issue of new ordinary shares having a par value of one euro, to fulfill said allotments. The payment was paid on December 7, 2016, with and impact in equity amounting to 500 million euros.

Additionally, the shareholders of 70.01% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica, S.A. Thus, the final number of shares issued in the capital increase was 137,233,781 shares with a nominal value of 1 euro each.

### **Proposed distribution of profit attributable to equity holders of the parent**

Telefónica, S.A. generated 24 million euros of profit in 2016.

The Company's Board of Directors will submit the following proposed distribution of 2016 profit for approval at the Shareholders' Meeting:

|                | Millions of euros |
|----------------|-------------------|
| Legal reserve  | 2                 |
| Other reserves | 22                |
| Total          | 24                |

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**Dividends distribution in 2015 and capital increase**

Approval was given at the Board of Directors' Meeting of April 29, 2015 to pay a gross 0.40 euros dividend per outstanding share against 2015 profit. This dividend was paid on May 12, 2015 and the total gross amount paid was 1,912 million euros.

At its meeting held on November 13, 2015, the Executive Commission of Telefónica, S.A.'s Board of Directors agreed to carry out the execution of the increase in paid-up capital, related to the shareholders compensation by means of a scrip dividend, approved by the Annual General Shareholder's Meeting of Telefónica, S.A. held on June 12, 2015.

Thus, each shareholder received one free allotment right for each Telefónica share held. Such free allotment rights were traded on the Continuous Market in Spain during a period of 15 calendar days. Once this trading period ended, the shareholders of 20.01% of the free-of-charge allotment rights accepted the irrevocable purchase commitment assumed by Telefónica, S.A. Cash payment to these shareholders was made on December 7, 2015, representing an impact in equity of 337 million euros.

The shareholders of 79.99% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica, S.A. Nevertheless, Telefónica, S.A. has waived the subscription of new shares corresponding to its treasury shares, so the final number of shares issued in the capital increase was 110,857,946 shares with a nominal value of 1 euro each.

**Dividends distribution in 2014 and capital increase**

Approval was given at the Board of Directors' Meeting of April 25, 2014 to pay a gross 0.40 euros dividend per outstanding share against 2014 profit. This dividend was paid on May 7, 2014 for a gross amount of 1,790 million euros.

At its meeting held on November 14, 2014, the Executive Commission of Telefónica, S.A.'s Board of Directors agreed to carry out the execution of the increase in paid-up capital, related to the shareholders compensation by means of a scrip dividend, approved by the Annual General Shareholder's Meeting held on May 30, 2014.

Thus, each shareholder received one free allotment right for each Telefónica share held. Such free allotment rights were traded on the Continuous Market in Spain during a period of fifteen calendar days. Once this trading period ended, the shareholders of 15.8% of the free-of-charge allotment rights accepted the irrevocable purchase commitment

assumed by Telefónica, S.A. Cash payment to these shareholders was made on December 8, 2014, representing an impact in equity of 242 million euros.

The shareholders of 84.2% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica, S.A. Nevertheless, Telefónica, S.A. has waived the subscription of new shares corresponding to its treasury shares, so the final number of shares issued in the capital increase was 106,179,744 shares with a nominal value of 1 euro each.

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Table of Contents**c) Other equity instruments****Undated deeply subordinated securities**

The undated deeply subordinated securities have been issued by Telefónica Europe B.V. unless specified otherwise.

The characteristic of the undated deeply subordinated securities during the exercises 2016, 2015 and 2014 are the following (millions of euros):

| Issue date  | Coupon |  |      | Exercisable from issuer |              |             |
|-------------|--------|--|------|-------------------------|--------------|-------------|
|             | Annual | Variable                                     |      | 2016                    | 2015         | 2014        |
|             | Fix    |  |      |                         |              |             |
| 09/15/16    | 3.750% | from 03/15/22 rate SWAP + spread incremental | 2022 | 1,000-                  | -            |             |
| 03/30/15(*) | 8.50%  | from 03/30/20 rate SWAP + spread incremental | 2020 | 452                     | 452          | -           |
| 12/04/14    | 4.20%  | from 12/04/19 rate SWAP + spread incremental | 2019 | 850                     | 850          | 850         |
| 03/25/14    | 5%     | from 03/25/20 rate SWAP + spread incremental | 2020 | 750                     | 750          | 750         |
|             | 5.875% | from 03/25/24 rate SWAP + spread incremental | 2024 | 1,000                   | 1,000        | 1,000       |
| 11/26/13    | 6.75%  | from 11/26/20 rate SWAP + spread incremental | 2020 | 716                     | 716          | 716         |
| 09/18/13    | 6.5%   | from 09/18/18 rate SWAP + spread incremental | 2018 | 1,125                   | 1,125        | 1,125       |
|             | 7.625% | from 09/18/21 rate SWAP + spread incremental | 2021 | 625                     | 625          | 625         |
|             |        |  |      | <b>6,5185</b>           | <b>5,185</b> | <b>0,66</b> |

(\*) Issued by Colombia Telecomunicaciones, S.A. ESP (500 million US dollars)

In all issuances of subordinated perpetual instruments, the issuer has an option to defer the payment of coupons; holders of these securities cannot call for payment.

As the repayment of principal and the payment of coupons depend solely on Telefónica's decision, these subordinated perpetual instruments are equity instruments and are presented under "Other equity instruments" in the accompanying consolidated statement of changes in equity.

On September 15, 2016, Telefónica Europe, B.V. issued undated deeply subordinated guaranteed fixed rate reset securities, with the subordinated guarantee of Telefónica, S.A., in an aggregate principal amount of 1,000 million euros and subject to a call option exercisable starting on the fifth anniversary and a half from the issuance date. The Securities will accrue interest at a rate of 3.75% annually as from (and including) the issue date up to March 15, 2022.

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From (and including) March 15, 2022, the Securities will accrue a fixed rate of interest equal to the applicable 5.5 year Swap Rate plus a margin of: (i) 3.858% per year as from March 15, 2022 up to (but excluding) March 15, 2027; (ii) 4.108% per year as from March 15, 2027 up to (but excluding) March 15, 2042; and (iii) 4.858% per year as from (and including) March 15, 2042.

In 2016, the payment of the coupons related to the undated deeply subordinated in an aggregate amount, net of tax effects, of 255 million euros (247 and 129 million euros in 2015 and 2014, respectively), was recorded as “Retained earnings” in the consolidated statements of changes in equity.

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**Notes mandatorily convertible into shares of Telefónica, S.A.**

On September 24, 2014, Telefónica Participaciones, S.A.U., issued 1,500 million euros of notes mandatorily convertible into new and/or existing shares of Telefónica, S.A. at a nominal fixed interest rate of 4.9%, due on September 25, 2017, guaranteed by Telefónica, S.A. The notes could be converted at the option of the noteholders or the issuer at any time from the 41<sup>st</sup> day after the issue date up to the 25<sup>th</sup> trading day prior to the maturity date. The minimum conversion price of the notes will be equal to 11.9 euros per share and the maximum conversion price will be equal to 14.5775 euros per share, resulting in a premium equal to 22.5% over the minimum conversion price.

These notes mandatorily convertible were compound instruments that have been split into its two components: a debt component amounting 215 million euros, corresponding to the present value of the coupons; and an equity component, for the remaining amount, due to the issuer option to convert the treasury shares to a fix ratio, included in the heading “other equity instruments”. The second coupon was paid in 2016 amounting to 74 million euros (73 million euros in 2015).

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**d) Legal reserve**

According to the consolidated text of the Corporate Enterprises Act, companies must transfer 10% of profit for the year to a legal reserve until this reserve reaches at least 20% of share capital. The legal reserve can be used to increase capital by the amount exceeding 10% of the increased share capital amount. Except for this purpose, until the legal reserve exceeds the limit of 20% of share capital, it can only be used to offset losses, if there are no other reserves available. At December 31, 2015, this reserve was amounting to 984 million euros. The Shareholders' Meeting at May 12, 2016 approved an allocation of 1 million with a charge to the profit of exercise 2015. At December 31, 2016, after the capital increase carried forward in 2016, the Company needs to increase the legal reserve by 23 million euros additionally, until obtain the legal reserve will fully constituted. The proposed distribution of 2016 profit includes an allocation of 2 million euros regarding this concept.

**e) Retained earnings**

These reserves include undistributed profits of companies comprising the consolidated Group less interim dividends paid against profit for the year, actuarial gains and losses, the impact of the asset ceiling on defined-benefit plans and the payment of coupons related to subordinated securities, if applicable.

In addition, these reserves include revaluation reserves and reserve for cancelled share capital. These reserves are regulated by some restrictions for their distribution.

**Revaluation reserves**

The balance of "Revaluation reserves" arose as a result of the revaluation made pursuant to Royal Decree-Law 7/1996 dated June 7 and may be used, free of tax, to offset any losses incurred in the future and to increase capital. Also it may be allocated to unrestricted reserves, provided that the capital gain has been realized.

The capital gain will be deemed to have been realized in respect of the portion on which the depreciation has been recorded for accounting purposes or when the revalued assets have been transferred or derecognized. In this respect, an amount of 8 million euros was reclassified to "Retained earnings" in 2016 (8 million euros in 2015 and 6 million euros in 2014), corresponding to revaluation reserves subsequently considered unrestricted. At December 31, 2016, this reserve amounts to 85 million euros (93 million euros at December 31, 2015).

**Reserve for cancelled share capital**

In accordance with Section 335.c) of the Corporate Enterprises Act and to render null and void the right of opposition provided for in Section 334 of the same Act, whenever the Company decreases capital it records a reserve for cancelled share capital for an amount equal to the par value of the cancelled shares, which can only be used if the same requirements as those applicable to the reduction of share capital are met. In 2016, a reserve for cancelled share capital amounting to 75 million euros was recorded, the same amount as the capital reduction made in the year. In 2015, a reserve for cancelled share capital amounting to 74 million euros, the same amount as the capital reduction made in the year. The cumulative amount at December 31, 2016 and 2015 was 731 and 656 million euros, respectively.

**f) Translation differences**

The breakdown of the accumulated contribution of translation differences at December 31 is as follows:

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|                     |          |          |          |
|---------------------|----------|----------|----------|
| Millions of euros   | 2016     | 2015(*)  | 2014     |
| Brazilian real      | (5,999)  | (9,884)  | (5,552)  |
| Venezuelan bolivars | (3,165)  | (3,141)  | (2,923)  |
| Pound sterling      | (2,918)  | (1,395)  | (1,901)  |
| Other currencies    | (2,658)  | (2,369)  | (1,756)  |
| Total Group         | (14,740) | (16,789) | (12,132) |

(\*) Amended data (See Note 2).

**g) Treasury share instruments**

At December 31, 2016, 2015 and 2014, Telefónica, S.A. held the following treasury shares:

|                             | Number of shares | Euros per share   |               | Market value* | %        |
|-----------------------------|------------------|-------------------|---------------|---------------|----------|
|                             |                  | Acquisition price | Trading price |               |          |
| Treasury shares at 12/31/16 | 141,229,134      | 10.48             | 8.82          | 1,246         | 2.80339% |
| Treasury shares at 12/31/15 | 141,639,159      | 11.69             | 10.24         | 1,450         | 2.84690% |
| Treasury shares at 12/31/14 | 128,227,971      | 11.68             | 11.92         | 1,528         | 2.75332% |

(\*) Millions of euros

In 2016, 2015 and 2014 the following transactions involving treasury shares were carried out:

|                             | Number of shares |
|-----------------------------|------------------|
| Treasury shares at 12/31/13 | 29,411,832       |
| Acquisitions                | 100,723,415      |
| Disposals                   | (129,177)        |
| Employee share option plan  | (1,778,099)      |
| Treasury shares at 12/31/14 | 128,227,971      |
| Acquisitions                | 138,036,450      |
| Disposals                   | (47,824,300)     |
| Employee share option plan  | (2,724,699)      |
| Capital reduction           | (74,076,263)     |
| Treasury shares at 12/31/15 | 141,639,159      |
| Acquisitions                | 77,087,297       |
| Employee share option plan  | (2,869,334)      |
| Capital reduction           | (74,627,988)     |
| Treasury shares at 12/31/16 | 141,229,134      |

Treasury shares purchases in 2016 amounted to 668 million euros (1,654 million euros and 1,176 million euros in 2015 and 2014, respectively).

Treasury shares sold, including share plan redemptions, in 2016, 2015 and 2014 amounted to 26 million euros, 593 million euros and 1 million euros, respectively.

The main sale of treasury shares in 2015 was the exchange with Vivendi, S.A. of 46 million of Telefónica, S.A.'s treasury shares, for 58.4 million preferred shares of Telefônica Brasil, S.A., amounting to 555 million euros (see Note 5).

On June 30, 2016, the third phase of the Telefónica, S.A. long-term incentive plan called "Performance and Investment Plan 2013-2016" ("PIP 2013-2016") ended, which did not entail the delivery of any shares to Telefónica Group managers.

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On June 30, 2015, the second phase of the Telefónica, S.A. long-term incentive plan called “Performance and Investment Plan 2012-2015” (“PIP 2012-2015”) ended. According to the level of “Total Shareholder Return” (TSR) achieved, 77%, 2,724,699 shares were delivered (see Note 19).

On October 13, 2016, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders’ Meeting of Telefónica held on May 12, 2016, the public deed of this share capital reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,627,988 of the own shares of Telefónica, S.A. totalling 813 million euros were cancelled.

On July 24, 2015, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders’ Meeting of Telefónica held on June 12, 2015, the public deed of this share capital reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,076,263 of the own shares of Telefónica, S.A. totalling 886 million euros were cancelled.

The Company maintains a derivative financial instrument subject to net settlement on a notional equivalent to 35.2 million of Telefónica shares in 2016 (33.8 million equivalent shares in 2015), recognized under “Current interest-bearing debt” in the consolidated financial statements for both fiscal years.

**h) Equity attributable to non-controlling interests**

“Equity attributable to non-controlling interests” represents the share of non-controlling interests in the equity and income or loss for the year of fully consolidated Group companies. The movements in this heading of the 2016, 2015 and 2014 consolidated statement of financial position are as follows:

| Millions of euros                    | Balance at 12/31/15 | Sales of non-controlling interests and inclusion of companies | Acquisitions of non-controlling interests and exclusion of companies | Dividends paid | Profit/(loss) for the year | Change in translation differences | Other movements | Balance at 12/31/16 |
|--------------------------------------|---------------------|---|--|----------------|----------------------------|-----------------------------------|-----------------|---------------------|
| Telefônica Brasil, S.A.              | 4,644               | –   | –  | (232)          | 257                        | 1,099                             | (12)            | 5,756               |
| Telefónica Deutschland Holding, A.G. | 4,638               | –   | –  | (263)          | (217)                      | –                                 | (8)             | 4,150               |
| Telecomunicaciones, S.A., ESP        | (30)                | –   | –  | –              | (32)                       | (7)                               | (19)            | (88)                |
|                                      | 354                 | –   | –  | (28)           | 19                         | 8                                 | 1               | 354                 |

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Telefónica  
 Centroamericana  
 Inversiones, S.L.

|       |       |   |     |       |    |       |      |        |
|-------|-------|---|-----|-------|----|-------|------|--------|
| Other | 59    | 1 | (8) | (1)   | 3  | 3     | (1)  | 56     |
| Total | 9,665 | 1 | (8) | (524) | 30 | 1,103 | (39) | 10,228 |

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| Millions of euros                                 | Balance at 12/31/14 | Sales of non-controlling interests and inclusion of companies | Acquisitions of non-controlling interests and exclusion of companies | Dividends paid | Profit/(loss) for the year | Change in translation differences | Other movements | Balance at 12/31/15 |
|---|---------------------|---|--|----------------|----------------------------|-----------------------------------|-----------------|---------------------|
| Telefônica Brasil, S.A.                           | 3,656               | 4,359   | (1,714)  | (346)          | 288                        | (1,603)                           | 4               | 4,644               |
| Telefónica Deutschland Holding A.G.               | 5,178               | –   | (116)  | (268)          | (159)                      | –                                 | 3               | 4,638               |
| Telefónica Colombia Telecomunicaciones, S.A., ESP | (50)                | 17  | –  | –              | (8)                        | 8                                 | 3               | (30)                |
| Telefónica Centroamericana Inversiones, S.L.      | 326                 | –   | –  | (25)           | 18                         | 34                                | 1               | 354                 |
| Other   | 76                  | (8)   | –  | (2)            | (4)                        | –                                 | (3)             | 59                  |
| <b>Total</b>                                      | <b>9,186</b>        | <b>4,368</b>  | <b>(1,830)</b>   | <b>(641)</b>   | <b>135</b>                 | <b>(1,561)</b>                    | <b>8</b>        | <b>9,665</b>        |

| Millions of euros                                 | Balance at 12/31/13 | Sales of non-controlling interests and inclusion of companies | Acquisitions of non-controlling interests and exclusion of companies | Dividends paid | Profit/(loss) for the year | Change in translation differences | Other movements | Balance at 12/31/14 |
|---|---------------------|---|--|----------------|----------------------------|-----------------------------------|-----------------|---------------------|
| Telefónica Czech Republic, a.s.                   | 666                 | –   | (666)  | –              | –                          | –                                 | –               | –                   |
| Telefônica Brasil, S.A.                           | 3,491               | –   | –  | (269)          | 423                        | (5)                               | 16              | 3,656               |
| Telefónica Deutschland Holding A.G.               | 1,962               | 3,615   | –  | (122)          | (277)                      | –                                 | –               | 5,178               |
| Telefónica Colombia Telecomunicaciones, S.A., ESP | (165)               | –   | –  | –              | 91                         | 7                                 | 17              | (50)                |
| Telefónica Centroamericana Inversiones, S.L.      | 283                 | 6   | –  | (14)           | 9                          | 41                                | 1               | 326                 |
| Other   | 60                  | 10  | –  | (1)            | 5                          | 4                                 | (2)             | 76                  |
| <b>Total</b>                                      | <b>6,297</b>        | <b>3,631</b>  | <b>(666)</b>   | <b>(406)</b>   | <b>251</b>                 | <b>47</b>                         | <b>32</b>       | <b>9,186</b>        |

Revenues, OIBDA, capital expenditure and the main items of the statement of financial position for the main companies of the Telefónica Group with non-controlling interests, which are Telefônica Brasil and Telefónica Germany, are included in Note 4. The statements of cash flows of these companies are as follows:

| Millions of euros                              | 2016  | 2015  | 2014  |
|--|-------|-------|-------|
| Telefônica Brasil                              |       |       |       |
| Net cash flow provided by operating activities | 3,123 | 2,893 | 3,138 |



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|  |         |         |         |
|--|---------|---------|---------|
| Net cash flow used in investing activities | (2,039) | (4,111) | (2,544) |
| Net cash flow used in financing activities | (1,218) | 1,530   | (1,096) |
|  | (134)   | 312     | (502)   |

Millions of euros

|  |         |         |         |
|--|---------|---------|---------|
| Telefónica Germany                             | 2016    | 2015    | 2014    |
| Net cash flow provided by operating activities | 2,154   | 2,081   | 1,620   |
| Net cash flow used in investing activities     | (1,252) | (2,180) | (4,081) |
| Net cash flow used in financing activities     | (1,323) | (1,023) | 3,530   |
|  | (421)   | (1,122) | 1,069   |

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**2016**

In 2016 movement is remarkable the effect of dividends declared by Telefónica Brazil, S.A. and Telefónica Deutschland Holding, A.G., as well as the impact of translation differences, mainly by the evolution of the Brazilian real.

Colombia Telecomunicaciones and its shareholders are analyzing the most appropriate measures to strengthen its equity position.

**2015**

In 2015, “Sales of non-controlling interests and inclusion of companies” reflects the effect of the capital increase in Telefônica Brasil, S.A. for the acquisition of GVT, and the changes in the investment percentages related to the same operation (see Note 5). Additionally, it is worth highlighting the changes in the investment percentages in Colombia Telecomunicaciones, pursuant to amendment n° 1 of the Framework investment Agreement executed with the Colombian Government (see Note 21.b).

**2014**

In 2014, “Sales of non-controlling interests and inclusion of companies” reflects the effect of the capital increase in Telefónica Deutschland Holding, A.G. for the acquisition of E-Plus, and the changes in the investment percentages related to the same operation, amounting to 3,627 million euros, revised data to reflect the finalization of the purchase price allocation of E-Plus (see Note 5). The removal of Telefónica Czech Republic, a.s. from the scope of consolidation is also significant.

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## Note 13. Financial assets and liabilities

## 1.- Financial assets

The breakdown of financial assets of the Telefónica Group at December 31, 2016 and 2015 is as follows:

December 31, 2016

| Millions of euros            | Fair value through profit or loss |                   | Measurement hierarchy |        |                         |   |  |    | Held-to-maturity investments | Rest of financial assets at amortized cost | Total carrying amount | Total fair value |
|------------------------------|-----------------------------------|-------------------|-----------------------|--------|-------------------------|---|--|----|------------------------------|--|-----------------------|------------------|
|                              | Held for trading                  | Fair value option | Available-for-sale    | Hedges | Level 1 (Quoted prices) | Level 2 (Other directly observable market inputs) | Level 3 (Inputs not based on observable market data) |    |                              |  |                       |                  |
| Non-current financial assets | 1,716                             | 270               | 1,333                 | 3,332  | 864                     | 5,766   | 21   | –  | 3,114                        | 9,765                                      | 9,765                 |                  |
| Investments                  | –                                 | –                 | 825                   | –      | 620                     | 205   | –  | –  | –                            | 825  | 825                   |                  |
| Long-term credits            | –                                 | 270               | 508                   | –      | 76                      | 681   | 21   | –  | 1,330                        | 2,108                                      | 1,954                 |                  |
| Deposits and guarantees      | –                                 | –                 | –                     | –      | –                       | –   | –  | –  | 1,938                        | 1,938                                      | 1,938                 |                  |
| Derivative instruments       | 1,716                             | –                 | –                     | 3,332  | 168                     | 4,880   | –  | –  | –                            | 5,048                                      | 5,048                 |                  |
| Impairment losses            | –                                 | –                 | –                     | –      | –                       | –   | –  | –  | (154)                        | (154)                                      | –                     |                  |
| Current financial assets     | 883                               | 118               | 115                   | 1,173  | 483                     | 1,806   | –  | 39 | 4,362                        | 6,690                                      | 6,690                 |                  |
| Financial investments        | 883                               | 118               | 115                   | 1,173  | 483                     | 1,806   | –  | 39 | 626                          | 2,954                                      | 2,954                 |                  |
| Cash and cash equivalents    | –                                 | –                 | –                     | –      | –                       | –   | –  | –  | 3,736                        | 3,736                                      | 3,736                 |                  |
| Total financial assets       | 2,599                             | 388               | 1,448                 | 4,505  | 1,347                   | 7,572   | 21   | 39 | 7,476                        | 16,455                                     | 16,455                |                  |

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December 31, 2015 (\*)

| Millions of euros            | Fair value through profit or loss |                   | Measurement hierarchy |        |                         |   |  |                              |  |                       |                  |
|------------------------------|-----------------------------------|-------------------|-----------------------|--------|-------------------------|---|--|------------------------------|--|-----------------------|------------------|
|                              | Held for trading                  | Fair value option | Available-for-sale    | Hedges | Level 1 (Quoted prices) | Level 2 (Other directly observable market inputs) | Level 3 (Inputs not based on observable market data) | Held-to-maturity investments | Rest of financial assets at amortized cost | Total carrying amount | Total fair value |
| Non-current financial assets | 2,340                             | 238               | 1,823                 | 2,975  | 1,511                   | 5,847   | 18   | 148                          | 2,881                                      | 10,405                | 10,405           |
| Investments                  | –                                 | –                 | 1,289                 | –      | 1,068                   | 221   | –  | –                            | –  | 1,289                 | 1,289            |
| Long-term credits            | –                                 | 238               | 534                   | –      | 79                      | 675   | 18   | 145                          | 1,966                                      | 2,883                 | 2,376            |
| Deposits and guarantees      | –                                 | –                 | –                     | –      | –                       | –   | –  | 3                            | 1,422                                      | 1,425                 | 1,425            |
| Derivative instruments       | 2,340                             | –                 | –                     | 2,975  | 364                     | 4,951   | –  | –                            | –  | 5,315                 | 5,315            |
| Impairment losses            | –                                 | –                 | –                     | –      | –                       | –   | –  | –                            | (507)                                      | (507)                 | –                |
| Current financial assets     | 859                               | 116               | 85                    | 1,540  | 448                     | 2,152   | –  | 10                           | 3,058                                      | 5,668                 | 5,668            |
| Financial investments        | 859                               | 116               | 85                    | 1,540  | 448                     | 2,152   | –  | 10                           | 443  | 3,053                 | 3,053            |
| Cash and cash equivalents    | –                                 | –                 | –                     | –      | –                       | –   | –  | –                            | 2,615                                      | 2,615                 | 2,615            |
| Total financial assets       | 3,199                             | 354               | 1,908                 | 4,515  | 1,959                   | 7,999   | 18   | 158                          | 5,939                                      | 16,073                | 16,073           |

(\*) Amended data (see Note 2).

The calculation of the fair values of the Telefónica Group's debt instruments required an estimate, for each currency and counterparty, of a credit spread curve using the prices of the Group's bonds and credit derivatives.

Derivatives are measured using the valuation techniques and models normally used in the market, based on money-market curves and volatility prices available in the market.

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## a) Non-current financial assets

The movement in items composing “Non-current financial assets” in 2016 and 2015 is as follows:

| Millions of euros                            | Investments  | Long-term credits | Deposits and guarantees | Derivative financial assets | Impairment provision | Total         |
|--|--------------|-------------------|-------------------------|-----------------------------|----------------------|---------------|
| Balance at 12/31/14                          | <b>1,278</b> | <b>3,137</b>      | <b>1,561</b>            | <b>5,499</b>                | <b>(502)</b>         | <b>10,973</b> |
| Acquisitions                                 | 156          | 1,305             | 140                     | 489                         | (30)                 | 2,060         |
| Disposals                                    | (2,349)      | (911)             | (146)                   | (26)                        | (1)                  | (3,433)       |
| Inclusion of companies                       | –            | 29                | 160                     | –                           | –                    | 189           |
| Translation differences                      | (7)          | (83)              | (411)                   | 81                          | 30                   | (390)         |
| Fair value adjustments and financial updates | 522          | 55                | 119                     | 586                         | –                    | 1,282         |
| Transfers and others                         | 1,689        | (649)             | 2                       | (1,314)                     | (4)                  | (276)         |
| Balance at 12/31/15                          | <b>1,289</b> | <b>2,883</b>      | <b>1,425</b>            | <b>5,315</b>                | <b>(507)</b>         | <b>10,405</b> |
| Acquisitions                                 | 73           | 995               | 169                     | 73                          | (13)                 | 1,297         |
| Disposals/Aplication                         | (446)        | (975)             | (102)                   | (270)                       | 402                  | (1,391)       |
| Translation differences                      | 8            | (31)              | 337                     | (15)                        | 30                   | 329           |
| Fair value adjustments and financial updates | (103)        | (21)              | 102                     | 151                         | –                    | 129           |
| Transfers and others                         | 4            | (743)             | 7                       | (206)                       | (66)                 | (1,004)       |
| Balance at 12/31/16                          | <b>825</b>   | <b>2,108</b>      | <b>1,938</b>            | <b>5,048</b>                | <b>(154)</b>         | <b>9,765</b>  |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

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**Investments**

“Investments” includes the fair value of investments in companies where Telefónica does not exercise significant control and for which there is no specific disposal plan for the short term (see Note 3.i).

On July 10, 2016, Telefónica sold 1.51% of the share capital of China Unicom (Hong Kong) Limited for 322 million euros (see Note 20). This transaction had a negative impact of 155 million euros on consolidated financial results. At December 31, 2016, Telefónica maintained a 1% stake in the share capital of China Unicom (Hong Kong) Limited, valued at 263 million euros (2.51% at December 31, 2015, valued at 672 million euros).

Additionally, the Telefónica Group’s shareholding in Banco Bilbao Vizcaya Argentaria, S.A. (BBVA) amounts to 283 million euros (298 million euros at December 31, 2015), representing 0.67% of its share capital at December 31, 2016 (0.69% at December 31, 2015).

As of December 31, 2014, the stake in Telco, S.p.A. was 66% amounting to a book value of 73 million euros (registered as available-for-sale financial asset). The demerger of Telco, S.p.A. was formalized on June 17, 2015. Thereafter, the ordinary shares in Telecom Italia, S.p.A. held by Telco, S.p.A. (equivalent to 22.3% of the company’s ordinary share capital) were assigned to shareholders, whereby the new company Telco TE, S.p.A., fully-owned by Telefónica (consolidated under the full integration method), received shares equivalent to 14.72% of the ordinary share capital of Telecom Italia. “Transfers and others” of the above table in 2015 mainly includes the impact of the aforementioned demerger (see Note 9).

In compliance with the commitments undertaken in the acquisition agreement of GVT, Telefónica delivered 1,110 million ordinary shares in Telecom Italia, S.p.A. (representing 8.2% of the ordinary shares in the company) to Vivendi, S.A. in exchange for 4.5% of the share capital in Telefônica Brasil, S.A. (see Note 5).

Also, Telco TE, S.p.A. signed a sale and purchase agreement with a financial entity to transfer 872 million ordinary shares in Telecom Italia S.p.A., representing 6.5% of the ordinary shares of the latter, for approximately 1,025 million euros.

Likewise, Telefónica arranged several hedging instruments which will allow Telefónica, S.A. to repurchase the shares of Telecom Italia, S.p.A. that are necessary to meet its exchange obligations under the mandatory exchangeable bonds for shares of Telecom Italia, S.p.A., issued by Telefónica, S.A. in July 2014 and maturing in July, 2017. These instruments are recorded under caption “Derivative instruments” of financial liabilities on the accompanying disclosure.

The positive impact in the Net financial expense for the year 2015 related with the transactions with Telecom Italia shares described above amounted to 380 million euros.

At year-end the Group assessed the securities in its portfolio of listed available-for-sale assets individually for impairment. The analysis did not uncover the need to recognize any significant impairment losses.

**Long-term credits and impairment losses**

The composition of long-term credits is as follows:

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| Million euros                            | 12/31/2016 | 12/31/2015 (*) |
|--|------------|----------------|
| Long-term trade receivables              | 593        | 703            |
| Long-term prepayments                    | 338        | 371            |
| Long-term receivables for indirect taxes | 144        | 104            |
| Other long-term credits                  | 1,033      | 1,705          |
| Total                                    | 2,108      | 2,883          |

(\*) Amended data (see Note 2).

“Other long-term credits” includes long-term financial assets of the subsidiary Seguros de Vida y Pensiones Antares, S.A., fundamentally fixed-income securities, amounting to 749 million euros and 747 million euros at December 31, 2016 and 2015, respectively. These assets are mainly intended to cover the obligations from the defined benefit plans of Telefónica de España (ITP and Survival), though they do not qualify as “plan assets” under IAS 19 (see Note 15).

The movement in impairment corrections in 2016, was mainly due to the write-off of long-term receivables after the agreement reached by Telefónica Móviles México with other operators on disputes over interconnection tariffs in prior years.

**Derivative financial assets**

In “Transfers and others” in 2015 there was the reclassification to short-term derivative financial assets relating to Telefónica, S.A., amounting to 1,292 million euros.

**b) Current financial assets**

This heading of financial investments includes the following items:

Derivative financial assets with a short-term maturity or not used to hedge non-current items in the consolidated statement of financial position, in the amount of 1,872 million euros at December 31, 2016 (2,140 million euros at December 31, 2015).

Short-term investments in financial instruments recognized at fair value to cover commitments undertaken by the Group’s insurance companies, amounting to 304 million euros at December 31, 2016 (396 million euros at December 31, 2015), recorded at fair value.



Short-term deposits and guarantees amounting to 450 million euros at December 31, 2016 (269 million euros at December 31, 2015) including collateral guarantees on derivatives with BBVA amounting to 240 million euros (see Note 10).

Short-term credits, net of impairment provisions, amounting to 205 million euros at December 31, 2016 (222 million euros at December 31, 2015).

Current investments of cash surpluses which, given their characteristics, have not been classified as “Cash and cash equivalents.”

Current financial assets that are highly liquid and have maturity periods of three months or less from the date contracted, and present an insignificant risk of value changes, are recorded under “Cash and cash equivalents” on the accompanying consolidated statement of financial position.

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## 2.- Financial liabilities

The breakdown of financial liabilities at December 31, 2016 and the corresponding maturities schedule is as follows:

Millions of euros

| Maturity                            | Current |       |       |       |       | Subsequent years | Non-current total | Total  |
|-------------------------------------|---------|-------|-------|-------|-------|------------------|-------------------|--------|
|                                     | 2017    | 2018  | 2019  | 2020  | 2021  |                  |                   |        |
| Debentures and bonds                | 7,559   | 4,992 | 3,501 | 4,951 | 4,765 | 16,316           | 34,525            | 42,084 |
| Promissory notes & commercial paper | 3,061   | -     | -     | 113   | -     | 186              | 299               | 3,360  |
| Total Issues                        | 10,620  | 4,992 | 3,501 | 5,064 | 4,765 | 16,502           | 34,824            | 45,444 |
| Loans and other payables            | 3,357   | 1,903 | 1,336 | 780   | 1,482 | 2,540            | 8,041             | 11,398 |
| Derivative instruments (Note 16)    | 772     | 300   | 348   | 1,003 | 533   | 563              | 2,747             | 3,519  |
| Total                               | 14,749  | 7,195 | 5,185 | 6,847 | 6,780 | 19,605           | 45,612            | 60,361 |

The estimate of future payments for interest on these financial liabilities at December 31, 2016 is as follows: 2,168 million euros in 2017, 1,694 million euros in 2018, 1,436 million euros in 2019, 1,185 million euros in 2020, 956 million euros in 2021 and 5,185 million euros in years after 2021. For floating rate financing, the Group mainly estimates future interest using the forward curve of the various currencies at December 31, 2016.

The amounts shown in this table take into account the fair value of derivatives classified as financial liabilities (i.e., those with a negative mark-to-market) and excludes the fair value of derivatives classified as current financial assets (1,872 million euros), and those classified as non-current (5,048 million euros) (i.e., those with a positive mark-to-market).

In 2015 and 2016 the Group entered into agreements to extend payment terms with various suppliers, and with factoring companies when such payments are discounted. When the new extended payment terms exceed customary payment terms in the industry, trade liabilities are reclassified to other financial liabilities and the deferred payments made are recognized in net cash flow used in financing activities (see Note 20). At December 31, 2016 the corresponding amount pending payment, recognized in "Loans and other payables", was 210 million euros (927 million euros at December 31, 2015). The deferred payments made in relation to this item during the year amounted to 1,758 million euros (5 million euros in 2015).

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The composition of these financial liabilities, by category, at December 31, 2016 and 2015 is as follows:

December 31, 2016

| Millions of euros           | Fair value through profit or loss |                   | Measurement hierarchy |                         |   |  | Liabilities at amortized cost | Total carrying amount | Total fair value |
|-----------------------------|-----------------------------------|-------------------|-----------------------|-------------------------|---|--|-------------------------------|-----------------------|------------------|
|                             | Held for trading                  | Fair value option | Hedges                | Level 1 (Quoted prices) | Level 2 (Other directly observable market inputs) | Level 3 (Inputs not based on observable market data) |                               |                       |                  |
| Issues                      | –                                 | –                 | –                     | –                       | –   | –  | 45,444                        | 45,444                | 48,686           |
| Loans and other payables    | –                                 | –                 | –                     | –                       | –   | –  | 11,398                        | 11,398                | 11,398           |
| Derivative instruments      | 2,299                             | –                 | 1,220                 | 64                      | 3,455   | –  | –                             | 3,519                 | 3,519            |
| Total financial liabilities | 2,299                             | –                 | 1,220                 | 64                      | 3,455   | –  | 56,842                        | 60,361                | 63,603           |

December 31, 2015 (\*)

| Millions of euros           | Fair value through profit or loss |                   | Measurement hierarchy |                         |   |  | Liabilities at amortized cost | Total carrying amount | Total fair value |
|-----------------------------|-----------------------------------|-------------------|-----------------------|-------------------------|---|--|-------------------------------|-----------------------|------------------|
|                             | Held for trading                  | Fair value option | Hedges                | Level 1 (Quoted prices) | Level 2 (Other directly observable market inputs) | Level 3 (Inputs not based on observable market data) |                               |                       |                  |
| Issues                      | –                                 | –                 | 360                   | –                       | 360   | –  | 45,012                        | 45,372                | 48,761           |
| Loans and other payables    | –                                 | –                 | –                     | –                       | –   | –  | 11,380                        | 11,380                | 11,284           |
| Derivative instruments      | 2,582                             | –                 | 753                   | 146                     | 3,189   | –  | –                             | 3,335                 | 3,335            |
| Total financial liabilities | 2,582                             | –                 | 1,113                 | 146                     | 3,549   | –  | 56,392                        | 60,087                | 63,380           |

(\*) Amended data (see Note 2).

The calculation of the fair values of the Telefónica Group's debt instruments required an estimate, for each currency and subsidiary, of the credit spread curve using the prices of the Group's bonds and credit derivatives.

At December 31, 2016, some of the financing arranged by Telefónica Group companies in Latin America (Brazil, Panama, Ecuador and Guatemala) which amount to approximately 4% of the Telefónica Group's gross debt was subject to compliance with certain financial covenants. To date, these covenants are being met. Due to the absence of cross-defaults, breach of the covenants would not affect the debt at a Telefónica, S.A. level. Some of the financing arranged by Colombia Telecomunicaciones, S.A., ESP is subject to compliance with a financial covenant, that, once it has been reached, the amount of any new additional indebtedness is limited to approximately 285 million euros

equivalents (at December 31, 2016, 112 million euros were available), without a breach has taken place.

Part of the amount owed by the Telefónica Group includes restatements to amortized cost at December 31, 2016 and 2015 as a result of fair value interest rate and exchange rate hedges.

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## a) Issues

The movement in issues of debentures, bonds and other marketable debt securities in 2016 and 2015 is as follows:

| Millions of euros                      | Debenture and bond issues | Short-term promissory      |         |
|--|---------------------------|----------------------------|---------|
|  |                           | notes and commercial paper | Total   |
| Balance at 12/31/14                    | 44,228                    | 502                        | 44,730  |
| New issues                             | 1,602                     | 1,308                      | 2,910   |
| Redemptions, conversions and exchanges | (3,805)                   | –                          | (3,805) |
| Revaluation and other movements        | 1,532                     | 5                          | 1,537   |
| Balance at 12/31/15                    | 43,557                    | 1,815                      | 45,372  |
| New issues                             | 5,693                     | 1,566                      | 7,259   |
| Redemptions, conversions and exchanges | (6,873)                   | (25)                       | (6,898) |
| Revaluation and other movements        | (293)                     | 4                          | (289)   |
| Balance at 12/31/16                    | 42,084                    | 3,360                      | 45,444  |

**Debentures and bonds**

At December 31, 2016, the nominal amount of outstanding debentures and bonds issues is 40,055 million euros (41,252 million euros at December, 31, 2015). Appendix III presents the characteristics of all outstanding debentures and bond issues at year-end 2016, as well as the significant issues made in the year.

Telefónica, S.A. has a full and unconditional guarantee on issues made by Telefónica Emisiones, S.A.U., Telefónica Finanzas México, S.A. de C.V. , Telefónica Europe, B.V. and Telefónica Participaciones, S.A.U., all of which are, directly or indirectly, fully-owned subsidiaries of Telefónica, S.A.

**Short-term promissory notes and commercial paper**

The main programs for issuance of promissory notes and commercial paper are the following:

- At December 31, 2016, Telefónica Europe, B.V. had a program for issuance of commercial paper, guaranteed by Telefónica, S.A., for up to 5,000 million euros. The outstanding balance of commercial paper issued under this program at December 31, 2016 was 2,630 million euros, issued at an average interest rate

of -0.01% for 2016 (1,431 million euros issued in 2015 at an average rate of 0.089%).

At December 31, 2016, Telefónica, S.A. had a corporate promissory note program for 500 million euros, which can be increased to 2,000 million euros, with an outstanding balance at December 31, 2016 amounting to 370 million euros (66 million euros in 2015).

On March 13, 2015 Telefónica Germany, GmbH & Co. OHG made an issuance of debt instruments in the local market (*schuld Scheindarlehen* and *namensschuldverschreibung*) for an aggregate amount of 300 million euros with different maturity terms until 2032.

b) Interest-bearing debt

The average interest rate on outstanding loans and other payables at December 31, 2016 was 3.84% (2.31% in 2015). This percentage does not include the impact of hedges arranged by the Group.

The main financing transactions included under “Interest-bearing debt” outstanding at December 31, 2016 and 2015 and their nominal amounts are provided in Appendix V.

Interest-bearing debt arranged or repaid in 2016 mainly includes the following:

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| Description                                  | Limit<br>12/31/2016<br>(millions) | Currency | Outstanding<br>balance 12/31/2016<br>(million euros) | Arrangement<br>date | Maturity<br>date | Drawdown<br>2016<br>(million<br>euros) | Repayment<br>2016 (million<br>euros) |
|--|-----------------------------------|----------|--|---------------------|------------------|--|--------------------------------------|
| Telefónica, S.A.                             |                                   |          |  |                     |                  |  |                                      |
| Structured financing (*)                     | 669                               | USD      | 635  | 02/22/13            | 01/31/23         | -                                      | (111)                                |
| Structured financing (*)                     | 532                               | USD      | 505  | 08/01/13            | 10/31/23         | 124                                    | (82)                                 |
| Syndicated facility <sup>(1)</sup> (Note 20) | 3,000                             | EUR      | -  | 02/18/14            | 02/18/21         | 1,280                                  | (1,980)                              |
| Syndicated facility <sup>(2)</sup>           | 2,500                             | EUR      | 550  | 02/19/15            | 02/19/22         | 300                                    | (250)                                |
| Syndicated facility <sup>(3)</sup> (Note 20) | 1,500                             | EUR      | -  | 11/17/15            | 02/15/19         | 3,070                                  | (3,070)                              |
| Structured financing (*)                     | 737                               | USD      | 324  | 12/11/15            | 03/11/26         | 337                                    | (12)                                 |
| Structured financing (*)                     | 492                               | EUR      | 240  | 12/11/15            | 03/11/26         | 248                                    | (8)                                  |
| Bilateral loan                               | 100                               | EUR      | 100  | 02/23/16            | 02/23/19         | 100                                    | -                                    |
| Bilateral loan                               | 100                               | EUR      | 100  | 02/23/16            | 02/23/21         | 100                                    | -                                    |
| Loan   | 300                               | EUR      | 300  | 03/08/16            | 03/08/21         | 300                                    | -                                    |
| Bilateral loan                               | 300                               | EUR      | 300  | 10/24/16            | 03/19/19         | 300                                    | -                                    |

Telefónica  
Móviles Chile,  
S.A.

|                     |     |     |     |          |          |     |   |
|---------------------|-----|-----|-----|----------|----------|-----|---|
| Syndicated facility | 150 | USD | 142 | 04/15/16 | 04/15/21 | 142 | - |
|---------------------|-----|-----|-----|----------|----------|-----|---|

Telefónica  
Germany GmbH  
& Co. OHG

|                     |     |     |    |          |          |     |       |
|---------------------|-----|-----|----|----------|----------|-----|-------|
| Syndicated facility | 750 | EUR | 50 | 03/22/16 | 03/22/21 | 600 | (550) |
|---------------------|-----|-----|----|----------|----------|-----|-------|

|                              |     |     |     |          |          |     |   |
|------------------------------|-----|-----|-----|----------|----------|-----|---|
| EIB Financing <sup>(4)</sup> | 450 | EUR | 250 | 06/13/16 | 06/13/25 | 250 | - |
|------------------------------|-----|-----|-----|----------|----------|-----|---|

Telefónica  
Europe, B.V.

|                          |       |     |   |          |          |   |   |
|--------------------------|-------|-----|---|----------|----------|---|---|
| Structured financing (*) | 1,500 | EUR | - | 11/28/16 | 11/28/24 | - | - |
|--------------------------|-------|-----|---|----------|----------|---|---|

(1) Extended for 12 additional months of the syndicated facility signed in February 2014.

(2) Extended for 12 additional months of the syndicated facility signed in February 2015.

(3) On November 15, 2016 an amendment was signed extending the maturity for 12 additional months of the syndicated facility and an early repayment of 1,500 million euros was made.

(4) This financing is Split in 5 tranches with a maturity to as late as 2025.

(\*) Facility with amortization schedule.

At December 31, 2016, the Telefónica Group presented availabilities of financing from different sources amounting approximately to 14,627 million euros (of which 13,491 million euros maturing in more than twelve months) (13,684 million euros at December 31, 2015).

#### Loans by currency

The breakdown of “Loans and other payables” by currency at December 31, 2016 and 2015, along with the equivalent value of foreign-currency loans in euros, is as follows:

| Currency         | Outstanding balance (in millions) |           |          |          |
|------------------|-----------------------------------|-----------|----------|----------|
|                  | Currency                          |           | Euros    |          |
|                  | 12/31/16                          | 12/31/15  | 12/31/16 | 12/31/15 |
| Euro             | 5,174                             | 5,798     | 5,174    | 5,798    |
| US dollar        | 2,812                             | 2,596     | 2,668    | 2,384    |
| Brazilian Real   | 4,744                             | 5,218     | 1,381    | 1,228    |
| Colombian Peso   | 5,473,409                         | 5,131,558 | 1,731    | 1,497    |
| Pounds Sterling  | 109                               | 13        | 127      | 17       |
| Other currencies |                                   |           | 317      | 456      |
| Total Group      |                                   |           | 11,398   | 11,380   |

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## Note 14. Trade and other payables

The composition of “Trade and other payables” is as follows:

| Millions of euros                                      | 12/31/2016  |         | 12/31/2015 (*) |         |
|--|-------------|---------|----------------|---------|
|  | Non-current | Current | Non-current    | Current |
| Trade payables   | 80          | 8,043   | 78             | 8,668   |
| Payables to suppliers of property, plant and equipment | 9           | 3,816   | 10             | 3,701   |
| Debt for spectrum acquisition                          | 608         | 504     | 936            | 438     |
| Other payables   | 325         | 1,721   | 358            | 2,048   |
| Deferred revenue                                       | 903         | 1,569   | 1,006          | 1,473   |
| Payable to associates and joint ventures               | –           | 497     | –              | 806     |
| (Note 9)   |             |         |                |         |
| Total  | 1,925       | 16,150  | 2,388          | 17,134  |

(\*) Amended data (see Note 2).

“Deferred revenue” principally includes the amount of deferred revenue from sales of prepaid cards, from handsets transferred to the distributor, rights of use on the cable network, activation fees not yet recognized in the income statement and loyalty campaigns. In addition, grants are included amounting to 110 million euros (116 million euros at December 31, 2015).

At December 31, 2016, “Debt for spectrum acquisition” comprises the deferred portion of the payment for acquiring the spectrum use license in Mexico in 2010, for an equivalent of 654 million euros (798 million euros at December 31, 2015), and the deferred portion of the payment for the refarming of the radioelectric spectrum acquired in 2014 by Telefónica Brazil, amounting to an equivalent of 288 million euros (210 million euros at December 31, 2015, see Appendix VI). The short term payables in Mexico and Brazil for the concepts previously mentioned, at December 31, 2016, amounted to 73 and 261 million euros, respectively (88 and 94 million euros, respectively at December 31, 2015).

The detail of current “Other payables” at December 31, 2016 and 2015 is as follows:

| Millions of euros                                      | Balance at 12/31/2016 | Balance at 12/31/2015 (*) |
|--|-----------------------|---------------------------|
| Dividends pending payment to non-controlling interests | 257                   | 229                       |
| Accrued employee benefits                              | 774                   | 788                       |
| Advances received on orders                            | 189                   | 217                       |
| Other non-financial non-trade payables                 | 501                   | 814                       |
| Total  | 1,721                 | 2,048                     |

(\*) Amended data (see Note 2).

“Other non-financial non-trade payables” at December 31, 2015 included Telefónica, S.A.’s irrevocable commitment to pay a 325 million euros donation to Fundación Telefónica to provide this entity with the financing required to implement the social programs and activities it currently performs or could initiate in the short and mid term to fulfill its purpose as a foundation (see Note 18). The pending payment at December 31, 2016 amounted to 272 million euros.

**Information on average payment period to suppliers. (Third additional provision, “Information requirement” of Law 15/2010 of July 5)**

In accordance with the aforementioned Law, the following information corresponding to the Spanish companies of the Telefónica Group is disclosed:

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|                                  | 2016       | 2015 |
|----------------------------------|------------|------|
| Number of days                   |            |      |
| Weighted average maturity period | 45         | 49   |
| Ratio of payments                | 45         | 50   |
| Ratio of outstanding invoices    | 42         | 36   |
| Million of euros                 |            |      |
| Total payments                   | 6,7276,397 |      |
| Outstanding invoices             | 651        | 710  |

The Telefónica Group's Spanish companies adapted their internal processes and payment schedules to the provisions of Law 15/2010 (amended by Law 31/2014) and Royal Decree-Law 4/2013, amending Law 3/2004, which establishes measures against late payment in commercial transactions. Engagement conditions with commercial suppliers in 2016 included payment periods of up to 60 days, according to the terms agreed between the parties.

For efficiency purposes and in line with general business practice, the Telefónica Group's companies in Spain have agreed payment schedules with suppliers, whereby most of the payments are made on set days of each month. Invoices falling due between two payment days are settled on the following payment date in the schedule.

Payments to Spanish suppliers in 2016 surpassing the established legal limit were the result of circumstances or incidents beyond the payment policies, mainly the delay in issuing invoices (legal obligation of the supplier), the closing of agreements with suppliers over the delivery of goods or the rendering of services, or occasional processing issues.

The average payment period to suppliers of the Telefónica Group's companies in Spain in 2016, calculated in accordance with the only additional provision of the Resolution of the Instituto de Contabilidad y Auditoría de Cuentas (Spanish Accounting and Audit Institute) dated January 29, 2016, amounted to 45 days (49 days in 2015).

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## Note 15. Provisions

The amounts of provisions in 2016 and 2015 are as follows:

| Millions of euros                     | 12/31/2016   |              |               | 12/31/2015 (*) |              |               |
|---------------------------------------|--------------|--------------|---------------|----------------|--------------|---------------|
|                                       | Current      | Non-current  | Total         | Current        | Non-current  | Total         |
| <b>Employee benefits</b>              | <b>1,002</b> | <b>6,147</b> | <b>7,149</b>  | <b>1,007</b>   | <b>5,371</b> | <b>6,378</b>  |
| Termination plans                     | 709          | 1,685        | 2,394         | 707            | 1,876        | 2,583         |
| Post-employment defined benefit plans | 3            | 935          | 938           | –              | 689          | 689           |
| Other benefits                        | 290          | 3,527        | 3,817         | 300            | 2,806        | 3,106         |
| <b>Other provisions</b>               | <b>1,218</b> | <b>3,726</b> | <b>4,944</b>  | <b>1,015</b>   | <b>3,083</b> | <b>4,098</b>  |
| <b>Total</b>                          | <b>2,220</b> | <b>9,873</b> | <b>12,093</b> | <b>2,022</b>   | <b>8,454</b> | <b>10,476</b> |

(\*) Amended data (see Note 2).

In 2016 the Group recorded a provision in the amount of 1,380 million euros (3,217 million euros in 2015) in order to increase the efficiency for the future representing a further step towards the initiatives focusing on the simplification and transformation of Telefónica. Of this amount, 789 million euros relates to the Telefónica de España, Telefónica Móviles España and Telefónica Soluciones Individual Suspension Plan described in “Other benefits” (2,896 million euros in 2015).

**Termination plans**

The movement in provisions for post-employment plans in 2016 and 2015 is as follows:

| Millions of euros                                | Total   |
|--|---------|
| Provisions for post-employment plans at 12/31/14 | 3,386   |
| Additions  | 217     |
| Retirements/amount applied                       | (1,031) |
| Transfers  | (14)    |
| Translation differences and accretion            | 25      |
| Provisions for post-employment plans at 12/31/15 | 2,583   |
| Additions  | 571     |
| Retirements/amount applied                       | (822)   |
| Transfers  | 35      |
| Translation differences and accretion            | 27      |
| Provisions for post-employment plans at 12/31/16 | 2,394   |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

**Telefónica Spain**

Concerning the 2003-2007 labor force reduction plan in Telefónica de España, concluded with 13,870 employees taking part, provisions recorded at December 31, 2016 and 2015 amounted to 152 and 268 million euros, respectively. The amount for this provision classified as current totaled 69 million euros at December 31, 2016.

Concerning the 2011-2013 labor force reduction plan in Telefónica de España, concluded with 6,830 employees taking part, provisions recorded at December 31, 2016 and 2015 amounted to 1,353 and 1,705 million euros, respectively. The amount for this provision classified as current totaled 322 million euros at December 31, 2016.

The companies bound by these commitments calculated provisions required at 2016 and 2015 year-end using actuarial assumptions pursuant to current legislation, including the PERM/F- 2000C mortality tables and a high quality credit market based interest rate.

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The discount rate used for these provisions at December 31, 2016, was 0.47%, with an average length of the plans of 2.5 years.

**Telefónica Germany**

Within the context of transformation of Telefónica Deutschland following the purchase of E-Plus (see Note 5) in a bid to increase profitability by securing operational synergies, a provision for employee restructuring was made in 2014 amounting to 321 million euros (additional 4 million euros in 2015). In 2016 an additional provision was made amounting to 46 million euros.

This provision amounted to 100 million euros at December 31, 2016 (174 million euros at December 31, 2015).

**Telefónica, S.A.**

With respect to the simplification and transformation process of the Telefónica Group, Telefónica, S.A. launched in 2015 a voluntary termination plan ending in December 2017 for the employees who met the requirements defined by the Plan regarding age and seniority in the Company, among others. Following this transformation and simplification framework, the Company has, on the one hand, extended the plan termination until 2018 and on the other hand, has set up in December 2016 a new voluntary programme aimed at some employees who met certain requirements related to seniority in the Company. The amount accrued for this concept at December 31, 2016 totals 184 million euros (120 million euros in 2015).

**Post-employment defined benefit plans**

The Group has a number of defined-benefit plans in the countries where it operates. The following tables present the main data of these plans:

12/31/2016

| Millions of euros                  | Spain | United Kingdom | Germany | Brazil | Hispano-américa | Others | Total   |
|------------------------------------|-------|----------------|---------|--------|-----------------|--------|---------|
| Obligation                         | 533   | 1,834          | 233     | 737    | 25              | 16     | 3,378   |
| Assets                             | –     | (1,662)        | (128)   | (982)  | –               | (8)    | (2,780) |
| Net provision before asset ceiling | 533   | 172            | 105     | (245)  | 25              | 8      | 598     |

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|               |     |     |     |     |    |   |     |
|---------------|-----|-----|-----|-----|----|---|-----|
| Asset ceiling | -   | -   | -   | 337 | -  | - | 337 |
| Net provision | 533 | 172 | 105 | 95  | 25 | 8 | 938 |
| Net assets    | -   | -   | -   | 3   | -  | - | 3   |

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12/31/2015 (\*)

| Millions of euros                  | Spain | United Kingdom | Germany | Brazil | Hispano-américa | Others | Total   |
|------------------------------------|-------|----------------|---------|--------|-----------------|--------|---------|
| Obligation                         | 552   | 1,613          | 198     | 449    | 31              | 15     | 2,858   |
| Assets                             | –     | (1,753)        | (122)   | (637)  | –               | (10)   | (2,522) |
| Net provision before asset ceiling | 552   | (140)          | 76      | (188)  | 31              | 5      | 336     |
| Asset ceiling                      | –     | –              | –       | 206    | –               | –      | 206     |
| Net provision                      | 552   | 5              | 76      | 20     | 31              | 5      | 689     |
| Net assets                         | –     | 145            | –       | 2      | –               | –      | 147     |

(\*) Amended data (see Note 2).

The movement in the present value of obligations in 2016 and 2015 is as follows:

| Millions of euros                       | Spain | United Kingdom | Germany | Brazil | Hispano-américa | Other | Total |
|---|-------|----------------|---------|--------|-----------------|-------|-------|
| Present value of obligation at 12/31/14 | 593   | 1,529          | 201     | 624    | 37              | 11    | 2,995 |
| Translation differences                 | –     | 94             | –       | (146)  | (15)            | 1     | (66)  |
| Current service cost                    | 8     | –              | 7       | 2      | 6               | –     | 23    |
| Interest cost                           | 8     | 60             | 4       | 61     | 3               | 1     | 137   |
| Actuarial losses and gains              | (8)   | (38)           | (12)    | (44)   | 4               | 2     | (96)  |
| Benefits paid                           | (49)  | (32)           | (2)     | (48)   | (4)             | –     | (135) |
| Present value of obligation at 12/31/15 | 552   | 1,613          | 198     | 449    | 31              | 15    | 2,858 |
| Translation differences                 | –     | (251)          | –       | 125    | (9)             | –     | (135) |
| Current service cost                    | 7     | –              | 6       | 1      | 7               | –     | 21    |
| Interest cost                           | 8     | 54             | 5       | 59     | 4               | 1     | 131   |
| Actuarial losses and gains              | 17    | 444            | 31      | 149    | 2               | –     | 643   |
| Benefits paid                           | (51)  | (26)           | (3)     | (46)   | (3)             | –     | (129) |
| Other movements                         | –     | –              | (4)     | –      | (7)             | –     | (11)  |
| Present value of obligation at 12/31/16 | 533   | 1,834          | 233     | 737    | 25              | 16    | 3,378 |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

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Movements in the fair value of plan assets in 2016 and 2015 are as follows:

| Millions of euros                     | United Kingdom | Germany | Brazil | Other | Total |
|---------------------------------------|----------------|---------|--------|-------|-------|
| Fair value of plan assets at 12/31/14 | 1,567          | 112     | 838    | 11    | 2,528 |
| Translation differences               | 93             | –       | (202)  | (2)   | (111) |
| Interest income                       | 62             | 3       | 86     | 1     | 152   |
| Actuarial losses and gains            | (53)           | (1)     | (42)   | –     | (96)  |
| Company contributions                 | 110            | 9       | 1      | –     | 120   |
| Benefits paid                         | (26)           | (1)     | (45)   | –     | (72)  |
| Inclusion of companies                | –              | –       | 1      | –     | 1     |
| Fair value of plan assets at 12/31/15 | 1,753          | 122     | 637    | 10    | 2,522 |
| Translation differences               | (256)          | –       | 171    | –     | (85)  |
| Interest income                       | 59             | 3       | 86     | 1     | 149   |
| Actuarial losses and gains            | 134            | (2)     | 132    | –     | 264   |
| Company contributions                 | –              | 9       | 1      | –     | 10    |
| Benefits paid                         | (26)           | (2)     | (45)   | –     | (73)  |
| Other movements                       | (2)            | (2)     | –      | (3)   | (7)   |
| Fair value of plan assets at 12/31/16 | 1,662          | 128     | 982    | 8     | 2,780 |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

The Group's principal defined-benefit plans are:

a) ITP (Spain)

Telefónica Spain reached an agreement with its employees whereby it recognized supplementary pension payments for employees who had retired as of June 30, 1992, equal to the difference between the pension payable by the social security system and that which would be paid to them by ITP (Institución Telefónica de Previsión). Once the aforementioned supplementary pension payments had been quantified, they became fixed, lifelong and non-updateable and 60% of the payments are transferable to the surviving spouse, recognized as such as of June 30, 1992, and to underage children.

The amount for this provision totaled 265 million euros at December 31, 2016 (291 million euros at December 31, 2015).

b) Survival (Spain)

Serving employees who did not join the defined pension plan are still entitled to receive survivorship benefits at the age of 65.

The amount for this provision totaled 268 million euros at December 31, 2016 (261 million euros at December 31, 2015).

As detailed in Note 13, the Group has long-term financial assets to cover the obligations of these two defined benefit plans.

The average length of the plans is 8 years. The main actuarial assumptions used in valuing these plans are as follows:

|                                  | Survival<br>12/31/2016 | 12/31/2015             | ITP<br>12/31/2016                 | 12/31/2015                        |
|----------------------------------|------------------------|------------------------|-----------------------------------|-----------------------------------|
| Discount rate                    | 1.26%                  | 1.66%                  | 1.16%                             | 1.48%                             |
| Expected rate of salary increase | 0% - 0.5%              | 0% - 0.5%              | —                                 | —                                 |
| Mortality tables                 | PERM/F-2000P -<br>OM77 | PERM/F-2000P -<br>OM77 | 90% PERM 2000C/98%<br>PERF 2000 C | 90% PERM 2000C/98%<br>PERF 2000 C |
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The table below shows the sensitivity of the value of termination, post-employment and other obligations, among which is included the Individual Suspension Plan, of Telefónica Group companies in Spain to changes in the discount rate:

| -100 b.p.       |                            | +100 b.p.       |                            |
|-----------------|----------------------------|-----------------|----------------------------|
| Impact on value | Impact on income statement | Impact on value | Impact on income statement |
| -318            | -273                       | 291             | 251                        |

A 100 b.p. increase in the discount rate would reduce the value of the liabilities by 291 million euros and have a positive impact on income statement of 251 million euros before tax. On the other hand, a 100 b.p. decrease in the discount rate would increase the value of the liabilities by 318 million euros and have a negative impact on income statement of 273 million euros before tax.

The Telefónica Group actively manages this position and has arranged a derivatives portfolio to significantly reduce the impact of changes in the discount rate (see Note 16).

**Telefónica United Kingdom Pension Plan**

The Telefónica United Kingdom Pension Plan provides pension benefits to the various companies of the Telefónica Group in United Kingdom coming from the O2 Group. The Plan is comprised of defined contribution and defined benefit sections. The defined benefit sections were closed to future accrual with effect from February 28, 2013. The companies continued to provide retirement benefits through the defined contribution sections of the Plan.

The number of beneficiaries of these plans at December 31, 2016 and 2015 are 4,532 and 4,548 respectively. At December 31, 2016, the weighted average duration of the Plan was 23 years.

The main actuarial assumptions used in valuing the Plan are as follows:

|  | 12/31/2016  | 12/31/2015  |
|--|-------------|-------------|
| Nominal rate of pension payment increase | 3.15%       | 3.15%       |
| Discount rate                            | 2.60%       | 3.80%       |
| Expected inflation                       | 3.35%       | 3.35%       |
| Mortality tables                         | 95% S2NA,   | 95% S2NA,   |
|  | CMI 2015 1% | CMI 2015 1% |

The increase in the present value of the obligation in 2016 is mainly a result of the decrease of the rate used to discount it, decisively affected by the fall in interest rates. The methodology used to calculate the discount rate is the same as that of the prior year.

Fair value of Plan assets is as follows:

| Millions of euros    | 12/31/2016 | 12/31/2015 |
|----------------------|------------|------------|
| Shares               | 357        | 350        |
| Bonds                | 1,306      | 1,294      |
| Cash equivalents (1) | 109        |            |
| Total                | 1,662      | 1,753      |

At December 31, 2016, reasonably possible changes to one of the following actuarial assumptions, holding other assumptions constant, would have affected the defined benefit obligation by the amounts shown below:

| Millions of euros                   | Increase in defined benefit obligation |
|-------------------------------------|--|
| Discount rate (0.25% decrease)      | 123                                    |
| Expected inflation (0.25% increase) | 105                                    |
| Life expectancy (1 year longer)     | 43                                     |

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**Telefônica Brazil pension plans**

Telefônica Brazil sponsors the following post-employment benefit plans:

| Plans   | Management entity                    | Sponsor   |
|---|--------------------------------------|---|
| Health plans  |                                      |   |
| Plano de Assistência Médica ao Aposentado y Programa de Coberturas Especiais (PAMA/PCE) | Fundação Sistel de Seguridade Social | Telefônica Brasil, jointly and severally with other companies resulting from the privatization of Telebrás (Telecomunicações Brasileiras, S.A.) |
| Assistencia médica – Lei 9.656/98   | Telefônica Brasil                    | Telefônica Brasil   |
| Pension plans   |                                      |   |
| PBS Assistidos (PBS-A)  | Fundação Sistel de Seguridade Social | Telefônica Brasil, jointly and severally with other companies resulting from the privatization of Telebrás (Telecomunicações Brasileiras, S.A.) |
| CTB   | Telefônica Brasil                    | Telefônica Brasil   |
| Telefônica BD   | Visão Prev                           | Telefônica Brasil   |
| Planes PREV   | Visão Prev                           | Telefônica Brasil   |
| Planes VISAO  | Visão Prev                           | Telefônica Brasil, Telefónica Data and TGLog  |

The main actuarial assumptions used in valuing these plans are as follows:

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|                                 | 12/31/2016      | 12/31/2015         |
|---------------------------------|-----------------|--------------------|
| Discount rate                   | 10.77% - 10.85% | 12.53% -<br>13.63% |
| Nominal rate of salary increase | 6.18%           | 6.69%              |
| Long term inflation rate        | 4.50%           | 4.00%              |
| Growth rate for medical costs   | 7.64%           | 8.15% -<br>9.18%   |
| Mortality tables                | AT 2000 M/F     | AT 2000<br>M/F     |

On September 30, 2015, the Conselho Deliberativo da Sistel approved, pursuant to a court judgment, the creation of a fund (Fundo de Compensação e Solvência) formed from the capital of the special reserve under the PBS-A plan, to bridge the shortfall existing in another of the plans managed by the body and sponsored by Telefônica Brasil, known as PAMA. The ruling requires the sponsoring companies, including Telefônica Brasil, to maintain the coverage of the original PAMA plan and to rectify any deficits that may arise. This transfer of reserves led to a real reduction in future contributions, which had a positive impact on Other comprehensive income for the year 2015, in the amount of 430 million Brazilian reais (101 million euros, approximately), 284 million reais net of tax (67 million euros, approximately).

The discount rate and the growth rate for medical costs are considered to be the most significant actuarial assumptions with a reasonable possibility of fluctuations depending on demographic and economic changes and that may significantly change the amount of the post-employment benefit obligation. The sensitivity to changes in these assumptions is shown below:

|                  | Present value of the discounted obligation at the current discount rate | Present value of the obligation by increasing the discount rate by 0.5% | Present value of the obligation by reducing the discount rate by 0.5% |
|------------------|---|---|---|
| Pension plans    | 513   | 493   | 535   |
| Health plans     | 224   | 209   | 240   |
| Total obligation | <b>737</b>  | <b>702</b>  | <b>775</b>  |

|                  | Present value of the obligation at the current growth rate for medical costs | Present value of the obligation by increasing the rate by 1% | Present value of the obligation by reducing the rate by 1% |
|------------------|--|--|--|
| Pension plans    | 513  | 513  | 513  |
| Health plans     | 224  | 259  | 195  |
| Total obligation | <b>737</b>   | <b>772</b>   | <b>708</b>   |

Other benefits

Telefónica de España, Telefónica Móviles España and Telefónica Soluciones Individual Suspension Plan

In 2015 Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U. and Telefónica Soluciones de Informática y Comunicaciones de España, S.A.U. signed the 1st Collective Agreement of Related Companies (CEV), wholly backed by the largest labor unions. This agreement considered, among other elements, a plan of measures for individual suspension of the employment relationship in 2016 and 2017, applying principles of voluntariness, universality, non-discrimination and social responsibility. In December 2016, the Collective Agreement of Related Companies was extended until 2018, by virtue of the provisions of this same agreement.

This plan is based on mutual agreement between the company and the employees, and implies the possibility of voluntarily suspending the employment relationship for an initial three-year period, renewable for consecutive three-year periods until the retirement age. The employees who meet the age and seniority requirements may enter into the Individual Suspension Plan (PSI) in the periods opened for this purposes.

In 2016, the current value of the forecast payment flows to meet the commitments of this program (applying certain hypothesis about estimated number of accessions and future reintegration ratio) was recognized. This figure was calculated using actuarial criteria (PERM/F-2000C tables, combined with the invalidity table published in the 1977 ministerial order) and a high quality credit market based interest rate.

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An expense of 789 million euros was recorded for the Individual Suspension Plan in the consolidated income statement for 2016. In 2015, an expense was recognized totaling 2,896 million euros, for those commitments assumed when the Collective Agreement of Related Companies was initially signed. The corresponding provision is recognized under “Other provisions” in the above table, with a balancing entry in the consolidated income statement under “Personnel expenses”. The provision as of December 31, 2016 amounted to 3,666 million euros.

The discount rate used for these provisions at December 31, 2016, was 0.9%, with an average length of the Plan of 5.7 years.

**Other provisions**

The movement in “Other provisions” in 2016 and 2015 is as follows:

|                                       | Millions of euros |
|---------------------------------------|-------------------|
| Other provisions at December 31, 2014 | 3,828             |
| Additions and accretion               | 1,464             |
| Retirements/amount applied            | (898)             |
| Inclusion of companies                | 220               |
| Transfers                             | 63                |
| Translation differences and other     | (579)             |
| Other provisions at December 31, 2015 | 4,098             |
| Additions and accretion               | 1,403             |
| Retirements/amount applied            | (889)             |
| Translation differences and other     | 332               |
| Other provisions at December 31, 2016 | 4,944             |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

“Other provisions” include the provisions for dismantling of assets recognized by Group companies in the amount of 1,001 million euros (786 million euros at the 2015 year end), of which 457 million euros correspond to Telefónica Germany (394 million euros at the 2015 year end).

In addition to the employee restructuring plan in Telefónica Deutschland described above, this company made provisions of 43 and 69 million euros in 2016 and 2015, respectively, primarily to cover the costs linked to the cancellation of certain contracts as a result of the integration with E-Plus (see Note 5).



At December 31, 2016, Telefónica Brazil has the following provisions for an amount of 2,099 million euros equivalent to cover the risks to which it is exposed:

Provisions for disputes regarding federal, state and municipal taxes totaling approximately 1,139 million euros (817 million euros at December 31, 2015).

Provisions for labor-related contingencies of approximately 413 million euros (284 million euros at December 31, 2015), which basically relate to claims filed by former and outsourced employees.

Civil claims by private consumers and consumer associations regarding services rendered, and other legal proceedings related with normal operations. Certain administrative proceedings are also in progress concerning disputes about obligations established in sector regulations. The amount accrued for these matters totals approximately 547 million euros (393 million euros at December 31, 2015).

In 2015, the Group established a provision of 1,521 million Peruvian soles (approximately 431 million euros) in relation to tax claims involving Telefónica Peru (see Note 17). At December 31, 2016 this provision amounted to 464 million euros.

The provision relating to the goodwill amortized for tax, mainly related to the acquisition of Vivo, amounts to 147 million euros at December 31, 2016 (79 million euros at December 31, 2015, see Note 17).

Given the nature of the risks covered by these provisions, it is not possible to determine a reliable schedule of potential payments, if any.

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Note 16. Derivative financial instruments and risk management policies

The Telefónica Group is exposed to various financial market risks as a result of: (i) its ordinary business activity, (ii) debt incurred to finance its business, (iii) its investments in companies, and (iv) other financial instruments related to the above commitments.

The main market risks affecting Group companies are as follows:

**Exchange rate risk:** arises primarily from: (i) Telefónica's international presence, through its investments and businesses in countries that use currencies other than the euro (primarily in Latin America, but also in the United Kingdom), (ii) debt denominated in currencies other than that of the country where the business is conducted or the home country of the company incurring such debt, and (iii) for those trade receivables or payables in foreign currency related to the company with the transaction registered.

**Interest rate risk:** arises primarily in connection with changes in interest rates affecting: (i) financial expenses on floating rate debt (or short-term debt likely to be renewed), due to changes in interest rates and (ii) the value of long-term liabilities at fixed interest rates.

**Share price risk:** arises primarily from changes in the value of the equity investments (that may be bought, sold or otherwise involved in transactions), from changes in the value of derivatives associated with such investments, from changes in the value of treasury shares and from equity derivatives.

**Liquidity risk:** the Telefónica Group is also exposed to liquidity risk if a mismatch arises between its financing needs (including operating and financial expense, investment, debt redemptions and dividend commitments) and its sources of finance (including revenues, divestments, credit lines from financial institutions and capital market transactions). The cost of finance could also be affected by movements in the credit spreads (over benchmark rates) demanded by lenders.

**Country risk:** refers to the possible decline in the value of assets, cash flows generated or cash flows returned to the parent company as a result of political, economic or social instability in the countries where the Telefónica Group operates, especially in Latin America.

**Credit risk:** appears when a counterpart fails to meet or delays its payment obligations in accordance with the agreed terms, driving an impairment in an asset due to: (i) solvency issues, or (ii) no intention to pay.

**Risk management**

The Telefónica Group actively manages these risks through the use of derivatives (primarily on exchange rates, interest rates and share prices) and by incurring debt in local currencies, where appropriate, with a view to optimize the financial cost and to stabilizing cash flows, the income statement and investments. In this way, it attempts to protect the Telefónica Group's solvency, facilitate financial planning and take advantage of investment opportunities.

The Telefónica Group manages its exchange rate risk and interest rate risk in terms of net financial debt plus commitments and net financial debt as calculated by them. The Telefónica Group believes that these parameters are more appropriate to understanding its debt position. Net financial debt and net financial debt plus commitments take into account the impact of the Group's cash balance and cash equivalents including derivatives positions with a positive value linked to liabilities. Neither net financial debt nor net financial debt plus commitments as calculated by the Telefónica Group should be considered as a substitute for gross financial debt (the sum of current and non-current interest-bearing debt).

For a more detailed description on reconciliation of net financial debt and net financial debt plus commitments to gross financial debt, see Note 2.

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**Exchange rate risk**

The fundamental objective of the exchange rate risk management policy is that, in event of depreciation in foreign currencies relative to the euro, any potential losses in the value of the cash flows generated by the businesses in such currencies, caused by depreciation in exchange rates of a foreign currency relative to the euro, are offset (to some extent) by savings from the reduction in the euro value of debt denominated in such currencies. This objective is also reflected on the decrease of the sensitivity to exchange rate variations of the net debt to OIBDA ratio, in order to protect the Group solvency. The degree of exchange rate hedging varies depending on the type of investment and may easily and actively be adjusted. For transactions of purchase or sale of business in currencies other than euro, additional hedges can be made on the estimate prices of the transactions or on estimated cash flows and OIBDA.

At December 31, 2016, net debt in Latin American currencies was equivalent to approximately 6,486 million euros. However, the Latin American currencies in which this debt is denominated is not distributed in proportion to the OIBDA generated in each currency. The future effectiveness of the strategy described above as a hedge of exchange rate risks therefore depends on which currencies depreciate relative to the euro.

Telefónica occasionally takes out dollar-denominated debt to hedge the euro-dollar intermediate component in the relation Euro-Latin American currencies, either in Spain (where such debt is associated with an investment as long as it is considered to be an effective hedge) or in the country itself, where the market for local currency financing or hedges may be inadequate or non-existent. At December 31, 2016, the Telefónica Group's net debt denominated in dollars was equivalent to 497 million euros.

At December 31, 2016, the debt in pounds sterling was approximately 1.85 times the value of the business' operating income before depreciation and amortization (OIBDA) in 2016 for Group companies in the United Kingdom, which is in line with the target of twice that of previous years. At December 31, 2016, the debt denominated in pounds sterling was equivalent to 3,000 million euros, which is less than the 6,227 million euros at December 31, 2015 as a result of the current hedging policy at the end of 2015 related to the sale of the subsidiary O2 in the United Kingdom, which in the end was not approved by the European regulator in 2016 (see Note 2).

The Telefónica Group also manages exchange rate risk by seeking to reduce the negative impact of any exchange rate exposure on the income statement, as a result of transactions recognized on the balance sheet and highly probable transactions, regardless of whether there are open positions. Such open position exposure can arise for any of three reasons: (i) a thin market for local derivatives or difficulty in sourcing local currency finance which makes it impossible to arrange a low-cost hedge (as in Argentina and Venezuela), (ii) financing through intra-group loans, where the accounting treatment of exchange rate risk is different from that for financing through capital contributions, and (iii) as the result of a deliberate policy decision, to avoid the high cost of hedges that are not warranted by expectations or high risk of depreciation.

The main transactions that generate or may generate exchange rate risk (regardless of whether or not they have an impact on the income statement) are, among others, as follows: issues in currencies other than the functional currency of the Group company, highly probable transactions in other currencies, future cash inflows in other currencies, investments and divestments, provisions for collections or payments in foreign currency, the actual value of the investments (subsidiaries) in currencies other than the euro.

In 2016, negative foreign exchange differences (excluding monetary correction) amounted to 694 million euros (616 million euros in 2015), mainly due to fluctuations in the exchange rate of the Venezuelan bolivar from 198.70 to 673.76 Venezuelan bolívar fuerte per US dollar, that resulted in exchange losses of 882 million euros. On the other hand, the pound sterling hedge of the sale of Telefónica O2 UK provided an exchange gain of 187 million euros.

The following table illustrates the sensitivity of foreign currency gains and losses and of equity to changes in exchange rates, where: a) in calculating the impact on the income statement, the exchange rate position affecting the income statement at the end of 2016 was considered constant during 2017; b) in calculating the impact on equity, only monetary items have been considered, namely debt and derivatives such as hedges of net investment and loans to subsidiaries related to the investment, whose breakdown is considered constant in 2017 and identical to that existing at the end of 2016. In both cases, Latin American currencies are assumed change their value against the dollar and the rest of the currencies against the euro by 10%.

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Millions of euros

| Currency                         | Change     | Impact on the consolidated income statement | Impact on consolidated equity |
|----------------------------------|------------|---|-------------------------------|
| <b>All currencies vs EUR</b>     | <b>10%</b> | <b>43</b>                                   | <b>(241)</b>                  |
| USD vs EUR                       | 10%        | 2   | (21)                          |
| European currencies vs EUR       | 10%        | -   | (264)                         |
| Latin American currencies vs USD | 10%        | 41  | 44                            |
| All currencies vs EUR            | (10)%      | (43)  | 241                           |
| USD                              | (10)%      | (2)   | 21                            |
| European currencies vs EUR       | (10)%      | -   | 264                           |
| Latin American currencies vs USD | (10)%      | (41)  | (44)                          |

The Group's monetary position in Venezuela at December 31, 2016 is a net debt position of 269,079 million Venezuelan bolivars (equivalent to approximately -379 million euros). The average exposure in 2016 has been a debtor position, which led to a higher financial income in the amount of 1,181 million euros due to the effect of the monetary correction for inflation during the year.

**Interest rate risk**

The main objective of the interest rate risk management policy is to bring the Company's financing costs into line with the budget for financial expenses for the current year, as well as that indicated in the current strategic plan. In accordance with this objective, Telefónica decided to actively adjust the exposure of its debt to interest rates, i.e., the amount of debt that would accrue interest at fixed rates and variable rates.

In order to meet this target, Telefónica mainly carry out the following:

- a) The interest rate of borrowings tied to a variable interest rate was set.
- b) Interest rate fluctuations of debt tied to a variable interest rate were reduced.
- c) Fixed rate debt instruments were converted into variable market rate debt instruments.

These transactions may be carried out against an existing underlying asset or those that are highly likely to take place in the future (for example, a highly probable future issue of debt).

The Telefónica Group's financial expenses are exposed to changes in interest rates. In 2016, the rates applied to the largest amount of short-term debt were mainly based on the Euribor, the Brazilian SELIC, the US dollar and pound sterling Libor, the Mexican UDI and the Colombian UVR. In nominal terms, at December 31, 2016, 50.8% of Telefónica's net financial debt plus commitments (or 61% of long-term net debt) was pegged to fixed interest rates for a period greater than one year, compared to 47.6% of net financial debt plus commitments (57% of long-term net debt) in 2015. Of the remaining 49.2% (net debt at floating rates or at fixed rates maturing in under one year), 0.5 percentage points had interest rates collared in a period over one year (or 0.3% of long-term debt), while at December 31, 2015 this was the case for 4 percentage points of net debt at floating rates or with fixed rates maturing within one year (2% of long-term net debt).

In addition, early retirement and Individual Suspension Plan liabilities (see Note 15) were discounted to present value over the year, based on the curve for instruments with very high credit quality. The decrease in interest rates has increased the market value of these liabilities. However, this increase was nearly completely offset by the increase in the value of the hedges on these positions.

Net financial results amounted to 2,219 million euros in 2016, 14.9% lower than the previous year, thanks to savings from the management of debt (pound sterling hedges linked to United Kingdom and the lower cost of debt in European currencies). On the other hand, the higher revenues resulting from the inflation in Venezuela were mainly offset by the income from the sale of equity investments, with the capital loss from the sale of the 1.5% stake in China Unicom (-155 million euros) in 2016, and the gain from the divestment of the holding in Telecom Italia, S.p.A (380 million euros) in 2015, being of particular note (see Note 13).

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To illustrate the sensitivity of the Company's net financial expense to fluctuations in short-term interest rates, on one hand a 100 basis point increase in interest rates in all currencies in which Telefónica has financial positions at December 31, 2016, and a 100 basis point decrease in all currencies has been assumed, and on the other hand a constant position equal to the position at year-end has been considered.

To calculate the sensitivity of equity to fluctuations in interest rates, on one hand a 100 basis point increase in interest rates in all currencies and in all periods on the yield curve in which Telefónica has financial positions at December 31, 2016, and a 100 basis point decrease in all currencies and all periods was assumed, and on the other hand only positions with cash flow hedges were considered, which are basically the only positions in which changes in market value due to interest rate fluctuations are recognized in equity.

Millions of euros

| Change in basis points (bp) | Impact on consolidated income statement | Impact on consolidated equity |
|-----------------------------|---|-------------------------------|
| +100bp                      | (232)                                   | 138                           |
| -100bp                      | 201                                     | (135)                         |

**Share price risk**

The Telefónica Group is exposed to changes in the value of equity investments from changes in the value of derivatives associated with such investments, from convertible or exchangeable instruments issued by Telefónica Group, from Share-based payments plans, from treasury shares and from equity derivatives over treasury shares.

According to the Share-based payments plans (see Note 19) the shares to be delivered to employees under such plan may be either the parent company treasury shares, acquired by them or any of its Group companies; or newly-issued shares. The possibility of delivering shares to beneficiaries of the plan in the future, implies a risk since there could be an obligation to hand over a maximum number of shares at the end of each phase, whose acquisition (in the event of acquisition in the market) in the future could imply a higher cash outflow than required on the start date of each phase if the share price is above the corresponding price on the phase start date. In the event that new shares are issued for delivery to the beneficiaries of the plan, there would be a dilutive effect for ordinary shareholders of Telefónica as a result of the higher number of shares delivered under such plan outstanding.

During 2014 and 2015, they were launched two new cycles of the long-term incentive Plan consisting of the delivery of shares of Telefónica, S.A. aimed at members of the Executives of Telefónica Group denominated Performance Share Plan (PIP). The third and last cycle of this Plan, initially scheduled for 2016, was cancelled (see Note 19).

To reduce the risk associated with variations in share price under these plans, Telefónica could acquire instruments that hedge the risk profile of some of these plans.



In addition, the Group may use part of the treasury shares of Telefónica, S.A. held at December 31, 2016 to cover shares deliverable under the PIP or the Global Employee Share Plan. The net asset value of the treasury shares could increase or decrease depending on variations in Telefónica, S.A.'s share price.

### **Liquidity risk**

The Telefónica Group seeks to match the schedule for its debt maturity payments to its capacity to generate cash flows to meet these maturities, while allowing for some flexibility. In practice, this has been translated into two key principles:

1. The Telefónica Group's average maturity of net financial debt is intended to stay above 6 years, or be restored above that threshold in a reasonable period of time if it eventually falls below it. This principle is considered as a guideline when managing debt and access to credit markets, but not a rigid requirement. When calculating the average maturity for the net financial debt and part of the undrawn credit lines can be considered as offsetting the shorter debt maturities, and extension options on some financing facilities may be considered as exercised, for calculation purposes.

2. The Telefónica Group must be able to pay all commitments over the next 12 months without accessing new borrowing or tapping the capital markets (drawing upon firm credit lines arranged with banks), assuming budget projections are met.

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At December 31, 2016, the average maturity of net financial debt (48,595 million euros) was 6.35 years (liquidity included).

At December 31, 2016, gross financial debt scheduled to mature in 2017 amounted to approximately 13,326 million euros (which includes the net position of derivative financial instruments and certain current payables). These maturities are lower than the amount of funds available, calculated as the sum of: a) cash and cash equivalents and current financial assets; b) annual cash generation projected for 2017, and c) undrawn credit facilities arranged with banks whose original maturity is over one year (an aggregate of more than 13,491 million euros at December 31, 2016), providing flexibility to the Telefónica Group with regard to accessing capital or credit markets in the next 12 months. For a further description of the Telefónica Group's liquidity and capital resources in 2016, see Note 13.2 Financial Liabilities and Appendix V.

**Country risk**

The Telefónica Group managed or mitigated country risk by pursuing two lines of action (in addition to its normal business practices):

- Partly matching assets to liabilities (those not guaranteed by the parent company) in the Telefónica Group's Latin American companies such that any potential asset impairment would be accompanied by a reduction in liabilities; and
1. American companies such that any potential asset impairment would be accompanied by a reduction in liabilities; and
  2. Repatriating funds generated in Latin America that are not required for the pursuit of new, profitable business development opportunities in the region.

Regarding the first point, at December 31, 2016, the Telefónica Group's Latin American companies had net financial debt not guaranteed by the parent company of 4,722 million euros, which represents 9.7% of net financial debt of the Group. Nevertheless, in certain countries, such as Venezuela, there is a net cash balance (instead of a net liability balance).

Regarding the net repatriation of funds to Spain, 781 million euros from Latin America companies have been received in 2016, of which 726 million euros were from dividends and 55 million euros were for other items.

In this regard, it is worth noting that since February 2003, Venezuela has had an exchange control mechanism in place, managed by the Centro Nacional de Comercio Exterior (CENCOEX). The body has issued a number of regulations ("providencias") governing the modalities of currency sales in Venezuela at official exchange rates. Foreign companies which are duly registered as foreign investors are entitled to request approval to acquire currencies at the

official exchange rate by the CENCOEX, in line with regulation number 056, article 2, section c) "Remittance of profits, income, interest and dividends from international investment" Telefónica Venezolana, C.A. (formerly Telcel, C.A.), a Telefónica Group subsidiary in Venezuela, obtained the aforementioned requested approval on 295 million Venezuelan bolivars in 2006, 473 million Venezuelan bolivars in 2007 and 785 million Venezuelan Bolivars in 2008. At December 31, 2016, payment of two dividends agreed by the company in the amount of 5,882 million Venezuelan bolivars is pending approval by the CENCOEX.

### **Credit risk**

The Telefónica Group trades in derivatives with creditworthy counterparties. Therefore, Telefónica, S.A. generally trades with credit entities whose "senior debt" ratings are of at least "A-" or in case of Spanish entities in line with the credit rating of Kingdom of Spain. In Spain, where most of the Group's derivatives portfolio is held, there are netting agreements with financial institutions, with debtor or creditor positions offset in case of bankruptcy, limiting the risk to the net position; however, the entity has decided not to present the netting on its consolidated statement of financial position. In addition, the CDS (Credit Default Swap) of all the counterparties with which Telefónica, S.A. operates is monitored at all times in order to assess the maximum allowable CDS for operating at any given time. Transactions are generally only carried out with counterparties whose CDS is below the threshold.

CVA or Credit Valuation Adjustment is the method used to measure credit risk for both counterparties and Telefónica in order to determine the fair value of the derivatives portfolio. This adjustment reflects the probability of default or the deterioration of the credit quality of both Telefónica and its counterparties. The simplified formula to calculate CVA is Expected Exposure times Probability of Default times Loss Given Default. In order to calculate these variables standard market practices are used.

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When managing credit risk, Telefónica considers the use of CDS, novations, derivatives with Break Clauses and signing CSA's under certain conditions.

For other subsidiaries, particularly those in Latin America, assuming a stable sovereign rating provides a ceiling which is below "A", trades are with local financial entities whose rating by local standards is considered to be of high creditworthiness.

Meanwhile, with credit risk arising from cash and cash equivalents, the Telefónica Group places its cash surpluses in high quality and highly liquid money-market assets. These placements are regulated by a general framework, revised annually. Counterparties are chosen according to criteria of liquidity, solvency and diversification based on the conditions of the market and countries where the Group operates. The general framework sets: the maximum amounts to be invested by counterparty based on its rating (long-term debt rating); and the instruments in which the surpluses may be invested (money-market instruments).

The Telefónica Group considers credit risk management as a key element to achieve its business and customer base growth targets in a manner that is both sustainable and consistent with Telefónica Corporate Risk Management Policy. This management approach relies on the active monitoring of the risk-reward balance within the commercial operations and on the adequate separation between the risk ownership and risk management functions.

Formal delegation of authority procedures and management practices are implemented in all Group companies, taking into account benchmark risk management techniques but adapted to the local characteristics of each market. Debtors that may cause a relevant impact on the Telefónica Group consolidated financial statements and increased risk profile products – due to customer target, term, channels or other commercial characteristics - are subject to specific management practices in order to mitigate the exposure to credit risk.

This commercial credit risk management model is embedded in the day-to-day operational processes, where the credit risk assessment guides both the product and services available for the different customers and the collection strategy.

The Telefónica Group's maximum exposure to credit risk is initially represented by the carrying amounts of the financial assets (Notes 11 and 13) and the guarantees given by the Telefónica Group.

Several Telefónica Group companies provide operating guarantees granted by external counterparties, which are offered during their normal commercial activity, in bids for licenses, permits and concessions, and spectrum acquisitions. At December 31, 2016, these guarantees amounted to approximately 5,134 million euros (3,990 million euros at December 31, 2015).

## Capital management

Telefónica's corporate finance department takes into consideration several factors for the evaluation of the Telefónica's capital structure, with the aim of maintaining the solvency and creating value to the shareholders.

The corporate finance department estimates the cost of capital on a continuous basis through the monitoring of the financial markets and the application of standard industry approaches for calculating weighted average cost of capital, or WACC, so that it can be applied in the valuation of businesses in course and in the evaluation of investment projects. Telefónica also uses as reference a net financial debt (excluding items of a non-recurring or exceptional nature) that allows for a comfortable investment grade credit rating as assigned by credit rating agencies, aiming at protecting credit solvency and making it compatible with alternative uses of cash flow that could arise at any time.

These general principles are refined by other considerations and the application of specific variables, such as country risk in the broadest sense, or the volatility in cash flow generation that are considered, when evaluating the financial structure of the Telefónica Group and its different areas.

## Derivatives policy

At December 31, 2016, the nominal value of outstanding derivatives with external counterparties amounted to 152,096 million equivalent, a 11.6% decrease from December 31, 2015 (172,141 million euros equivalent). This figure is inflated by the use in some cases of several levels of derivatives applied to the nominal value of a single underlying liability. For example, a foreign currency loan can be hedged into floating rate, and then each interest rate period can be fixed using a fixed rate hedge, or FRA (forward rate agreement) The high volume is also due to the fact that when a derivative transaction is cancelled, the company may either cancel the derivative or take the opposite position, which cancels out the variability thereof. The second option is usually chosen in order to cut costs. Even using such techniques to reduce the position, it is still necessary to take extreme care in the use of derivatives to avoid potential problems arising through error or a failure to understand the real position and its associated risks. The main principles in the management of derivatives are detailed as follow:

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1) Derivatives based on a clearly identified hedged items.

Telefónica's derivatives policy emphasizes the following points:

Acceptable underlyings include assets and liabilities, profits, revenues and cash flows in either a company's functional currency or another currency. These flows can be contractual (debt and interest payments, settlement of foreign currency payables, etc.), reasonably certain or foreseeable (PP&E purchases, future debt issues, commercial paper programs, etc.). The acceptability of an underlying asset in the above cases does not depend on whether it complies with accounting rules requirements for hedge accounting, as is required in the case of certain intragroup transactions, for instance. Parent company investments in subsidiaries with functional currencies other than the euro also qualify as acceptable underlying assets.

Economic hedges are hedges that have a designated underlying asset and that, under certain circumstances, may offset the changes in the value of the underlying asset. These economic hedges may not always meet the requirements and pass the effectiveness tests established by accounting standards to be treated as hedges for accounting purposes. The decision to arrange these hedges even if they fail the effectiveness test or if they do not meet certain requirements will depend on the marginal impact on the income statement and, therefore, on how far this may compromise the goal of having a stable income statement. In any case, the changes are recognized in the income statement.

2) Matching of the hedged item to one side of the derivative.

This matching basically applies to foreign currency debt and derivatives hedging foreign currency payments by Telefónica Group subsidiaries. The aim is to eliminate the risk arising from changes in foreign currency interest rates. Nonetheless, even when the aim is to achieve perfect hedging for all cash flows, the lack of liquidity in certain markets, especially in Latin American currencies, has meant that historically there have been mismatches between the terms of the hedges and those of the debts they are meant to hedge. The Telefónica Group intends to reduce these mismatches, provided that doing so does not involve disproportionate costs. In this regard, if adjustment does prove too costly, the financial timing of the underlying asset in foreign currency will be modified in order to minimize interest rate risk in foreign currency.

In certain cases, the timing of the underlying as defined for derivative purposes may not be exactly the same as the timing of the contractual underlying.

3) Matching the company contracting the derivative and the company that owns the hedged item.

Generally, the aim is to ensure that the hedging derivative and the hedged asset or liability belong to the same company. Sometimes, however, the holding companies (Telefónica, S.A. and Telefónica Latinoamérica Holding, S.L.) have arranged hedges on behalf of a subsidiary that owns the underlying asset. The main reasons for separating the hedge and the underlying asset were possible differences in the legal validity of local and international hedges (as a result of unforeseen legal changes) and the different credit ratings of the counterparties (of the Telefónica Group companies as well as those of the banks).

4) Ability to measure the derivative's fair value using the valuation systems available to the Telefónica Group.

Telefónica uses several tools to evaluate and manage the risk involved in derivatives and debt. These tools most notably include the Kondor+ system, licensed by Reuters, for extended use among various financial institutions, as well as the specialized libraries in the MBRM financial calculation, both of which are widespread throughout the market and have shown proven reliability. In order to perform these calculations, customary market techniques are used when configuring the calculation methods and information from money market curves is used on a daily basis as market inputs (swaps, deposits, FRAs, etc.) for interest rates, official fixings for exchange rates and the interest rates and volatility matrices for interest and FX rates that are listed in the multi-contributor systems, Reuters and Bloomberg. For those yield curves that are less liquid or whose prices published in Reuters and Bloomberg are considered not to adequately reflect the market situation, these curves will be requested from relevant banks in these markets.

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5) Sale of options only when there is an underlying exposure.

Telefónica considers the sale of options when: i) there is an underlying exposure (on the consolidated statement of financial position or associated with a highly probable cash outflow) that would offset the potential loss for the year if the counterparty exercised the option. This exposure does not have to be treated as a purchased option, but rather it can be another type of hedged item (in these cases, hedge accounting does not apply since this hedging instrument does not meet the criteria required by accounting standards to treat the sale of options as hedging instruments), or ii) the option is part of a structure in which another derivative offsets any loss. The sale of options is also permitted in option structures where, at the moment they are taken out, the net premium is either positive or zero.

For instance, it would be possible to sell short-term options on interest rate swaps that entitle the counterparty to receive a certain fixed interest rate, below the level prevailing at the time the option was sold. This would mean that if rates fell and the counterparty exercised its option, the Group would swap part of its debt from floating rate to a lower fixed rate, having received a premium.

6) Hedge accounting.

The main risks that may qualify for hedge accounting are as follows:

Variations in market interest rates (either money-market rates, credit spreads or both) that affect the value of the underlying asset or the measurement of the cash flows.

Variations in exchange rates that change the value of the underlying asset in the company's functional currency and affect the measurement of the cash flow in the functional currency.

Variations in the volatility of any financial variable, asset or liability that affect either the valuation or the measurement of cash flows on debt or investments with embedded options, whether or not these options are separable.

Variations in the valuation of any financial asset, particularly shares of companies included in the portfolio of "Available-for-sale financial assets".

Variations in the price of commodities related to contracts that the Group has with third parties.

Regarding the underlying:



Hedges can cover all or part of the value of the underlying.

The risk to be hedged can be for the whole period of the transaction or for only part of the period.

The underlying may be a highly probable future transaction, or a contractual underlying (loan, foreign currency payment, investment, financial asset, etc.) or a combination of both that defines an underlying with a longer term.

This may on occasion mean that the hedging instruments have longer terms than the related contractual underlying. This happens when the Group enters into long-term swaps, caps or collars to protect ourselves against interest rate rises that may raise the financial expense of its promissory notes, commercial paper and some floating rate loans which mature earlier than their hedges. These floating rate financing programs are highly likely to be renewed and Telefónica commits to this by defining the underlying asset in a more general way as a floating rate financing program whose term coincides with the maturity of the hedge. In those cases in which the underlying assets representing the risk hedged are cancelled or refinanced early, and if there is an open risk with similar characteristics as the underlying asset that was cancelled or refinanced early, either because there is new financing or because there is an underlying asset with similar characteristics and risk profile, the hedge may remain in force with the derivatives assigned thereto and the risk will be subject to the hedge arranged in the aforementioned refinancing. When either of these situations occurs, the effectiveness of the hedge will be reviewed taking into account the new situation.

Hedges can be of three types:

Fair value hedges.

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Cash flow hedges. Such hedges can be set at any value of the risk to be hedged (interest rates, exchange rates, etc.) or for a defined range (interest rates between 2% and 4%, above 4%, etc.). In this last case, the hedging instrument used is options and only the intrinsic value of the option is recognized as an effective hedge.

Hedges of net investment in consolidated foreign subsidiaries. Generally such hedges are arranged by the parent company and the other Telefónica holding companies. Wherever possible, these hedges are implemented through real debt in foreign currency. Often, however, this is not always possible as many Latin American currencies are non-convertible, making it impossible for non-resident companies to issue local currency debt. It may also be that the debt in the currency concerned is not enough to accommodate the required hedge (for example, pounds sterling), or that an acquisition is made in cash with no need for market financing. In these circumstances derivatives, either forwards or cross-currency swaps are used to hedge the net investment.

Hedges can comprise a combination of different derivatives.

Management of accounting hedges is not static, and the hedging relationship may change before maturity. Hedging relationships may change to allow appropriate management that serves the Group's stated principles of stabilizing cash flows, stabilizing net financial income/expense and protecting share capital. The designation of hedges may therefore be cancelled, before maturity, because of a change in the underlying, a change in perceived risk on the underlying or a change in market view. Derivatives included in these hedges may be reassigned to new hedges where they meet the effectiveness test and the new hedge is well documented. To gauge the efficiency of transactions defined as accounting hedges, the Group analyzes the extent to which the changes in the fair value or in the cash flows attributable to the hedged item would offset the changes in fair value or cash flows attributable to the hedged risk using a linear regression model both prospectively and retrospectively.

The main guiding principles for risk management are laid down by Telefónica's Finance Department and implemented by company financial officers (who are responsible for balancing the interests of each company and those of the Telefónica Group). The Corporate Finance Department may allow exceptions to this policy where these can be justified, normally when the market is too thin for the volume of transactions required or on clearly limited and small risks. New companies joining the Telefónica Group as a result of mergers or acquisitions may also need time to adapt.

7) Cancellation of derivatives.

When a derivative transaction is cancelled, the company may:

Cancel the derivative and pay its market value.

Take the opposite position which cancels out the variability thereof, if cancellation costs are high or if it is recommended for operating or business reasons.

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The breakdown of the financial results recognized in 2016, 2015 and 2014 is as follows:

| Millions of euros  | 2016    | 2015 (*) | 2014 (*) |
|--|---------|----------|----------|
| Interest income  | 723     | 1,068    | 553      |
| Dividends received   | 19      | 30       | 5        |
| Other financial income   | 38      | 250      | 228      |
| Subtotal   | 780     | 1,348    | 786      |
| Changes in fair value of financial assets at fair value through profit or loss             | 438     | (317)    | 1,004    |
| Changes in fair value of financial liabilities at fair value through profit or loss        | (463)   | 189      | (1,059)  |
| Transfer from equity to profit and loss from cash flow hedges (**)                         | (238)   | (207)    | (163)    |
| Transfer from equity to profit and loss from available-for-sale assets and others          | (136)   | 539      | –        |
| Gain/(loss) on fair value hedges   | (26)    | 62       | 865      |
| (Loss)/gain on adjustment to items hedged by fair value hedges                             | (6)     | 24       | (796)    |
| Subtotal   | (431)   | 290      | (149)    |
| Interest expenses  | (2,225) | (3,146)  | (2,556)  |
| Ineffective portion of cash flow hedges  | 1       | –        | –        |
| Accretion of provisions and other liabilities  | (466)   | (313)    | (400)    |
| Other financial expenses   | (365)   | (520)    | (200)    |
| Subtotal   | (3,055) | (3,979)  | (3,156)  |
| Net finance costs excluding foreign exchange differences and hyperinflationary adjustments | (2,706) | (2,341)  | (2,519)  |

(\*) Amended data (see Note 2).

(\*\*)The difference in 2016 between this amount and the impact in the consolidated statement of comprehensive income (184 million euros) is because of recycling the hedges related to the operation of Telefónica United Kingdom, recorded in the exchange differences account in the consolidated income statement (see Note 23).

The breakdown of Telefónica's derivatives at December 31, 2016, their fair value at year-end and the expected maturity schedule is as set forth in the table below:

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2016

| Millions of euros                 | Fair value |                                |       |       |                  | Total   |
|-----------------------------------|------------|--------------------------------|-------|-------|------------------|---------|
|                                   | (**)       | Notional amount Maturities (*) |       |       |                  |         |
| Derivatives                       |            | 2017                           | 2018  | 2019  | Subsequent years |         |
| Interest rate hedges              | (407)      | (535)                          | (481) | (653) | 667              | (1,002) |
| Cash flow hedges                  | 172        | (505)                          | 150   | (417) | 3,597            | 2,825   |
| Fair value hedges                 | (579)      | (30)                           | (631) | (236) | (2,930)          | (3,827) |
| Exchange rate hedges              | (1,038)    | 823                            | 1,170 | 359   | 2,760            | 5,112   |
| Cash flow hedges                  | (1,062)    | 1,028                          | 1,170 | 359   | 2,760            | 5,317   |
| Fair value hedges                 | 24         | (205)                          |       |       |                  | (205)   |
| Interest and exchange rate hedges | (1,842)    | (260)                          | 24    | 1,149 | 4,273            | 5,186   |
| Cash flow hedges                  | (1,707)    | (277)                          | 309   | 1,160 | 4,215            | 5,407   |
| Fair value hedges                 | (135)      | 17                             | (285) | (11)  | 58               | (221)   |
| Net investment Hedges             | (7)        | (2,309)                        | (33)  | (36)  |                  | (2,378) |
| Other Derivatives                 | (107)      | 1,256                          | (332) | (437) | (2,702)          | (2,215) |
| Interest rate                     | 9          | 1,232                          | (471) | (456) | (2,818)          | (2,514) |
| Exchange rate                     | (101)      | (574)                          | 139   | 19    | 116              | (299)   |
| Others                            | (15)       | 598                            |       |       |                  | 598     |

(\*) For interest rate hedges, the positive amount is in terms of fixed "payment." For foreign currency hedges, a positive amount means payment in functional vs. foreign currency.

(\*\*) Positive amounts indicate payables.

The fair value of the Telefónica Group derivatives at December 31, 2016 amounted to a positive MTM (accounts receivable) of 3,401 million euros.

Derivatives arranged by the Group at December 31, 2016 are detailed in Appendix IV.

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The breakdown of Telefónica's derivatives at December 31, 2015, their fair value at year-end and the expected maturity schedule are as set forth in the table below:

| 2015<br>Millions of euros         | Fair value<br>(**) | Notional amount Maturities (*) |       |       |                  |  | Total   |
|-----------------------------------|--------------------|--------------------------------|-------|-------|------------------|--|---------|
|                                   |                    | 2016                           | 2017  | 2018  | Subsequent years |  |         |
| Derivatives                       |                    |                                |       |       |                  |  |         |
| Interest rate hedges              | (744)              | 860                            | 126   | (349) | (2,336)          |  | (1,699) |
| Cash flow hedges                  | 343                | (340)                          | 460   | 333   | 2,769            |  | 3,222   |
| Fair value hedges                 | (1,087)            | 1,200                          | (334) | (682) | (5,105)          |  | (4,921) |
| Exchange rate hedges              | (1,480)            | (2,200)                        | 891   | 1,170 | 2,936            |  | 2,797   |
| Cash flow hedges                  | (1,449)            | (3,058)                        | 891   | 1,170 | 2,936            |  | 1,939   |
| Fair value hedges                 | (31)               | 858                            |       |       |                  |  | 858     |
| Interest and exchange rate hedges | (1,561)            | 462                            | 330   | 362   | 6,072            |  | 7,226   |
| Cash flow hedges                  | (1,316)            | 363                            | 536   | 366   | 5,386            |  | 6,651   |
| Fair value hedges                 | (245)              | 99                             | (206) | (4)   | 686              |  | 575     |
| Net investment Hedges             | (108)              | (615)                          | (94)  | (33)  | (36)             |  | (778)   |
| Other Derivatives                 | (227)              | (1,449)                        | (94)  | (279) | (1,176)          |  | (2,998) |
| Interest rate                     | (72)               | (1,882)                        | (289) | (399) | (1,176)          |  | (3,746) |
| Exchange rate                     | (434)              | 27                             | (108) | 120   |                  |  | 39      |
| Others                            | 279                | 406                            | 303   |       |                  |  | 709     |

(\*) For interest rate hedges, the positive amount is in terms of fixed "payment." For foreign currency hedges, a positive amount means payment in functional vs. foreign currency.

(\*\*) Positive amounts indicate payables.

The fair value of the Telefónica Group derivatives at December 31, 2015 amounted to a positive MTM (accounts receivable) of 4,120 million euros.

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## Note 17. Income tax matters

Pursuant to a Ministerial Order dated December 27, 1989, Telefónica, S.A. files consolidated tax returns in Spain for certain Group companies. The consolidated tax group comprised 58 and 52 companies in 2016 and 2015, respectively.

This tax consolidation regime applies indefinitely providing the companies continue to meet the requirements set down in prevailing legislation, and that application of the regime is not expressly waived.

Group companies resident in Spain that are not part of this consolidation regime and non-resident companies file individual or aggregated tax returns under the tax law applicable in each country.

**Deferred taxes movement**

The movements in deferred taxes in the Telefónica Group in 2016 and 2015 are as follows:

| Millions of euros                                      | Deferred tax assets | Deferred tax liabilities |
|--|---------------------|--------------------------|
| Balance at December 31, 2015                           | 8,675               | 2,550                    |
| Additions  | 2,141               | 327                      |
| Disposals  | (2,325)             | (519)                    |
| Transfers  | (194)               | (12)                     |
| Translation differences and hyperinflation adjustments | (28)                | 14                       |
| Company movements and others                           | (40)                | 35                       |
| Balance at December 31, 2016                           | 8,229               | 2,395                    |

| Millions of euros                                      | Deferred tax assets | Deferred tax liabilities |
|--|---------------------|--------------------------|
| Balance at December 31, 2014                           | 6,867               | 2,566                    |
| Additions  | 3,863               | 340                      |
| Disposals  | (2,578)             | (286)                    |
| Transfers  | 201                 | (100)                    |
| Translation differences and hyperinflation adjustments | (281)               | (47)                     |
| Company movements and others                           | 603                 | 77                       |
| Balance at December 31, 2015                           | 8,675               | 2,550                    |

Note: In 2016 Telefónica United Kingdom is no longer presented as a discontinued operation, thus the 2015 movement has been amended (see Note 2).

**Movements in 2016**

Among other changes, the amendment to the Spanish Corporate Income Tax Law by Royal Decree-Law (RDL) 3/2016, of 2 December, limits the use of tax loss carryforwards to 25%. As a result of the testing on the recoverability of deferred tax assets, carried out by the Group under the new legislative framework, it has derecognized deferred tax assets relating to tax loss carryforwards amounting to 866 million euros.

Furthermore, in compliance with the sixteenth transitional provision of this amended Royal Decree-Law, which requires the inclusion of one-fifth of the investment portfolio impairment losses which had been deductible in the tax base before January 1, 2013, the Group has reclassified 237 million euros of deferred tax liabilities in order to recognize a higher tax payable to the Spanish tax authorities, corresponding to one-fifth of the tax losses affected by this law.

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Likewise, as a result of the testing on the recoverability mentioned before, the Group has capitalized tax deductions in the companies of the tax group in Spain amounting to 755 million euros, which had yet to be recognized at December 31, 2015.

In 2016 the additions of deferred tax assets recognized in the amount of 334 million euros were the result of the provisions recognized during the year in relation to the various workforce restructuring plans of the companies included in the tax group in Spain (see Note 15).

The companies in the Spanish tax group recognized deferred tax assets totaling 134 million euros in 2016, as a result of the limit placed on deductible financial expenses.

The disposals of deferred tax assets in 2016 also included the impact of the Group's labor force reduction plans in Spain, amounting to 224 million euros.

The additions of deferred tax assets included tax credits recognized in the amount of 115 million euros by the German company Group 3G UMTS Holding GmbH. Furthermore, this company applied tax loss carryforwards in 2016 amounting to 89 million euros.

As a result of the testing on the recoverability of deferred tax assets in Telefónica Germany GmbH & Co OHG at year-end, this company capitalized tax losses in the amount of 112 million euros, and derecognized temporary differences in deferred tax assets amounting to 201 million euros.

The disposals of deferred tax liabilities in 2016 includes 112 million euros corresponding to the tax on dividends to foreign beneficiaries in Argentina, repealed during the year.

The movements relating deferred tax recognized directly in equity in 2016 amounted to 69 million euros of additions and 64 million euros of disposals.

**Movements in 2015**

Additions of deferred tax assets in 2015 included, among others, the capitalization of tax credits according to the evolution of litigation and tax inspections opened to the tax group in Spain. The capitalized amount totaled 1,157

million euros, corresponding to the recognition of all the tax loss carryforwards generated within the tax group in Spain that were unused at beginning of 2015, and the tax credit for the negative taxable base resulting from the calculation of the 2015 Income tax provision, amounting to 644 million euros.

As a result of the provision recognized for the Telefónica Spain Individual Suspension Plan (see Note 15) a temporary difference arose amounting to 724 million euros.

In 2015 Telefónica, S.A. approved a donation to the Telefónica Foundation amounting to 325 million euros (see Note 18), which generated a deferred tax asset of 130 million euros.

Colombia Telecomunicaciones recorded additions of deferred tax assets in the amount of 172 million euros, resulting mainly from the finance lease agreement with PARAPAT, and the doubtful debts portfolio.

The additions of deferred tax assets included tax credits recognized in the amount of 109 million euros by the German company Group 3G UMTS Holding GmbH. Furthermore, this company applied tax loss carryforwards in 2015 amounting to 96 million euros.

Following the internal restructuring of Telefónica Germany GmbH & Co. OHG, this company recognized deferred tax assets from temporary differences in the amount of 349 million euros, and de-recognized tax credits for loss carryforwards in the amount of 421 million euros.

Based on Spanish tax group companies' business plans, besides the best available estimation of taxable income, within an appropriate term to the market situation where the companies operate, the Group wrote down 526 million euros of deductions, and alternatively registered tax credits derived from the above mentioned tax credits for loss carryforwards.

Disposals of deferred tax assets included the effect of the demerger of Telco, which made possible the tax deduction of the impairment caused by the difference between the acquisition value and the market value of the stake of Telefónica on the demerger date, in the amount of 744 million euros.

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The disposals of deferred tax assets in 2015 also included the impact of the Group’s labor force reduction plans, amounting to 198 million euros.

“Company movements” related to the entry into the scope of consolidation of DTS and GVT (see Note 5).

Colombia Telecomunicaciones recorded additions in deferred tax liabilities in the amount of 95 million euros, resulting from temporary differences mainly related to derivative financial instruments.

The movements relating deferred tax recognized directly in equity in 2015 amounted to 36 million euros of additions and 123 million euros of disposals.

**Expected realization of deferred tax assets and liabilities**

In the majority of cases, realization of the Group’s deferred tax assets and liabilities depends on the future activities carried out by the different companies, on tax regulations in the different countries in which these companies operate, and on the strategic decisions affecting the companies. Under the assumptions made, the estimated realization of deferred tax assets and liabilities recognized in the consolidated statement of financial position at December 31, 2016 is as follows:

| 12/31/2016               | Total     | Less than 1 year | More than 1 year |
|--------------------------|-----------|------------------|------------------|
| Deferred tax assets      | 8,229,162 | 4,624            | 6,605            |
| Deferred tax liabilities | 2,395,448 |                  | 1,947            |

**Deferred tax assets**

Deferred tax assets in the accompanying consolidated statements of financial position include the tax loss carryforwards, unused tax credits recognized and deductible temporary differences recognized at the end of the reporting period.

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| Millions of euros                             | 12/31/2016 | 12/31/2015 (*) |
|---|------------|----------------|
| Tax credits for loss carryforwards            | 2,513      | 3,149          |
| Unused tax deductions                         | 1,727      | 938            |
| Deferred tax assets for temporary differences | 3,989      | 4,588          |
| Total deferred tax assets                     | 8,229      | 8,675          |

(\*) Amended data (see Note 2).

**Tax credits for loss carryforwards**

The movements in Tax credits for loss carryforwards in the Telefónica Group in 2016 and 2015 are as follows:

| Tax credits for loss carryforwards       | Balance at 12/31/2015 | Additions | Reversals    | Inclusion of companies | Translation differences and other | Balance at 12/31/2016 |
|--|-----------------------|-----------|--------------|------------------------|-----------------------------------|-----------------------|
| Spain                                    | <b>2,520</b>          | 2         | (866)        | -                      | (39)                              | <b>1,617</b>          |
| Germany                                  | <b>413</b>            | 226       | (89)         | -                      | -                                 | <b>550</b>            |
| Hispanoamérica                           | <b>192</b>            | 157       | -            | -                      | (28)                              | <b>321</b>            |
| Other companies                          | <b>24</b>             | 6         | (2)          | -                      | (3)                               | <b>25</b>             |
| Total tax credits for loss carryforwards | <b>3,149</b>          | 391       | <b>(957)</b> | -                      | <b>(70)</b>                       | <b>2,513</b>          |

| Tax credits for loss carryforwards       | Balance at 12/31/2014 | Additions | Reversals    | Inclusion of companies | Translation differences and other | Balance at 12/31/2015 |
|--|-----------------------|-----------|--------------|------------------------|-----------------------------------|-----------------------|
| Spain                                    | <b>1,168</b>          | 1,801     | (1)          | 439                    | (887)                             | <b>2,520</b>          |
| Germany                                  | <b>821</b>            | 109       | (517)        | -                      | -                                 | <b>413</b>            |
| Hispanoamérica                           | <b>280</b>            | 23        | (82)         | -                      | (29)                              | <b>192</b>            |
| Other companies                          | <b>26</b>             | -         | -            | -                      | (2)                               | <b>24</b>             |
| Total tax credits for loss carryforwards | <b>2,295</b>          | 1,933     | <b>(600)</b> | <b>439</b>             | <b>(918)</b>                      | <b>3,149</b>          |

The Spanish tax group had unused tax loss carryforwards at December 31, 2016 amounting to 11,513 million euros:

| 12/31/2016   | Total        | Less than 1 year | More than 1 year |
|--|--------------|------------------|------------------|
| Tax loss carryforwards generated in the tax group                      | <b>8,140</b> | 403              | 7,737            |
| Tax loss carryforwards generated before consolidation in the tax group | <b>3,373</b> | -                | 3,373            |

Among other changes, the amendment to the Spanish Corporate Income Tax Law by Royal Decree-Law 3/2016, of December 2, limits the use of tax loss carryforwards to 25%. As a result of the testing on the recoverability of deferred tax assets, carried out by the Group under the new legislative framework, it has derecognized deferred tax assets relating to tax loss carryforwards amounting to 866 million euros. Total tax credits for loss carryforwards in Spain in the statement of financial position at December 31, 2016 amounted to 1,617 million euros (2,520 million euros at

December 31, 2015). This amount includes tax loss carryforwards of the companies of the DTS Group, purchased in 2015. Total unrecognized tax credits of the Spanish tax group amounted to 1,261 million euros at December 31, 2016. These tax credits do not expire.

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The Group companies in Germany have recognized 550 million euros of unrecognized tax credits for loss carryforwards at December 31, 2016. Total unrecognized tax credits for loss carryforwards of these companies amount to 6,434 million euros. These tax credits do not expire.

Recognized tax credits in the consolidated statement of financial arising from the Latin American subsidiaries at December 31, 2016 amounted to 321 million euros. Total unrecognized tax credits for tax loss carryforwards in Latin America amount to 273 million euros.

**Deductions**

The Group has recognized 1,727 million euros corresponding to the total amount of unused tax deductions at December 31, 2016, of the tax group in Spain, generated primarily from export activity, double taxation and donations to non-profit organizations.

In 2016 and 2015, tax credits from deductions were recognized, in the amount of 755 and 65 million euros, respectively.

**Temporary differences**

The sources of deferred tax assets and liabilities from temporary differences recognized at December 31, 2016 and 2015 are as follows:

| Millions of euros   | 12/31/2016 | 12/31/2015 (*) |
|---|------------|----------------|
| Goodwill and intangible assets  | 1,347      | 910            |
| Property, plant and equipment   | 1,243      | 1,124          |
| Personnel commitments   | 1,665      | 1,491          |
| Provisions  | 1,134      | 1,337          |
| Investments in subsidiaries, associates and other shareholdings                                       | -          | 163            |
| Inventories and receivables   | 356        | 376            |
| Other   | 1,154      | 1,189          |
| Total deferred tax assets for temporary differences   | 6,899      | 6,590          |
| Deferred tax assets and liabilities offset  | (2,910)    | (2,000)        |
| Total deferred tax assets for temporary differences registered in the statement of financial position | 3,989      | 4,590          |

(\*) Amended data (see Note 2).



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| Millions of euros  | 12/31/2016 | 12/31/2015<br>(*) |
|--|------------|-------------------|
| Goodwill and intangible assets   | 2,308      | 1,426             |
| Property, plant and equipment  | 1,190      | 1,168             |
| Personnel commitments  | 34         | 53                |
| Provisions   | 31         | 31                |
| Investments in subsidiaries, associates and other shareholdings  | 1,299      | 1,430             |
| Inventories and receivables  | 85         | 101               |
| Other  | 358        | 341               |
| Total deferred tax liabilities for temporary differences   | 5,305      | 4,550             |
| Deferred tax assets and liabilities offset   | (2,910)    | (2,000)           |
| Total deferred tax liabilities for temporary differences registered in the statement of financial position | 2,395      | 2,550             |

(\*) Amended data (see Note 2).

Deferred tax assets and liabilities are offset if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

The heading "Other" includes, among others, the difference between the accounting and tax values created by the value of financial derivatives at year end (see Note 16).

## Tax payables and receivables

Current tax payables and receivables at December 31, 2016 and 2015 are as follows:

| Millions of euros            | Balance at 12/31/2016 | Balance at 12/31/2015 (*) |
|------------------------------|-----------------------|---------------------------|
| Taxes payable                |                       |                           |
| Tax withholdings             | 81                    | 134                       |
| Indirect taxes               | 1,086                 | 1,047                     |
| Social security              | 157                   | 160                       |
| Current income taxes payable | 486                   | 424                       |
| Other                        | 522                   | 476                       |
| Total                        | 2,332                 | 2,241                     |

(\*) Amended data (see Note 2).

| Millions of euros               | Balance at 12/31/2016 | Balance at 12/31/2015 (*) |
|---------------------------------|-----------------------|---------------------------|
| Tax receivables                 |                       |                           |
| Indirect tax                    | 790                   | 593                       |
| Current income taxes receivable | 601                   | 516                       |
| Other                           | 142                   | 232                       |
| Total                           | 1,533                 | 1,341                     |

(\*) Amended data (see Note 2).



**Reconciliation of book profit before taxes to taxable income**

The reconciliation between book profit before tax and the income tax expense from continuing operations for 2016, 2015 and 2014 is as follows:

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| Millions of euros   | 2016  | 2015 (*) | 2014 (*) |
|---|-------|----------|----------|
| Accounting profit before tax  | 3,245 | 906      | 3,635    |
| Tax expense at prevailing statutory rate  | 897   | 209      | 1,046    |
| Permanent differences   | (42)  | 177      | 317      |
| Changes in deferred tax charge due to changes in tax rates<br>(Capitalization) / reversal of tax deduction and tax relief | 1     | (8)      | 89       |
| Reversal / (capitalization) of loss carryforwards   | (762) | 453      | (74)     |
| Increase / (Decrease) in tax expense arising from temporary differences   | 714   | (1,200)  | (255)    |
| Other   | (8)   | 72       | (792)    |
| Income tax expense  | 46    | 452      | 52       |
| Breakdown of current/deferred tax expense   | 846   | 155      | 383      |
| Current tax expense   | 1,012 | 1,753    | 1,480    |
| Deferred tax expense / (benefit)  | (166) | (1,598)  | (1,097)  |
| Total income tax expense  | 846   | 155      | 383      |

(\*) Amended data (see Note 2).

“Other” in 2015 includes the impacts of the inspections in the tax group in Spain and the provision recognized in Telefónica del Perú.

**Tax inspections and tax-related lawsuits****Inspections in the tax group in Spain**

With regard to the tax inspection for the years 2001 to 2004, the Supreme Court issued a ruling in 2015, accepting the tax losses incurred by the Group in relation to the transfer of certain interests in TeleSudeste, Telefónica Móviles México and Lycos as tax deductible, rejecting the other contentions, and therefore the contingencies related to this process disappeared. This resulted in recognition of a tax expense of 49 million euros in the 2015 consolidated income statement. However, this did not require payment of any tax because the Company applied unused tax loss carryforwards to offset the effect of these adjustments, at the corresponding tax rate for each period.

In 2012, tax inspections for all taxes for the years 2005 to 2007 were completed, with the Company signing off a corporate income tax assessment of 135 million euros, which was paid in 2012, whilst disputing other adjustments with which it disagreed. Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, since the adjustments proposed were offset by unused tax loss carryforwards, the Company filed an appeal with the Central Economic-Administrative Court against these adjustments in May 2015, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends.

In July 2015 tax inspections for all taxes for the years 2008 to 2011 were completed, with the Company signing off certain corporate income tax assessments and disputing others. This resulted in 2015 in an expense amounting to 206 million euros. However, this did not require any tax payment, as the adjustments arising from the inspection were

offset by unused tax loss carryforwards, at the corresponding tax rate for each period.

Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, in July 2015 the Company filed an appeal with the Central Economic-Administrative Court against the adjustments it disputes, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends, and the criteria to use tax loss carryforwards in the years subject to settlement.

At 2016 year end, it is not expected that there is any need to recognize additional liabilities for the outcome of this litigation.

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**Telefónica Brazil**

The Telefónica Group is involved in a range of tax litigation in Brazil over direct and indirect taxes (including those relating to GVT). This includes a number of appeals relating to ICMS tax (a tax similar to VAT, levied on telecommunications services). There is a dispute with the Brazilian tax authorities over which services should be subject to settlement of this tax. In 2016 the tax authorities embarked upon a new round of inspections in this regard.

To date the most significant issues have focused on the requirement to collect ICMS on penalties charged to customers for non-compliance, Internet advertising services, and complementary or additional services to the basic telecommunications services such as value-added services, modem rental, and the application of this tax on the basic fee (*assinatura básica*).

All related procedures are being contested in all instances (administrative and court proceedings). The aggregate amount of the relevant proceedings, updated to take into account interest, fines and other items, is approximately 14,676 million Brazilian reais (approximately 4,272 million euros). No provisions have been set aside for these matters, as the risk of them giving rise to liabilities is not probable. Telefónica Brazil has obtained independent expert reports supporting its position, i.e. that the aforesaid services are not subject to ICMS.

In addition, in December 2016, Telefónica Brazil received a proposed adjustment from the tax authorities in relation to the tax amortization, from October to December 2011, of the goodwill generated by Telefónica Brazil's acquisition and merger of Vivo. This procedure is at its first administrative stage and no provisions have been made, since the potential risk associated to this proceeding has been classified as “not probable” and Telefónica Brazil has received independent expert reports that support this view.

**Telefónica del Perú**

With regard to tax matters in Peru, litigation continues over corporate income tax for 2000 and 2001, payments on account in respect of the year 2000, recoverable balances for 1998 and 1999, and the interest and penalties that should apply to these.

In August 2015, the court of second instance handed down a ruling partially upholding the position of Telefónica del Perú, ruling in its favor on three of the five objections filed by the tax authorities and appealed against to the courts, relating, inter alia, to corporate income tax for 2000-2001 (among others). This dispute accounts for more than 75% of the total amount under litigation, with the objections relating to insolvency provisions, interest on borrowing and leases of space for public telephones. Both the tax authorities and the company have filed appeals against the decision in higher courts.

At the time of authorization for issue of these consolidated financial statements, the settlements carried out by SUNAT for 2000 and 2001 are in the final instance of the legal process (under review by the Supreme Court) in 2016, and a ruling has not yet been released.

In connection with these proceedings in Peru, the Group and its legal advisors consider that the Group's position continues to be based on robust legal arguments.

In parallel to the aforementioned court proceedings, the tax authorities proceeded to collect corporate income tax due for the years 2000-2001 and payments on account of corporate income tax in respect of the year 2000. There were successive reductions to the sums claimed in the two cases following appeals filed by Telefónica del Perú against the settlements and due to the precautionary measures imposed. The company paid out 286 million Peruvian soles (approximately, 80 million euros) in 2012 and 2013 pending the final rulings.

In the context of these execution processes, in June 2015 the tax authorities issued Compliance Resolutions demanding payment of 1,521 million Peruvian soles (approximately 431 million euros). An appeal was filed against this with the Tax Court, and the adoption of precautionary suspension measures duly requested from the legal authorities (as a definitive court ruling on these cases is currently pending). No ruling was made in relation to these appeals in 2016.

Given the sentences and rulings handed down in June and August 2015, the Group decided to recognize a provision in the 2015 consolidated financial statements of 431 million euros (see Note 15).

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**Tax deductibility of financial goodwill**

Spain added a new article 12.5 to its Corporate Income Tax Law, which came into force on January 1, 2002. The article regulated the deductibility of tax amortization of financial goodwill arising from the acquisition of non-Spanish companies, which could be amortized over 20 years at 5% per annum. Following the entry into force of the Laws 9/2011 of August 19, 2011 and 16/2013 of October 29, 2013, the amount of goodwill amortization deductible for tax purposes under article 12.5 for the years 2011 to 2015 was reduced from 5% to 1%. The effect is temporary because the 4% not amortized during five years (20% in total) will be recovered extending the deduction period from the initial 20 years to 25 years.

The Telefónica Group, under this regulation, has been amortizing for tax purposes the financial goodwill from its investments, both direct and indirect, in O2, BellSouth and Colt (prior to December 21, 2007) and Vivo (acquired in 2010). The positive accumulated effect in the corresponding settlements of corporate income tax from 2004 to the closing of December 31, 2016, was 1,063 million euros.

In relation to this tax incentive, the European Commission (EC) has in recent years commenced three proceedings against the Spanish State as it deems that this tax benefit could constitute an example of state aid. Although the EC itself acknowledged the validity of its first two decisions for those investors that invested in European companies (for operations carried out before December 21, 2007 in the first decision, and before May 21, 2011 for investments in other countries in the second decision), in its third decision from October 15, 2014 it calls into question the applicability of the principle of legitimate expectations in the application of the incentive for indirect acquisitions, whatever the date of acquisition may have been.

However, at the issuance date of these consolidated financial statements the three decisions continue subject to a final ruling. The first two were annulled by two judgments of the General Court of the European Union, which were appealed by the EC before the Court of Justice of the European Union and sent again to the General Court by the Judgment dated December 21, 2016, to reassess the tax incentive. The third decision is still pending a judgment at first instance. Furthermore, there are doubts in the Spanish courts regarding the classification of the incentive as a deduction and if this deduction would remain in the case of a subsequent transfer of the relevant stake.

The Group has continued provisioning the amount of the goodwill amortized for tax purposes, corresponding mainly to the purchase of Vivo, for a total of 147 million euros at December 31, 2016 (79 million euros at December 31, 2015). The amount relating to the companies of the O2 Group was reversed after the EC's decision to prohibit the sale of Telefónica United Kingdom (see Note 23).

**Years open for inspection**

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The years open for review by the tax inspection authorities for the main applicable taxes vary from one consolidated company to another, based on each country's tax legislation, taking into account their respective statute-of-limitations periods. In Spain, following the tax audit completed in 2015, the taxes from 2012 onwards are open to inspection with respect to the main companies of the Spanish tax group.

In the other countries in which the Telefónica Group has a significant presence, the years open for inspection by the relevant authorities are generally as follows:

- The last twelve years in Germany.
- The last ten years in El Salvador.
- The last eight years in United Kingdom.
- The last six years in Argentina and Colombia.
- The last five years in Brazil, Mexico, Uruguay and the Netherlands.
- The last four years in Venezuela, Peru, Guatemala, Nicaragua and Costa Rica.
- The last three years in Chile, Ecuador, the United States and Panama.

The tax inspection of the open years is not expected to give rise to additional material liabilities for the Group.

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## Note 18. Revenue and expenses

**Revenues**

The breakdown of “Revenues” is as follows:

| Millions of euros     | 2016   | 2015 (*) | 2014 (*) |
|-----------------------|--------|----------|----------|
| Rendering of services | 47,321 | 49,681   | 46,007   |
| Net sales             | 4,715  | 5,235    | 4,370    |
| Total                 | 52,036 | 54,916   | 50,377   |

(\*) Amended data (see Note 2).

**Other income**

The breakdown of “Other income” is as follows:

| Millions of euros                | 2016  | 2015 (*) | 2014 (*) |
|----------------------------------|-------|----------|----------|
| Own work capitalized             | 867   | 946      | 774      |
| Gain on disposal of companies    | 228   | 18       | 5        |
| Gain on disposal of other assets | 130   | 298      | 367      |
| Government grants                | 28    | 33       | 36       |
| Other operating income           | 510   | 716      | 525      |
| Total                            | 1,763 | 2,011    | 1,707    |

(\*) Amended data (see Note 2).

“Gain on disposal of companies” in 2016 includes the gain on disposal of Telefónica Media Argentina, S.A. and Atlántida Comunicaciones, S.A., holding companies of the Group’s stake in Televisión Federal, S.A. (Telefé), amounting to 199 million euros.

“Gain on disposal of other assets” includes gains from the sale of telephone towers of 1 million euros, 65 million euros and 198 million euros in 2016, 2015 and 2014, respectively. In 2015 it is also included the result of a spectrum swap with AT&T carried out by Telefónica Móviles México, amounting to 79 million euros.



“Other operating income” in 2015 included the registered result from the difference between the preliminary purchase price of E-Plus estimated at the end of the valuation period and the final price agreed with KPN, which amounted to 104 million euros (see Note 5). In 2015 it is also included an income resulting from the expiration of an account payable in Telefónica Brazil, amounting to 98 million euros.

**Other expenses**

The breakdown of “Other expenses” is as follows:

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| Millions of euros   | 2016   | 2015 (*) | 2014 (*) |
|---|--------|----------|----------|
| Leases  | 1,076  | 1,163    | 1,039    |
| Advertising   | 1,256  | 1,367    | 1,226    |
| Other external services   | 10,436 | 11,586   | 9,811    |
| Taxes other than income tax   | 1,136  | 1,232    | 1,094    |
| Change in trade provisions  | 799    | 831      | 693      |
| Losses on disposal of fixed assets and changes in provisions for fixed assets | 71     | 39       | 58       |
| Goodwill impairment (Note 7)  | 215    | 104      | –        |
| Other operating expenses  | 352    | 480      | 368      |
| Total   | 15,341 | 16,802   | 14,289   |

(\*)Amended data (see Note 2).

“Other external services” in 2015 included a 325 million euros expense in relation with the Telefónica, S.A.’s irrevocable commitment to pay a 325 million euros donation to Fundación Telefónica to provide this entity with the financing required to implement the social programs and activities it currently performs or could initiate in the short and medium term to fulfill its purpose as a foundation.

**Estimated payment schedule**

The estimated payment schedule in millions of euros for the next few years on operating leases and purchase and other contractual commitments (non-cancellable without penalty cost) are as follows:

| 12/31/2016  | Total         | Less than 1 year | 1 to 3 years | 3 to 5 years | More than 5 years |
|---|---------------|------------------|--------------|--------------|-------------------|
| Telefónica Brazil   | <b>4,326</b>  | 544              | 1,073        | 881          | 1,828             |
| Telefónica Germany  | <b>2,402</b>  | 510              | 671          | 489          | 732               |
| Telefónica Hispanoamérica                                 | <b>2,251</b>  | 435              | 686          | 544          | 586               |
| Telefónica Spain  | <b>919</b>    | 158              | 270          | 216          | 275               |
| Telefónica United Kingdom                                 | <b>452</b>    | 138              | 130          | 75           | 109               |
| Others  | <b>110</b>    | 16               | 31           | 24           | 39                |
| Operating lease obligations <sup>(1)</sup>                | <b>10,460</b> | <b>1,801</b>     | <b>2,861</b> | <b>2,229</b> | <b>3,569</b>      |
| Purchase and other contractual obligations <sup>(2)</sup> | <b>12,426</b> | <b>5,391</b>     | <b>3,883</b> | <b>1,204</b> | <b>1,948</b>      |

(1) This item includes definitive payments (non-cancellable without penalty cost). Our operating lease obligations have in some cases extension options conditioned on the applicable law of each country. Accordingly, we have included only those amounts that represent the initial contract period.

(2) This item includes definitive payments (non-cancellable without penalty cost) due for agreements to purchase goods (such as network equipment) and services.

At December 31, 2016, the present value of future payments for Telefónica Group operating leases was 7,894 million euros (2,450 million euros in Telefónica Brazil, 2,294 million euros in Telefónica Germany, 1,748 million euros in Telefónica Hispanoamérica, 882 million euros in Telefónica Spain, 418 million euros in Telefónica United Kingdom and 102 million euros in other companies classified as “Others” on the table above).

The main finance lease transactions are described in Note 22.

## **Headcount**

The table below presents the breakdown of the Telefónica Group’s average number of employees by segment (see Note 4) in 2016, 2015 and 2014, together with total headcount at December 31 each year. Comparative figures have been amended to include the employees in Telefónica United Kingdom (see Note 2).

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|                           | 2016           |                | 2015           |                | 2014           |                |
|---------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
|                           | Average        | Year-end       | Average        | Year-end       | Average        | Year-end       |
| Telefónica Spain          | 29,538         | 28,107         | 31,354         | 32,171         | 29,840         | 30,020         |
| Telefónica United Kingdom | 7,454          | 7,075          | 7,677          | 7,616          | 7,576          | 7,436          |
| Telefónica Germany        | 8,341          | 8,517          | 9,941          | 8,557          | 6,596          | 10,848         |
| Telefónica Brazil         | 34,247         | 33,782         | 28,488         | 33,847         | 18,337         | 18,419         |
| Telefónica Hispanoamérica | 38,889         | 38,901         | 38,232         | 37,951         | 38,098         | 38,104         |
| Other companies           | 13,651         | 10,941         | 17,877         | 17,364         | 20,050         | 18,673         |
| <b>Total</b>              | <b>132,120</b> | <b>127,323</b> | <b>133,569</b> | <b>137,506</b> | <b>120,497</b> | <b>123,500</b> |

The Group consolidates GVT and DTS from May 2015 (see Note 5). The number of employees of GVT and DTS at that date was 18,179 and 1,818, respectively.

The Group consolidates E-Plus from October 2014 (see Note 5). The number of employees of the E-Plus Group at that date was 5,033.

Of the final headcount at December 31, 2016, approximately 37.6% are women (37.8% at December 31, 2015).

At December 31, 2016, the number of employees with disabilities is 855 (239 in Spain).

In 2015 Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U. and Telefónica Soluciones de Informática y Comunicaciones de España, S.A.U. signed the first Collective Agreement of Related Companies (CEV). This agreement contemplated, among other elements, a plan of measures for individual suspension of the employment relationship in 2016 and 2017. In December 2016, the CEV was extended until 2018, by virtue of the provisions of this same agreement. In 2016, the expense relating to the forecast payments to meet the commitments resulting from the extension of this program was recognized. A total of 789 million euros was recorded for the Individual Suspension Plan in 2016 (2,896 million euros in 2015) (see Note 15).

**Depreciation and amortization**

The breakdown of “Depreciation and amortization” on the consolidated income statement is as follows:

| Millions of euros                             | 2016         | 2015 (*)     | 2014 (*)     |
|---|--------------|--------------|--------------|
| Depreciation of property, plant and equipment | 5,951        | 6,071        | 5,357        |
| Amortization of intangible assets             | 3,698        | 3,633        | 3,191        |
| <b>Total</b>                                  | <b>9,649</b> | <b>9,704</b> | <b>8,548</b> |

(\* Amended data (see Note 2).

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Table of Contents**Earnings per share**

As detailed in Notes 2 and 23, the comparative figures of Profit for the period have been amended with respect to those presented in the 2015 consolidated financial statements, in order to cease to present Telefónica United Kingdom as a discontinued operation.

Basic earnings per share amounts are calculated by dividing (a) the profit for the year attributable to equity holders of the parent, adjusted for the net coupon corresponding to the undated deeply subordinated securities and for the interest cost accrued in the period in relation to the debt component of the mandatorily convertible notes of the parent company (see note 12) by (b) the weighted average number of ordinary shares outstanding during the year plus the weighted average number of ordinary shares that would be issued upon the conversion of the said mandatorily convertible notes from the date of their issuance.

Diluted earnings per share amounts are calculated by dividing the net profit for the year attributable to ordinary equity holders of the parent, adjusted as described above, by the weighted average number of ordinary shares adjusted as described in the preceding paragraph, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

Both basic and diluted earnings per share attributable to equity holders of the parent are calculated based on the following data:

| Millions of euros  | 2016  | 2015  | 2014  |
|--|-------|-------|-------|
| Profit attributable to ordinary equity holders of the parent from continuing operations  | 2,369 | 616   | 3,001 |
| Adjustment for the net coupon corresponding to undated deeply subordinated securities  | (257) | (250) | (187) |
| Adjustment for the financial expense of the debt component of the mandatorily convertible notes  | 1     | 2     | –     |
| Total profit attributable to ordinary equity holders of the parent for basic and diluted earnings per share from continuing operations | 2,113 | 368   | 2,814 |

| Thousands   | 2016      | 2015 (*)  | 2014 (*)  |
|---|-----------|-----------|-----------|
| Number of shares  | 4,909,254 | 4,931,472 | 4,816,739 |
| Weighted average number of ordinary shares (excluding treasury shares) for basic earnings per share | 4,909,254 | 4,931,472 | 4,816,739 |
| Adjustment for mandatorily convertible notes  | 151,265   | 139,116   | 33,572    |
| Adjusted number of shares for basic earnings per share  | 5,060,519 | 5,070,588 | 4,850,311 |
| Telefónica, S.A. share option plans   | 2,716     | 5,093     | 11,407    |
| Weighted average number of ordinary shares outstanding for diluted earnings per share               | 5,063,235 | 5,075,681 | 4,861,718 |

(\*) Revised data due to the scrip dividend.

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For the purposes of calculating the earnings per share (basic and diluted), the weighted average number of shares outstanding is retrospectively adjusted for transactions that have changed the number of shares outstanding without a corresponding change in equity, as if such transactions had occurred at the beginning of the earliest period presented. Such is the case of the bonus share issues carried out to meet the scrip dividends paid in the last years have been taken into account (see Note 12).

Thus, basic and diluted earnings per share attributable to equity holders of the parent are as follows:

| Figures in euros           | 2016 | 2015 | 2014 |
|----------------------------|------|------|------|
| Basic earnings per share   | 0.42 | 0.07 | 0.58 |
| Diluted earnings per share | 0.42 | 0.07 | 0.58 |

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Note 19. Share-based payment plans

The main share-based payment plans in place in the 2014-2016 period are as follows:

**a) Long-term incentive plan based on Telefónica, S.A. shares: “Performance and Investment Plan 2011-2016”**

At the General Shareholders’ Meeting held on May 18, 2011, a long-term share-based incentive plan called “Performance and Investment Plan” was approved for Telefónica Group directors and executive officers.

Under this plan, a certain number of shares of Telefónica, S.A. were delivered to plan participants selected by the Company who decided to participate on compliance with stated requirements and conditions.

The plan lasted five years and was divided into three independent phases.

The first phase expired on June 30, 2014. The maximum number of shares assigned to this phase of the plan was 5,545,628 shares assigned on July 1, 2011, with a fair value of 8.28 euros per share. Delivery of shares was not required at the end of the phase according to the general conditions of the plan; therefore, managers did not receive any shares.

The second phase expired on June 30, 2015. The maximum number of shares assigned to this phase of the plan was 7,347,282, assigned on July 1, 2012, with a fair value of 5.87 euros per share. At the end date of this phase, it was determined that 77% of “Total Shareholder Return” (TSR) had been achieved, under the terms and conditions of the plan. Therefore, the eligible Telefónica Group executives received a total of 2,724,699 shares (corresponding to a total of 3,691,582 gross shares, of which 966,883 shares were withheld at the option of the employee prior to distribution).

The third and final phase expired on June 30, 2016. The maximum number of shares assigned to this phase of the plan was 7,020,473 shares assigned on July 1, 2013, with a fair value of 6.40 euros per share. Delivery of shares was not required at the end of the phase according to the general conditions of the plan; therefore, managers did not receive any shares.

**b) Long-term incentive plan based on Telefónica, S.A. shares: “Performance and Investment Plan 2014-2019”**



The Telefónica, S.A. General Shareholders' Meeting on May 30, 2014 approved a new instalment of the long-term share-based incentive "Performance and Investment Plan" for certain senior executives and members of the Group's management team, operational on completion of the first "Performance and Investment Plan".

Like its predecessor, the term of the new plan is a total of five years divided into three phases. The initial and the second share allocations took place on October 1, 2014, and on October 1, 2015, respectively. Regarding the third phase of this 2016-2019 Plan, the Company's Board of Directors, following a favorable report from the Nomination, Compensation and Corporate Governance Committee, resolved not to execute or implement it, after having decided that it was not sufficiently in line with the Telefónica Group's strategic plan, taking into account the circumstances and macroeconomic environment.

The maximum number of shares allocated under the plan (including the amount of co-investment) and the number of shares outstanding at December 31, 2016 are set out below:

| Phase / assignment date     | No. of shares assigned | Outstanding shares at 12/31/16 | Unit fair value | End date           |
|-----------------------------|------------------------|--------------------------------|-----------------|--------------------|
| 1st phase / October 1, 2014 | 6,927,953              | 5,658,725                      | 6.82            | September 30, 2017 |
| 2nd phase / October 1, 2015 | 6,775,445              | 5,829,806                      | 6.46            | September 30, 2018 |

c) Telefónica, S.A. global share plan: "Global Employee Share Plan II" (2012-2014) and "Global Employee Share Plan III" (2015-2017)

The Telefónica, S.A. Ordinary General Shareholders' Meeting on May 18, 2011 approved a voluntary plan for incentivized purchases of Telefónica, S.A. shares for all employees of the Telefónica Group worldwide, with certain exceptions. Under this plan, participants who met certain requirements were offered the possibility of buying shares in Telefónica, S.A., which undertook to deliver them a certain number of free shares.

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The plan's share holding period came to an end in December 2014. More than 21,000 employees on the scheme were rewarded with a total of 1,778,099 shares from Telefónica, valued at approximately 20 million euros at the time they were delivered with effect in equity.

Likewise, the Telefónica, S.A. Ordinary General Shareholders' Meeting on May 30, 2014 approved a new voluntary plan for incentivized purchases of shares for the employees of the Group. Under this Plan, employees were offered the option to acquire Telefónica, S.A. shares during a twelve month period (the acquisition period), with the company undertaking to deliver a certain number of free shares to participants, subject to certain requirements. Each employee was limited to buying a maximum of 1,800 euros in Telefónica, S.A. shares, subject to a minimum of 300 euros. If the employee remains part of the Telefónica Group and holds on to the shares for one year following the acquisition period (the shareholding period), they will be entitled to receive one free share for each share they acquire and retain throughout the shareholding period.

The acquisition period commenced in July 2015 and ended in June 2016. As of December 31, 2016, 29,700 employees had registered for the plan. The plan will be settled in 2017 through the delivery of shares to employees.

d) Long-term incentive plan based on Telefónica, S.A. shares: "Talent for the Future Share Plan" (TFSP)

At the General Shareholders' Meeting held on May 30, 2014, a long-term share-based incentive plan called "Talent for the Future Share Plan" was approved for certain Telefónica Group employees.

Under this Plan, a certain number of shares of Telefónica, S.A. will be delivered to participants selected by the Company who have opted to take part in the scheme and meet the requirements and conditions stipulated to this end. The plan has been implemented for employees with persistently outstanding performance, high potential and key skills who are expected to take leading roles in the future, by granting a stake in the share capital of the Company

The term of the plan is five years and it is divided into three phases. The initial and the second share allocations took place on October 1, 2014, and on October 1, 2015, respectively. Regarding the third phase of this 2016-2019 Plan, the Company's Board of Directors, following a favorable report from the Nomination, Compensation and Corporate Governance Committee, resolved not to execute or implement it, after having decided that it was not sufficiently in line with the Telefónica Group's strategic plan, taking into account the circumstances and macroeconomic environment.

The maximum number of shares assigned and the number of shares outstanding at December 31, 2016 is as follows:

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| Phase /assignment<br>date | No. of shares assigned | No. of shares assigned<br>at 12/31/16 | Unit fair value | End date           |
|---------------------------|------------------------|---------------------------------------|-----------------|--------------------|
| 1st phase October 1, 2014 | 556,795                | 533,552                               | 6.82            | September 30, 2017 |
| 2nd phase October 1, 2015 | 618,000                | 592,500                               | 6.46            | September 30, 2018 |

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Note 20. Cash flow analysis

**Net cash flow provided by operating activities**

Net cash flow provided by operating activities amounted to 13,338 million euros in 2016, a 2.0% fall on the 13,615 million euros of 2015, which itself was an increase on the figure of 11.7% recognized in 2014.

The detail of net cash flow provided by operating activities is the following:

| Millions of euros  | 2016            | 2015 (*)        | 2014 (*)        | Var<br>16 vs 15 | Var<br>15 vs 14 |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|
| <b>Cash received from operations</b>   | <b>63,514</b>   | <b>67,582</b>   | <b>61,522</b>   | <b>(6.0%)</b>   | <b>9.9%</b>     |
| <b>Cash paid from operations</b>   | <b>(47,384)</b> | <b>(50,833)</b> | <b>(45,612)</b> | <b>(6.8%)</b>   | <b>11.4%</b>    |
| Cash paid to suppliers   | (40,831)        | (43,650)        | (39,566)        | (6.5%)          | 10.3%           |
| Cash paid to employees   | (5,815)         | (6,462)         | (5,257)         | (10.0%)         | 22.9%           |
| Payments related to cancellation of commitments  | (738)           | (721)           | (789)           | 2.4%            | (8.6%)          |
| <b>Net payments of interest and other financial expenses net of dividends received</b> | <b>(2,143)</b>  | <b>(2,445)</b>  | <b>(2,530)</b>  | <b>(12.4%)</b>  | <b>(3.4%)</b>   |
| Net interest and other financial expenses paid   | (2,187)         | (2,490)         | (2,578)         | (12.2%)         | (3.4%)          |
| Dividends received   | 44              | 45              | 48              | (2.2%)          | (6.3%)          |
| <b>Taxes paid</b>  | <b>(649)</b>    | <b>(689)</b>    | <b>(1,187)</b>  | <b>(5.8%)</b>   | <b>(42.0%)</b>  |
| Net cash flow provided by operating activities   | <b>13,338</b>   | <b>13,615</b>   | <b>12,193</b>   | <b>(2.0%)</b>   | <b>11.7%</b>    |

(\*) Amended data (see Note 2).

The changes in the main items included in the net cash flow from operating activities are as follows:

**Cash received from operations** fell 6% in 2016 with respect to the amount recognized in 2015, mainly due to exchange rate changes. In addition, the Company continued its active working capital management policy, focused on factoring and the advance monetization of revenues from financed sales.

Cash received from operations in 2015, showed an increase of 9.9% on the 2014 figure, largely driven by the active management of working capital, focused on factoring and the advance monetization of revenues from financed sales, the inclusion of GVT and DTS in the consolidation perimeter and the higher contribution of E-Plus in 2015, and the increase in revenues in T. Hispanoamérica.

**Cash paid from operations** in 2016, was down 6.8% on 2015, principally as a result of changes in the exchange rate and due to the active management of current liabilities through improvements in the processes and agreements to extend payment terms with suppliers, or factoring companies when payments are discounted (Note 13).

Cash paid from operations increased by 11.4% year-on-year in 2015. Active management of current liabilities through agreements to extend payment terms with suppliers, or factoring companies when payments are discounted, enabled the Group to counteract the effect of the higher payments resulting from the changes to the consolidation scope and increased commercial activity in Latin America.

**Cash paid to employees** fell by 10% in 2016, compared with the figure for 2015, largely due to changes in the headcount.

Cash paid to employees in 2015, experienced a year-on-year increase of 22.9%, as a result of the higher costs associated with the change in average headcount after the inclusion of the new companies in the consolidation perimeter.

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**Net payments of interest and other financial expenses net of dividends received** declined by 12.4% in 2016 with respect to 2015, largely due to the lower cost of debt in European currencies. Net financial payments represent 3.94% of the net average financial debt plus commitments in the year.

Net payments of interest and other financial expenses net of dividends received in 2015, fell by 3.4% compared with 2014, despite Telefónica Group's average debt rising by 5.1%. Telefónica Spain's contribution to the reduction of payments of 4.2% was mainly due to capturing the benefits of a lower euro exchange rate and the reduction of the fixed-rate debt in euros. Net financial payments represent 4.96% of the net average financial debt plus commitments in the year.

**Taxes paid** were 5.8% lower, year-on-year, in 2016 mainly due to the lower payments in advance in Argentina and Brazil, and the exchange rate effect, offset by lower tax refunds and higher payments in advance in Spain.

Taxes paid fell 42% in 2015 compared to the payments made in 2014, principally as a result of lower payments in advance in Spain during 2015, and higher tax refunds, arising from prior years, in both Germany and Spain.

**Net cash flow used in investing activities**

Net cash flow used in investing activities amounted to 8,208 million euros in 2016, down 36.5% on 2015 (12,917 million euros), a figure which represented an increase of 29.6% on that of 2014 (9,968 million euros).

In respect of the main items included in the net cash flow used in investing activities, the detail is the following:

**(Payments on investments)/proceeds from the sale in property, plant and equipment and intangible assets, net** in 2016, decreased by 10.4% compared to 2015. The detail is the following:

| Millions of euros   | 2016           | 2015 (*)        | 2014 (*)       | Var<br>16 vs 15 | Var<br>15 vs<br>14 |
|---|----------------|-----------------|----------------|-----------------|--------------------|
| Proceeds from the sale in property, plant and equipment and intangible assets                                       | 134            | 254             | 340            | (47.2%)         | (25.3%)            |
| Payments on investments in property, plant and equipment and intangible assets                                      | (9,321)        | (10,510)        | (9,205)        | (11.3%)         | 14.2%              |
| <b>(Payments on investments)/proceeds from the sale in property, plant and equipment and intangible assets, net</b> | <b>(9,187)</b> | <b>(10,256)</b> | <b>(8,865)</b> | <b>(10.4%)</b>  | <b>15.7%</b>       |

(\*) Amended data (see Note 2).

**Payments on investments in property, plant and equipment and intangible assets** fell by 11.3% in 2016 compared to a year earlier, mainly due to lower payments in Telefónica Germany, which itself was due to the significant impact of spectrum licenses in 2015. Spectrum license payments totaled 349 million euros in 2016, notably in Group companies in Peru and Brazil.

Payments on investments in property, plant and equipment and intangible assets totaled 10,510 million euro in 2015, a rise of 14.2% compared to a year earlier, mainly due to higher payments in Telefónica Germany, which was partially offset by the fall in payments from Telefónica Brazil. These were the result of lower investments and the impact of a fall in the exchange rate. Spectrum license payments totaled 1,309 million euros in 2015, mainly in Group companies in Germany, Spain, Argentina and Ecuador.

The detail of **proceeds on disposals of companies, net of cash and cash equivalents disposed** and **payments on investments in companies, net of cash and cash equivalents acquired** is the following:

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| Millions of euros  | 2016        | 2015(*)        | 2014(*)        | Var<br>16 vs 15 | Var<br>15 vs 14 |
|--|-------------|----------------|----------------|-----------------|-----------------|
| Sale of Televisión Federal, S.A. (Telefé) (see Note 18)                                | 306         | –              | –              |                 |                 |
| Proceeds arising from hedges associated with Telefónica United Kingdom                 | 399         | –              | –              |                 |                 |
| Sale of Yourfone GmbH  | –           | 57             | –              |                 |                 |
| Sale of Telefónica Czech Republic  | –           | 313            | 2,163          |                 |                 |
| Sale of Telefónica Ireland   | –           | –              | 754            |                 |                 |
| Sale of 2.5% of China Unicom (Hong Kong) Limited                                       | –           | –              | 687            |                 |                 |
| Others   | 62          | (16)           | 11             |                 |                 |
| <b>Proceeds on disposals of companies, net of cash and cash equivalents disposed</b>   | <b>767</b>  | <b>354</b>     | <b>3,615</b>   | <b>n.m.</b>     | <b>(90.2%)</b>  |
| Acquisition of DTS (see Note 5)  | (36)        | (697)          | (325)          |                 |                 |
| Acquisition of GVT (see Note 5)  | –           | (2,450)        | –              |                 |                 |
| Acquisition of E-Plus (see Note 5)   | –           | –              | (4,569)        |                 |                 |
| Others   | (18)        | (34)           | (126)          |                 |                 |
| <b>Payments on investments in companies, net of cash and cash equivalents acquired</b> | <b>(54)</b> | <b>(3,181)</b> | <b>(5,020)</b> | <b>(98.3%)</b>  | <b>(36.6%)</b>  |

(\*) Amended data (see Note 2).

n.m.: not meaningful.

The detail of **proceeds on financial investments not included under cash equivalents** and **payments on financial investments not included under cash equivalents** is the following:

| Millions of euros  | 2016         | 2015 (*)     | 2014 (*)     | Var<br>16 vs 15 | Var<br>15 vs 14 |
|--|--------------|--------------|--------------|-----------------|-----------------|
| Sale of stake in Indra   | 85           | –            | –            |                 |                 |
| Sale of stake in China Unicom (Hong Kong) Limited (see Note 13)              | 322          | –            | –            |                 |                 |
| Sale of stake in Telecom Italia, S.p.A. (Note 13)                            | –            | 1,025        | –            |                 |                 |
| Sale of Telecom Italia's bond  | –            | –            | 103          |                 |                 |
| Sale of Atento   | –            | –            | 87           |                 |                 |
| Others   | 82           | 117          | 112          |                 |                 |
| <b>Proceeds on financial investments not included under cash equivalents</b> | <b>489</b>   | <b>1,142</b> | <b>302</b>   | <b>(57.2%)</b>  | <b>n.m.</b>     |
| Legal deposits   | (104)        | (86)         | (141)        |                 |                 |
| Investment in Mediaset Premium   | (20)         | (100)        | –            |                 |                 |
| Payment to shareholders of Telco, S.p.A.                                     | –            | (60)         | –            |                 |                 |
| Others   | (141)        | (180)        | (106)        |                 |                 |
| <b>Payments on financial investments not included under cash equivalents</b> | <b>(265)</b> | <b>(426)</b> | <b>(247)</b> | <b>(37.8%)</b>  | <b>72.5%</b>    |

(\*) Amended data (see Note 2).

n.m.: not meaningful.



Payments and proceeds on placements of cash surpluses not included under cash equivalents in 2016 and 2015 largely relate to placements made by Telefónica, S.A.

**Net cash flow used in financing activities**

Net cash flow used in financing activities amounted as net payment to 4,220 million euros, an increase of 16,8% with respect to 2015.

In 2015, the negative cash flow used in financing activities fell by 10.6% year-on-year, to reach 3,612 million euros, due largely to the increase of proceeds on loans, borrowings and promissory notes.

The detail of dividends paid, proceeds from issue of share capital increase, payments and proceeds of treasury shares and other operations with shareholder and operations with other equity holders is the following:

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| Millions of euros   | 2016           | 2015(*)        | 2014(*)        | Var<br>16 vs 15 | Var<br>15 vs 14 |
|---|----------------|----------------|----------------|-----------------|-----------------|
| Dividends paid byTelefónica, S.A. (**)  | (2,395)        | (2,237)        | (2,001)        |                 |                 |
| Payments to non-controlling interests of Telefônica Brasil, S.A.  | (216)          | (239)          | (187)          |                 |                 |
| Payments to non-controlling interests of Telefónica Deutschland Holding, A.G.                                 | (263)          | (267)          | (122)          |                 |                 |
| Payments to non-controlling interests of Telefónica Centroamérica Inversiones                                 | (27)           | (28)           | (14)           |                 |                 |
| Others  | (5)            | (4)            | (4)            |                 |                 |
| <b>Dividends paid</b> (see Note 12)   | <b>(2,906)</b> | <b>(2,775)</b> | <b>(2,328)</b> | <b>4.7%</b>     | <b>19.2%</b>    |
| Share capital increase of Telefónica, S.A. (Note 12)  | -              | 3,048          | -              |                 |                 |
| Share capital increase of Telefônica Brasil, S.A.   | -              | 1,258          | -              |                 |                 |
| Share capital increase by the non-controlling interests in Telefónica Deutschland                             | -              | -              | 814            |                 |                 |
| Others  | -              | (51)           | -              |                 |                 |
| <b>Proceeds from share capital increase</b>   | <b>-</b>       | <b>4,255</b>   | <b>814</b>     | <b>n.m.</b>     | <b>n.m.</b>     |
| Transactions with Telefónica, S.A. treasury shares (see Note 12 g)  | (645)          | (1,615)        | (1,204)        |                 |                 |
| Transactions with Telefónica Deutschland Holding, A.G. treasury shares  | -              | (133)          | -              |                 |                 |
| Transactions with Telefônica Brasil, S.A. treasury shares   | -              | (24)           | -              |                 |                 |
| Others  | (15)           | -              | (37)           |                 |                 |
| <b>(Payments)/proceeds of treasury shares and other operations with shareholders</b>                          | <b>(660)</b>   | <b>(1,772)</b> | <b>(1,241)</b> | <b>(62.8%)</b>  | <b>42.8%</b>    |
| Issuance of undated deeply subordinated securities (Note 12)  | 1,000          | 419            | 2,600          |                 |                 |
| Issuance of notes mandatorily convertible into shares of Telefónica, S.A. (See Note 12)                       | -              | -              | 1,285          |                 |                 |
| Payment of the coupon related to the issuances of undated deeply subordinated securities issued (See Note 12) | (344)          | (336)          | (172)          |                 |                 |
|   | <b>656</b>     | <b>83</b>      | <b>3,713</b>   | <b>n.m.</b>     | <b>(97.8%)</b>  |
| <b>Operations with other equity holders</b>   |                |                |                |                 |                 |

(\*)Amended data (see Note 2).

n.m.: not meaningful.

(\*\*)This amount differs from that indicated in Note 12 because of withholding taxes deducted in the payment to certain major shareholders.

The detail of proceeds on issue of debentures and bonds, and other debts, proceeds on loans, borrowings and promissory notes, cancellation of debentures and bonds, and other debts, repayments of loans, borrowings and promissory notes and financed operating payments and investments in property, plant and equipment and intangible assets payments is the following:

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| Millions of euros   | 2016           | 2015(*)        | 2014(*)        | Var 16 vs 15   | Var 15 vs 14   |
|---|----------------|----------------|----------------|----------------|----------------|
| Issued under the EMTN program of Telefónica Emisiones, S.A.U. (see Appendix III)  | 4,900          | 1,467          | 2,550          |                |                |
| Issued of non-dilutive convertible debentures in Telefónica Participaciones, S.A.U. (Appendix III)                                      | 600            | -              | -              |                |                |
| Issued under the SHELFF program of Telefónica Emisiones, S.A.U.   | -              | -              | 368            |                |                |
| Issue mandatorily convertible into Telecom Italia, S.p.A. shares  | -              | -              | 750            |                |                |
| Bond issue by Telefónica Deutschland Holding, A,G,  | -              | -              | 500            |                |                |
| Others  | 193            | 135            | 285            |                |                |
| <b>Proceeds on issue of debentures and bonds, and other debts</b>   | <b>5,693</b>   | <b>1,602</b>   | <b>4,453</b>   | <b>n.m.</b>    | <b>(64.0%)</b> |
| Syndicated loan of 3,000 million euros by Telefónica, S.A. (see Note 13)  | 3,070          | -              | -              |                |                |
| Syndicated loan of 2,500 million euros by Telefónica, S.A.  | -              | 2,060          | -              |                |                |
| Syndicated loan of 3,000 million euros by Telefónica, S,A, (see Note 13)  | 1,280          | 1,890          | -              |                |                |
| Issuance of debt instruments in the local market (schuldscheindarlehen and namensschuldverschreibung) by Telefónica Germany GmbH&Co OHG | -              | 300            | -              |                |                |
| Borrowings proceeds of 2,000 million euros in Telefónica, S.A.  | -              | -              | 2,000          |                |                |
| Others  | 5,982          | 4,534          | 2,290          |                |                |
| <b>Proceeds on loans, borrowings and promissory notes (see Appendix V)</b>  | <b>10,332</b>  | <b>8,784</b>   | <b>4,290</b>   | <b>17.6%</b>   | <b>n.m.</b>    |
| <b>Cancellation of debentures and bonds, and other debts</b>  | <b>(6,873)</b> | <b>(3,805)</b> | <b>(5,116)</b> | <b>80.6%</b>   | <b>(25.6%)</b> |
| Syndicated loan of 3,000 million euros by Telefónica, S.A. (see Note 13)  | (3,070)        | -              | -              |                |                |
| Syndicated loan of 2,500 million euros by Telefónica, S.A.  | -              | (1,560)        | -              |                |                |
| Syndicated loan of 3,000 million euros by Telefónica, S.A. (see Note 13)  | (1,980)        | (1,190)        | -              |                |                |
| Loans paid by GVT   | (93)           | (1,766)        | -              |                |                |
| Prepayments of loans and the maturity of Tranche A2   | -              | -              | (2,000)        |                |                |
| Prepayments of loans and the maturity of Tranche A3   | -              | -              | (1,672)        |                |                |
| Others  | (3,363)        | (5,342)        | (4,932)        |                |                |
| <b>Repayments of loans, borrowings and promissory notes (See Appendix V)</b>  | <b>(8,506)</b> | <b>(9,858)</b> | <b>(8,604)</b> | <b>(13.7%)</b> | <b>14.6%</b>   |
| Financed spectrum licences payments   | (198)          | (121)          | (22)           |                |                |
| Payments to suppliers with extended payment terms (Note 13)   | (1,758)        | (5)            | -              |                |                |
| <b>Financed operating payments and investments in property, plant and equipment and intangible assets payments (see Note 13.2)</b>      | <b>(1,956)</b> | <b>(126)</b>   | <b>(22)</b>    | <b>n.m.</b>    | <b>n.m.</b>    |

(\*) Amended data (see Note 2).

n.m.: not meaningful.

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Note 21. Other information

**a) Litigation and arbitration**

Telefónica and its group companies are party to several legal proceedings which are currently in progress in the courts of law and the arbitration bodies of the various countries in which we are present.

Based on the advice of our legal counsel it is reasonable to assume that these legal proceedings will not materially affect the financial condition or solvency of the Telefónica Group.

The contingencies arising from the litigation and commitments described below were evaluated (see Note 3.m) when the consolidated financial statements for the year ended December 31, 2016 were prepared. The provisions recorded in respect of the commitments taken as a whole are not material.

The following unresolved legal proceedings or those underway in 2016 are highlighted (see Note 17 for details of tax-related cases):

**Appeal against the decision by Agencia Nacional de Telecomunicações (“ANATEL”) regarding the inclusion of interconnection and network usage revenues in the Fundo de Universalização de Serviços de Telecomunicações (“FUST”)**

Vivo Group operators (currently Telefônica de Brasil), together with other cellular operators, appealed ANATEL’s decision of December 16, 2005, to include interconnection and network usage revenues and expenses in the calculation of the amounts payable into the FUST (Fundo de Universalização de Serviços de Telecomunicações) –a fund which pays for the obligations to provide Universal Service- with retroactive application from 2000. On March 13, 2006, Regional Federal Court no. 1. granted a precautionary measure which stopped the application of ANATEL’s decision. On March 6, 2007, a ruling in favor of the wireless operators was issued, stating that it was not appropriate to include the revenues received by transfer from other operators in the taxable income for the FUST’s calculation and rejecting the retroactive application of ANATEL’s decision. On January 26, 2016, ANATEL filed an appeal to overturn this decision with Brasilia Regional Federal Court no. 1.

At the same time, Telefônica Brasil and Telefónica Empresas, S.A., together with other wireline operators through ABRAFIX (Associação Brasileira de Concessionárias de Serviço Telefonico Fixo Comutado) appealed ANATEL’s decision of December 16, 2005, also obtaining the precautionary measures requested. On June 21, 2007, Federal

Regional Court no. 1 ruled that it was not appropriate to include the interconnection and network usage revenues in the FUST's taxable income and rejected the retroactive application of ANATEL's decision. ANATEL filed an appeal to overturn this ruling on April 29, 2008, before Brasilia Federal Regional Court no. 1, which was dismissed on May 10, 2016. ANATEL filed an appeal against this dismissal.

The fixed operators filed an appeal to clarify that revenues obtained through interconnection and dedicated line operation should not be included in the calculation of the amounts payable to the FUST. In addition, the court was also requested to rule on two grounds which had not been analyzed in the initial decision: (i) that the FUST has become obsolete, among other reasons, by the advance of mobile telephony; and (ii) that amounts collected are not applied to the purpose for which the FUST was created, since only a very low percentage of the revenues collected by the FUST is used to finance fixed telephony. Although the petition for clarification was dismissed on August 23, 2016, the court noted that the FUST should not be funded with revenues from interconnection and dedicated line operation.

The amount of the claim is quantified at 1% of the interconnection revenues.

**Public civil procedure by the São Paulo government against Telefônica Brasil for alleged reiterated malfunctioning in services provided**

This proceeding was filed by the Public Ministry of the State of São Paulo for alleged reiterated malfunctioning in the services provided by Telefônica Brasil, seeking compensation for damages to the customers affected. A general claim was filed by the Public Ministry of the State of São Paulo, for 1 billion Brazilian reais (approximately 225 million euros), calculated on the company's revenue base over the last five years.

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On April 2010, a ruling against the Telefónica Group was issued in first instance. The full impact of this proceeding will not be known until there is a final ruling, and the total amount of persons affected by and party to the proceeding is known. At that moment, the amount of the indemnity will be established, ranging between 1 billion and 60 million reais (approximately, between 225 and 13 million euros), depending on the number of parties. On May 5, 2010, Telefônica Brasil filed an appeal before the São Paulo Court of Justice, suspending the effect of the ruling.

On April 13, 2015, the appeal was judged in favor of Telefónica, by unanimous vote, reversing the earlier decision in first instance.

The Public Prosecutor filed an extraordinary petition for review at the High Court of Brasilia which refused to consider the petition due to the lack of legal requirements. A new appeal may be filed against such refusal.

**Appeal against the Decision of the EC dated January 23, 2013, to sanction Telefónica for the infringement of Article 101 of the Treaty on the functioning of the European Union**

On January 19, 2011, the EC initiated formal proceedings to investigate whether Telefónica, S.A. (Telefónica) and Portugal Telecom SGPS, S.A. (Portugal Telecom) had infringed European Union anti-trust laws with respect to a clause contained in the sale and purchase agreement of Portugal Telecom's ownership interest in Brasilcel, N.V., a joint venture in which both were venturers and which was the owner of the Brazilian company Vivo.

On January 23, 2013, the EC passed a ruling on the formal proceedings. The ruling imposed a fine on Telefónica of 67 million euros, as the EC ruled that Telefónica and Portugal Telecom committed an infraction of Article 101 of the Treaty on the Functioning of the European Union for having entered into the agreement set forth in Clause Nine of the sale and purchase agreement of Portugal Telecom's ownership interest of Brasilcel, N.V.

On April 9, 2013, Telefónica filed an appeal for annulment of this ruling with the European Union General Court. On August 6, 2013, the European Union General Court notified Telefónica of the response issued by the EC, in which the EC reaffirmed the main arguments of its ruling and, specially, that Clause Nine includes a competition restriction. On September 30, 2013, Telefónica filed its reply. On December 18, 2013, the EC filed its appeal.

A hearing was held on May 19, 2015, at the European Union General Court.

On June 28, 2016, the European Union General Court ruled. Although it declares the existence of an infringement of competition law, it annuls Article 2 of the contested Decision and requires the EC to reassess the amount of the fine

imposed. The General Court considers that the EC has not neutralized the allegations and evidences provided by Telefónica on services in which there was not potential competition or were outside the scope of Clause Nine.

Telefónica understands that there are grounds for believing that the ruling does not suit at law; consequently, it filed an appeal to the Court of Justice of the European Union, on September 11, 2016.

On November 23, 2016, the EC filed its response against the Telefónica's appeal. On January 30, 2017, Telefónica filed its reply.

**Claim of consumers association "FACUA" against Telefónica de España in connection with the increase of the price of Movistar Fusión**

On September 5, 2016, notification was given to Telefónica de España of a claim filed against it by the consumers association ("FACUA"). Through such claim, the association exercises an action to protect consumers' and users' collective interests stipulated in articles 11 of the Civil Procedure Act (*Ley de Enjuiciamiento Civil*) and 24.1 of the Consumer and Users Protection Act (*Ley General de Defensa de los Consumidores y Usuarios*) on the basis of alleged disloyalty towards the consumers, arising from the raising of the prices of the product "Movistar Fusión" from May 5, 2015, by an amount of 5 euros per month. The claim contains a first declaratory statement, stating that disloyalty arises from misleading advertising regarding the price rise; a second requests prohibitory injunction, requesting that Telefónica de España be ordered not to apply such price rise and to prohibit its future application to all customers who became customers of Movistar Fusión prior to May 5, 2015. It contains, besides, a third statement, requesting Telefónica de España to be condemned to repay the excess amounts collected as a result of the rise in prices to those customers who have chosen to maintain the service contracted, together with accrued interest on such amount.

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The claim was filed for an undetermined amount, given the impossibility of determining *a priori* the total amount of the claim. On October 28, 2016, Telefónica de España filed the response. A hearing will be held on March 7, 2017.

**Decision by the High Court regarding the acquisition by Telefónica of shares in Český Telecom by way of tender offer**

Venten Management Limited ("**Venten**") and Lexburg Enterprises Limited ("**Lexburg**"), were minority shareholders of CESKY TELECOM. In September 2005 both companies sold their shares to Telefónica in a mandatory tender offer. Subsequently Venten and Lexburg, in 2006 and 2009, respectively, filed actions against Telefónica claiming a higher price than the price for which they sold their shares in the mandatory tender offer.

On August 5, 2016, the hearing before the High Court in Prague took place in order to decide the appeal against the second decision of the Municipal Court, which had been favourable to Telefónica's position (as was also the case with the first decision of the Municipal Court). At the end of the hearing, the High Court announced the Second Appellate Decision by which it reversed the second decision of the Municipal Court and ordered Telefónica to pay 644 million Czech koruna (approximately 23 million euros) to Venten and 227 million Czech koruna (approximately 8 million euros) to Lexburg, in each case plus interest.

On December 28, 2016, the decision was delivered to Telefónica. Telefónica has filed an extraordinary appeal, requesting the suspension of the effects of the decision.

**Other contingencies**

Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.



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**b) Commitments**

**Agreement related to the Sale of Customer Relationship Management (“CRM”) Business, Atento**

As a result of the sale agreement of Atento by Telefónica, announced on October 12, 2012, and ratified on December 12, 2012, both companies signed a Master Service Agreement which regulates Atento’s relationship with the Telefónica Group as a service provider for a period of nine years and which was amended on May 16, 2014, and on November 8, 2016. This period was extended only for Spain and Brazil in November 2016, for two additional years until 2023.

By virtue of this Agreement, Atento became Telefónica’s preferred Contact Center and Customer Relationship Management (“CRM”) service provider, stipulating annual commitments in terms of turnover which is updated based on inflation and deflation that vary from country to country, pursuant to the volume of services Atento has been providing to the entire Group. Effective January 1, 2017, the minimum volume commitments that Telefónica must comply with have significantly decreased from Brazil.

Failure to meet the annual turnover commitments generally results in the obligation to the counterparty, to pay additional amounts, which would be calculated based on the difference between the actual amount of turnover and the predetermined commitment, applying a percentage based on the Contact Center’s business margin to the final calculation.

The Master Agreement sets forth a reciprocal arrangement, whereby Atento assumes similar commitments to subscribe its telecommunications services to Telefónica.

**Telefónica Latinoamérica Holding, S.L. as strategic partner of Colombia Telecomunicaciones, S.A. ESP**

Pursuant to amendment n° 1 of the Framework Investment Agreement executed on March 30, 2012, after the closing of the merger between Colombia Telecomunicaciones, S.A. ESP and Telefónica Móviles Colombia, S.A., the Colombian Government may, at any time, offer to Telefónica all or part of the shares it holds in the company, the latter being obliged to acquire them, (directly or via one of its subsidiaries) provided that any of the following circumstances becomes applicable: (i) Colombia Telecomunicaciones, S.A. ESP fails to meet its payment obligations under the terms of the "Contrato de Explotación", of two accumulated bi-monthly installments of the consideration fees; (ii) the increase in EBITDA is less than 5.75% in the measurement periods, and provided that during the twelve (12) months following the ordinary shareholders’ meetings during which the measurement was made, at least one of the following occurs: 1) Colombia Telecomunicaciones S.A. ESP makes capital investments (CAPEX) exceeding 12.5% of its revenues for services; 2) Colombia Telecomunicaciones S.A. ESP has paid a brand fee or any other type

of payment to the Strategic Partner for the use of its brands; or 3) orders and/or pays dividends with the favorable vote of the Strategic Partner.

From January 1, 2013, the Colombian Government can require Telefónica to vote in favor of the register of the shares of Colombia Telecomunicaciones, S.A. ESP in the National Securities and Issuer's Registry and in the Colombia Stock Exchange.

In addition, if Telefónica decides to dispose or transfer of all or part of its shareholding in Colombia Telecomunicaciones, S.A. ESP to third parties, Telefónica commits that: (i) the acquirer or transferee will be obliged to adhere to the Framework Investment Agreement; and (ii) that the acquirer or transferee will be obliged to present an offer to purchase all of the shares in Colombia Telecomunicaciones, S.A. ESP held by the Colombian Government (that amounts to 32.5% of the share capital) at the same price and under the same terms and conditions negotiated with Telefónica, through the legally-established procedure for disposal of shares held by public entities.

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**Agreement for the divestment of Telefónica's operations in the United Kingdom ("O2 UK")**

On March 24, 2015, Telefónica signed an agreement with Hutchison Whampoa Group for the acquisition by the latter of Telefónica's operations in the United Kingdom (O2 UK) for a price (firm value) of 10,250 million pounds sterling in cash (approximately 14,000 million euros at the exchange rate as of the date of the agreement).

On May 11, 2016, the European Commission made public its decision to prohibit the transaction under the European Union merger regulations, resulting in the termination of the aforementioned agreement between Telefónica and Hutchison Whampoa Group.

**Communications Investment Platform**

On May 8, 2015, Telefónica Open Future, S.L.U. ("**TOF**") signed a Limited Partnership Agreement (and related agreements) with Coral Group, L.L.C. (and affiliates thereof) pursuant thereto, TOF has committed to undertake investments up to 200 million U.S. dollar over a 7 year period (expandable up to two additional years) in technology companies that fall within the strategic priorities jointly agreed with Telefónica.

**Agreement for the sale of the shares of Telefónica Gestión de Servicios Compartidos España, S.A.U., Telefónica Gestión de Servicios Compartidos Argentina, S.A. and T-Gestiona Servicios Contables y Capital Humano, S.A.C.**

On March 1, 2016, a share purchase agreement between, on one hand, Telefónica, S.A., Telefónica Servicios Globales, S.L.U. and Telefónica Gestión de Servicios Compartidos Perú, S.A.C. (as sellers), and, on the other hand, IBM Global Services España, S.A., IBM del Perú, S.A.C., IBM Canada Limited and IBM Americas Holding, LLC (as purchasers) for the sale of the companies Telefónica Gestión de Servicios Compartidos España, S.A.U., Telefónica Gestión de Servicios Compartidos Argentina, S.A. and Tgestiona Servicios Contables y Capital Humano, S.A.C., for a total price of approximately 22 million euros, was ratified before Notary Public. This share purchase agreement was subscribed on December 31, 2015.

Following the aforementioned share purchase agreement and in connection with the latter transaction, also, on December 31, 2015, Telefónica subscribed a master services agreement with IBM for the outsourcing of economic-financial and HR activities and functions to be provided to the Telefónica Group during a period of ten years, for a total amount of approximately 450 million euros. Most of the Telefónica Group's subsidiary companies have already adhered to that master services agreement.

**c) Environmental matters**

Telefónica has a global Environmental Strategy that arises from the Environmental Policy and Energy Policy approved by the Board of Directors which sets out the road map for the Company to advance towards a green economy, reducing the environmental impact of its facilities at the same time as developing the potential for digital services to reduce the environmental footprint of other sectors.

Currently more than 80% of the Company has Environmental Management Systems (EMS) in accordance with Regulation ISO 14001, certified by an external body, which contribute to the proper management of its environmental aspects and to extending a culture of environmental responsibility across the whole supply chain. Telefónica has set itself the target of certifying 100% of operators under ISO 14001 by 2017.

Telefónica's environmental risks and climate change are controlled and managed under the Company's global risk model. The environmental aspects of the telecommunications operations are mainly focused on the risk of high geographical dispersion and energy consumption, which is controlled by means of environmental management based on uniform processes and a global energy efficiency programme.

The greatest environmental impact is in the network due to energy consumption, but also with physical elements, such as visual impact or waste. To implement and maintain the responsible network, Telefónica applies the best practices available and manages all environmental aspects of this from design to decommissioning.

Environmental legislation, which is abundant in almost all of the countries where Telefónica operates, applies mainly to the network infrastructures. Among these, it is worth mentioning the need to obtain environmental permits, waste management, noise control and measuring electromagnetic fields. Telefónica has common standards for all of its companies, in harmony with the principle of caution, establishes minimum guidelines for environmental management with the aim of minimizing the impact of infrastructures, these standards go beyond existing legislation. Also, these standards extend to all suppliers and contractors.

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Among the activities undertaken by the Group to manage the environmental aspects of its operations is the sharing, whenever possible, of the facilities' locations with other operators or communication tower management companies. This leads to a lesser visual and energy impact and a reduction in waste creation.

**d) Auditors' fees**

The expenses accrued in respect of the fees for services rendered to the various member firms of the EY international organization, of which Ernst & Young, S.L. (the auditors of the Telefónica Group) forms part, amounted to 26.47 million euros and 20.94 million euros in 2016 and 2015, respectively.

The detail of these amounts is as follows:

| <b>Millions of euros</b>   | <b>2016</b>  | <b>2015</b>  |
|----------------------------|--------------|--------------|
| Audit services (1)         | 23.37        | 20.38        |
| Audit-related services (2) | 3.10         | 0.56         |
| <b>Total</b>               | <b>26.47</b> | <b>20.94</b> |

(1) Audit services: services included under this heading are mainly the audit of the annual and reviews of interim financial statements, work to comply with the requirements of the Sarbanes-Oxley Act (Section 404) and the work in connection with the 20-F report to be filed with the US Securities and Exchange Commission (SEC).

(2) Audit-related services: This heading mainly includes services related to the review of the information required by regulatory authorities, agreed financial reporting procedures not requested by legal or regulatory bodies and the review of corporate responsibility reports.

EY has not rendered tax services or any other service other than those mentioned above to Telefónica Group companies.

The expenses accrued in respect of the fees for services rendered by other auditors in 2016 and 2015 amounted to 34.85 million euros and 52.97 million euros, respectively, as follows:

| <b>Millions of euros</b>                        | <b>2016</b>  | <b>2015</b>  |
|---|--------------|--------------|
| Audit services                                  | 0.94         | 1.07         |
| Audit-related services                          | 2.69         | 2.09         |
| Tax services                                    | 8.56         | 9.31         |
| All other services (consulting, advisory, etc.) | 22.66        | 40.50        |
| <b>Total</b>                                    | <b>34.85</b> | <b>52.97</b> |

**e) Trade and other guarantees**

The Company is required to issue trade guarantees and deposits for concession and spectrum tender bids (see Note 16) and in the ordinary course of its business. No significant additional liabilities in the accompanying consolidated financial statements are expected to arise from guarantees and deposits issued.

**f) Directors' and Senior Executives' compensation and other benefits**

**Directors' and Senior Executives' compensation**

The compensation of the members of Telefónica's Board of Directors is governed by article 35 of the Company's By-Laws, which provides that the annual amount of the compensation to be paid thereby to all of the Directors in their capacity as such, i.e., as members of the Board of Directors and for the performance of the duty of supervision and collective decision-making inherent in such body, shall be fixed by the shareholders at the General Shareholders' Meeting. The Board of Directors shall determine the exact amount to be paid within such limit and the distribution thereof among the Directors, taking into account the duties and responsibilities assigned to each Director, their membership on Committees within the Board of Directors and other objective circumstances that it deems relevant. Furthermore, Executive Directors shall receive such compensation as the Board determines for the performance of executive duties delegated or entrusted to them by the Board of Directors. Such compensation shall conform to the Director compensation policy approved by the shareholders at the General Shareholders' Meeting.

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In accordance with the foregoing, the shareholders acting at the Ordinary General Shareholders' Meeting held on April 11, 2003 set at 6 million euros the maximum amount of annual gross compensation to be received by the Board of Directors as a fixed allotment and as attendance fees for attending the meetings of the Advisory or Control Committees of the Board of Directors. Thus, as regards fiscal year 2016, the total amount of compensation received by the Directors of Telefónica, in their capacity as such, was 3,752,754 euros for the fixed allocation and for attendance fees.

The compensation of the Directors of Telefónica in their capacity as members of the Board of Directors, of the Executive Commission and/or of 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.

Set forth below are the amounts established in fiscal year 2016 as fixed amounts for belonging to the Board of Directors, the Executive Commission and the Advisory or Control Committees of Telefónica and the attendance fees for attending meetings of the Advisory or Control Committees of the Board of Directors.

**Compensation of the Board of Directors and of the Committees thereof****Amounts in euros**

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

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

Based on Mr. Alierta Izuel's special commitment as Director of Telefónica to the development of the Group's institutional relations, Mr. Alierta Izuel has a special annual fixed amount (in addition to what he is entitled as a Member of the Board of Directors and as a member of any of its Committees) of 500,000 euros.

In this regard, it is noted that the current Executive Chairman, Mr. José María Álvarez-Pallete López, has waived the receipt of the above amounts (i.e., 240,000 euros as Chairman of the Board of Directors and 80,000 euros as Chairman of the Executive Commission).

Likewise, the fixed remuneration of 1,923,100 euros that the Executive Chairman, Mr. José María Álvarez-Pallete López, has established for the 2017 financial year is equal to the one received in the year 2016, which was set in his capacity as Chief Executive Officer, remaining invariably after his appointment as Chairman. This compensation is a 13.8% lower to the compensation established for the position of Executive Chairman for the 2016 fiscal year.

**Individualized description**

Annex II provides an individual breakdown by item of the compensation and benefits that the members of the Board of Directors and of the Senior Management of the Company have received from Telefónica, S.A. and from other companies of the Telefónica Group during fiscal year 2016.

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## Note 22. Finance leases

The main finance leases at the Telefónica Group are as follows:

## a) Finance lease agreement at Colombia Telecomunicaciones, S.A. ESP

The Group, through its subsidiary Colombia Telecomunicaciones, S.A., ESP, has a finance lease agreement with *Patrimonio Autónomo Receptor de Activos de la Empresa Nacional de Telecomunicaciones* (PARAPAT), the consortium which owns the telecommunications assets and manages the pension funds for the entities which were predecessors to Colombia Telecomunicaciones, S.A. ESP.

This agreement includes the transfer of these assets and rights to Colombia Telecomunicaciones, S.A. ESP once the last installment of the consideration has been paid in line with the payment schedule:

| Millions of euros      | Present value | Revaluation | Pending payment |
|------------------------|---------------|-------------|-----------------|
| Within one year        | 152           | 9           | 161             |
| From one to five years | 517           | 207         | 724             |
| More than five years   | 606           | 951         | 1,557           |
| Total                  | 1,275         | 1,167       | 2,442           |

The net amount of property, plant and equipment recorded under the terms of this lease was 158 million euros at December 31, 2016.

## b) Future minimum lease payment commitments in relation to finance leases at Telefónica Germany companies

The payment schedule of finance leases of Telefónica Germany at December 31, 2016, is as follows:

| Millions of euros      | Present value | Revaluation | Pending payment |
|------------------------|---------------|-------------|-----------------|
| Within one year        | 15            | 1           | 16              |
| From one to five years | 17            | –           | 17              |
| More than five years   | –             | –           | –               |
| Total                  | 32            | 1           | 33              |

At December 31, 2016 there are net assets under finance lease agreements amounting to 163 million euros recognized under property, plant and equipment.

Additionally, Telefónica Germany acts as a lessor in financial leases related to those described above. The minimum lease payment receivables at December 31, 2016 are scheduled as follows:

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| Millions of euros                 | Present value | Revaluation | Pending receivables |
|-----------------------------------|---------------|-------------|---------------------|
| Within one year                   | 99            | –           | 99                  |
| From one to five years            | 8             | –           | 8                   |
| More than five years              | –             | –           | –                   |
| Total                             | 107           | –           | 107                 |
| Accumulated allowance             | (10)          |             |                     |
| Total after accumulated allowance | 97            |             |                     |

c) Future minimum lease payment commitments in relation to finance leases at Telefónica Brasil companies

The payment schedule of finance leases of Telefónica Brasil at December 31, 2016, is as follows:

| Millions of euros      | Present value | Revaluation | Pending payment |
|------------------------|---------------|-------------|-----------------|
| Within one year        | 13            | 2           | 15              |
| From one to five years | 42            | 17          | 59              |
| More than five years   | 54            | 115         | 169             |
| Total                  | 109           | 134         | 243             |

At December 31, 2016 there are net assets under finance lease agreements amounting to 87 million euros recognized under property, plant and equipment.

Additionally, Telefónica Brasil acts as a lessor in financial leases related to those described above. The minimum lease payment receivables at December 31, 2016 are scheduled as follows:

| Millions of euros      | Present value | Revaluation | Pending receivables |
|------------------------|---------------|-------------|---------------------|
| Within one year        | 98            | –           | 98                  |
| From one to five years | 79            | 1           | 80                  |
| More than five years   | –             | –           | –                   |
| Total                  | 177           | 1           | 178                 |

d) Future minimum lease payment commitments in relation to finance leases at Telefónica de España, S.A.U.

The payment schedule of finance leases of Telefónica de España, S.A.U. at December 31, 2016, is as follows:

| Millions of euros      | Present value | Revaluation | Pending payment |
|------------------------|---------------|-------------|-----------------|
| Within one year        | 58            | 4           | 62              |
| From one to five years | 26            | 1           | 27              |

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|                      |    |   |    |
|----------------------|----|---|----|
| More than five years | -  | - | -  |
| Total                | 84 | 5 | 89 |

At December 31, 2016 there are net assets under finance lease agreements amounting to 5 million euros recognized under property, plant and equipment.

Additionally, Telefónica de España, S.A.U. acts as a lessor in financial leases related to those described above. The minimum lease payment receivables at December 31, 2016 are scheduled as follows:

| Millions of euros      | Present value | Revaluation | Pending receivables |
|------------------------|---------------|-------------|---------------------|
| Within one year        | 67            | 1           | 68                  |
| From one to five years | 41            | -           | 41                  |
| More than five years   | -             | -           | -                   |
| Total                  | 108           | 1           | 109                 |

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Note 23. Recognition of Telefónica's operation in the United Kingdom

As described in Note 2, in 2016 Telefónica's operations in United Kingdom (O2 UK) are no longer presented as discontinued operations and its assets and liabilities cease to be classified as held for sale. Thus, items are presented line by line in the consolidated financial statements.

The change in classification entails that financial statements are amended to present O2 UK's assets and liabilities as if the disposal group had not been classified as held for sale. Also, the results of operations and net cash flows of O2 UK, previously presented in discontinued operations, are reclassified and included in income from continuing operations and net cash flows from continuing operations, respectively, for all periods presented.

The main impacts in 2015 are as follows:

Assets and liabilities are measured at the carrying amount that would have been recognised had the disposal group not been classified as held for sale in March 2015. Thus, the net carrying amount of those items is recorded for depreciation and amortisation amounting to 897 million euros in the year 2015. The related tax effect amounts to 180 million euros in the year 2015.

Derecognition of the deferred tax asset resulting from the estimated difference between the tax value and the agreed value in the highly probable sale of O2 UK amounting to 1,789 million euros as of December 31, 2015. Additionally, derecognition of the provision set up for the amount corresponding to the tax amortization of goodwill generated in 2006 in the acquisition of the companies involved in the sale agreement and deducted until December 31, 2015, amounting to 377 million euros as of December 31, 2015.

The impact in the consolidated income statement of the tax effects explained in the previous paragraph is a higher income tax expense amounting to 1,412 million euros in the year 2015.

Reclassification of the partial adjustment of the goodwill generated on the acquisition of Telefónica Digital Inc. amounting to 104 million euros to the "Other expenses" line item in the consolidated income statement for the year 2015.

In addition to this, hedging transactions entered into by the Group following the agreement with Hutchison Whampoa in order to hedge the foreign exchange risk associated with the amount to be collected in pounds sterling for the sale of O2 UK, no longer qualify for hedge accounting. Therefore, the amount accumulated in "Other comprehensive income" was recycled to the consolidated income statement in 2016 (positive impact amounting to 184 million euros before tax).

Reconciliation of figures for the year 2014 is not included since they coincide with those published in the consolidated financial statements for that fiscal year.

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Table of Contents**Consolidated statement of financial position at December 31, 2015**

A reconciliation of the consolidated statement of financial position reported in the 2015 consolidated financial statements and the amended statement of financial position as presented for comparative purposes in these consolidated financial statements is as follows:

| <b>Consolidated statement of financial position</b>  | <b>12/31/2015</b> | <b>Reclassification O2</b> | <b>12/31/2015</b>   |
|--|-------------------|----------------------------|---------------------|
| <b>Millions of euros</b>   |                   | <b>UK</b>                  | <b>Amended data</b> |
| <b>A) NON-CURRENT ASSETS</b>   | <b>91,427</b>     | <b>10,187</b>              | <b>101,614</b>      |
| Intangibles  | 18,562            | 2,587                      | 21,149              |
| Goodwill (*)   | 21,774            | 5,621                      | 27,395              |
| Property, plant and equipment  | 30,549            | 3,361                      | 33,910              |
| Deferred tax assets  | 10,460            | (1,785)                    | 8,675               |
| Other non-current assets   | 10,082            | 403                        | 10,485              |
| <b>B) CURRENT ASSETS</b>   | <b>31,576</b>     | <b>(12,861)</b>            | <b>18,715</b>       |
| Inventories  | 1,360             | 96                         | 1,456               |
| Trade and other receivables  | 8,301             | 1,925                      | 10,226              |
| Other current assets   | 4,312             | 82                         | 4,394               |
| Cash and cash equivalents  | 2,599             | 16                         | 2,615               |
| Non-current assets and disposal groups classified as held for sale                             | 15,004            | (14,980)                   | 24                  |
| <b>TOTAL ASSETS (A + B)</b>  | <b>123,003</b>    | <b>(2,674)</b>             | <b>120,329</b>      |
| <b>A) EQUITY</b>   | <b>27,556</b>     | <b>(2,120)</b>             | <b>25,436</b>       |
| Equity attributable to equity holders of the parent and other holders of equity instruments    | 17,891            | (2,120)                    | 15,771              |
| Non-controlling interests  | 9,665             | -                          | 9,665               |
| <b>B) NON-CURRENT LIABILITIES</b>  | <b>60,549</b>     | <b>(40)</b>                | <b>60,509</b>       |
| Non-current interest-bearing debt  | 47,117            | -                          | 47,117              |
| Non-current trade and other payables   | 2,381             | 7                          | 2,388               |
| Deferred tax liabilities   | 2,313             | 237                        | 2,550               |
| Non-current provisions   | 8,738             | (284)                      | 8,454               |
| <b>C) CURRENT LIABILITIES</b>  | <b>34,898</b>     | <b>(514)</b>               | <b>34,384</b>       |
| Current interest-bearing debt  | 12,953            | 17                         | 12,970              |
| Current trade and other payables   | 14,264            | 2,870                      | 17,134              |
| Other current liabilities  | 3,740             | 523                        | 4,263               |
| Liabilities associated with non-current assets and disposal groups classified as held for sale | 3,941             | (3,924)                    | 17                  |
| <b>TOTAL EQUITY AND LIABILITIES (A+B+C)</b>  | <b>123,003</b>    | <b>(2,674)</b>             | <b>120,329</b>      |

(\*) After the final resolution of the acquisition price of DTS, the goodwill was revised according to IFRS 3 (see Note 5).

Table of Contents**Consolidated income statements for the year ended December 31, 2015**

A reconciliation of the consolidated income statements for the year ended December 31, 2015 to the amended consolidated income statements included for comparative purposes within these consolidated financial statements is as follows:

| <b>Consolidated income statements</b><br><b>Millions of euros</b>      | <b>January – December 2015</b>     |                                |                     |
|--|------------------------------------|--------------------------------|---------------------|
|  | <b>Annual financial statements</b> | <b>Reclassi-fication O2 UK</b> | <b>Amended data</b> |
| Revenues   | 47,219                             | 7,697                          | 54,916              |
| Other income   | 1,841                              | 170                            | 2,011               |
| Supplies   | (12,910)                           | (3,637)                        | (16,547)            |
| Personnel expenses   | (9,800)                            | (549)                          | (10,349)            |
| Other expenses   | (14,936)                           | (1,866)                        | (16,802)            |
| <b>OPERATING INCOME BEFORE DEPRECIATION AND AMORTIZATION (OIBDA)</b>   | <b>11,414</b>                      | <b>1,815</b>                   | <b>13,229</b>       |
| Depreciation and amortization  | (8,517)                            | (1,187)                        | (9,704)             |
| <b>OPERATING INCOME</b>  | <b>2,897</b>                       | <b>628</b>                     | <b>3,525</b>        |
| <b>Share of loss of investments accounted for by the equity method</b> | <b>(5)</b>                         | <b>(5)</b>                     | <b>(10)</b>         |
| Finance income   | 2,090                              | (14)                           | 2,076               |
| Exchange gains   | 6,489                              | 15                             | 6,504               |
| Finance costs  | (4,400)                            | (17)                           | (4,417)             |
| Exchange losses  | (6,760)                            | (12)                           | (6,772)             |
| <b>Net financial expense</b>   | <b>(2,581)</b>                     | <b>(28)</b>                    | <b>(2,609)</b>      |
| <b>PROFIT BEFORE TAX</b>   | <b>311</b>                         | <b>595</b>                     | <b>906</b>          |
| Corporate income tax   | (13)                               | (142)                          | (155)               |
| <b>PROFIT AFTER TAX FROM CONTINUING OPERATIONS</b>                     | <b>298</b>                         | <b>453</b>                     | <b>751</b>          |
| <b>Profit after tax from discontinued operations</b>                   | <b>2,582</b>                       | <b>(2,582)</b>                 | <b>-</b>            |
| <b>PROFIT FOR THE YEAR</b>   | <b>2,880</b>                       | <b>(2,129)</b>                 | <b>751</b>          |
| Attributable to equity holders of the Parent                           | 2,745                              | (2,129)                        | 616                 |
| Attributable to minority interests                                     | 135                                | -                              | 135                 |



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A reconciliation of the consolidated statements of cash flows for the year ended December 31, 2015 to the amended statements of cash flows included for comparative purposes in these consolidated financial statements is as follows:

| Consolidated statement of cash flows  | January – December 2015    |                         |              |
|---|----------------------------|-------------------------|--------------|
|   | Annual financial statement | Reclassification, Q2 UK | Amended Data |
| Millions of euros   |                            |                         |              |
| Cash received from operations   | 57,705                     | 9,877                   | 67,582       |
| Cash paid from operations   | (42,800)                   | (8,033)                 | (50,833)     |
| Payments of interest and other financial expenses net of dividends received               | (2,410)                    | (35)                    | (2,445)      |
| Taxes paid  | (664)                      | (25)                    | (689)        |
| Net cash flow provided by operating activities from continuing operations                 | <b>11,831</b>              | 1,784                   | 13,615       |
| Net cash flow provided by operating activities from discontinued operations               | 1,784                      | (1,784)                 | -            |
| Net cash flow provided by operating activities  | <b>13,615</b>              | -                       | 13,615       |
| (Payments)/Proceeds on investments in property, plant and equipment and intangible assets | (9,147)                    | (1,109)                 | (10,256)     |
| Proceeds on disposals of companies, net of cash and cash equivalents disposed             | 373                        | (19)                    | 354          |
| Payments on investments in companies, net of cash and cash equivalents acquired           | (3,178)                    | (3)                     | (3,181)      |
| Proceeds on financial investments not included under cash equivalents                     | 1,064                      | 78                      | 1,142        |
| Payments on financial investments not included under cash equivalents                     | (286)                      | (140)                   | (426)        |
| (Payments)/proceeds on placements of cash surpluses not included under cash equivalents   | (584)                      | 27                      | (557)        |
| Government grants received  | 7                          | -                       | 7            |
| Net cash flow used in investing activities from continuing operations                     | <b>(11,751)</b>            | (1,166)                 | (12,917)     |
| Net cash flow used in investing activities from discontinued operations                   | (1,166)                    | 1,166                   | -            |
| Net cash flow used in investing activities  | (12,917)                   | -                       | (12,917)     |
| Dividends paid  | (2,775)                    | -                       | (2,775)      |
| Proceeds from issue of share capital increase   | 4,255                      | -                       | 4,255        |
| (Payments)/proceeds of treasury shares and other operations with shareholder              | (1,772)                    | -                       | (1,772)      |
| Operations with other equity holders  | 83                         | -                       | 83           |
| Proceeds on issue of debentures and bonds, and other debts                                | 1,602                      | -                       | 1,602        |
| Proceeds on loans, borrowings and promissory notes  | 8,770                      | 14                      | 8,784        |
| Cancellation of debentures and bonds, and other debts                                     | (3,805)                    | -                       | (3,805)      |
| Repayments of loans, borrowings and promissory notes                                      | (9,844)                    | (14)                    | (9,858)      |
|   | (126)                      | -                       | (126)        |

|   |                |   |         |
|---|----------------|---|---------|
| Financed operating payments and investments in property, plant and equipment and intangible assets payments |                |   |         |
| Net cash used in financing activities from continuing operations  | <b>(3,612)</b> | - | (3,612) |
| Net cash provided by in financing activities from discontinued operations                                   | -              | - | -       |
| Net cash used in financing activities   | <b>(3,612)</b> | - | (3,612) |
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Note 24. Events after the reporting period

The following events regarding the Telefónica Group took place between December 31, 2016 and the date of authorization for issue of the accompanying consolidated financial statements:

**Financing**

On January 10, 2017, Telefónica, S.A. redeemed 300 million euros of its 2,500 million euros syndicated credit facility signed on February 19, 2015 and maturing in 2021.

On January 17, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 1,750 million euros. This issuance was split into two series: one series, amounting to 1,250 million euros, maturing on January 17, 2025 and an annual coupon of 1.528% and the other series, amounting to 500 million euros maturing on October 17, 2028 and with an annual coupon of 2.318%. Both series of notes are guaranteed by Telefónica, S.A.

On January 17, 2017, Telefónica, S.A. amended the bilateral loan, signed originally on June 26, 2014 for an amount of 2,000 million euros and with an outstanding amount of 1,500 million euros, divided in two tranches with a new amortization schedule: tranche A for 500 million euros maturing on June 26, 2017 and tranche B for 1,000 million euros maturing on June 26, 2019. Later, on February 17, 2017, Telefónica, S.A. signed a new amendment to its bilateral loan extending the maturity date of the tranche A for 500 million euros until June 26, 2019.

On January 25, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 150 million euros, maturing on January 25, 2019. The notes are guaranteed by Telefónica, S.A.

On February 7, 2017, Telefónica Emisiones, S.A.U. redeemed 1,200 million euros, 100 million euros and 120 million euros of its notes, issued on February 7, 2011, March 21, 2011, February 7, 2012, respectively. The notes were guaranteed by Telefónica, S.A.

On February 8, 2017, Telefónica Brasil, S.A. issued notes (debentures) in an aggregate notional amount of 2,000 million Brazilian reais (approximately 600 million euros) maturing on February 8, 2022.

On February 15, 2017, Telefónica Europe, B.V. drew down an aggregate principal amount of 750 million euros of its long term financing of 1,500 million euros signed on November 28, 2016 and maturing in 2024.

On February 17, 2017, Telefónica Germany GmbH & Co. OHG agreed a 12-month extension on its 750 million euros syndicated credit facility dated on March 22, 2016 up to March 22, 2022.

## **Telxius**

On February 20, 2017 Telefónica reached an agreement for the sale of up to 40% of the total share capital of Telxius Telecom, S.A.U. to Taurus Bidco S.à.r.l. (hereafter, "KKR", an entity managed by Kohlberg Kravis Roberts & Co. L.P.), for a total amount of 1,275 million euros (12.75 euros per share).

The aforementioned agreement includes a purchase agreement for the sale of 62 million shares (representing 24.8% of the share capital) of Telxius Telecom, S.A.U. for a price of 790.5 million euros, as well as options over 38 million shares (representing 15.2% of the share capital) for a price of at least 484.5 million euros.

These options correspond to a call option exercisable by KKR and to a put option exercisable by Telefónica upon maturity of the call option.

The closing is subject to obtaining the corresponding regulatory approvals. The exercise window of the options would take place during the fourth quarter of 2017, provided that regulatory approvals have been obtained on that date.

After the transaction Telefónica will continue to maintain control over Telxius.

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## Appendix I: Scope of consolidation

## The main Companies of the Telefónica Group

The table below lists the main companies comprising the Telefónica Group at December 31, 2016 and the main investments consolidated using the equity method.

Included for each company are the company name, corporate purpose, country, functional currency, share capital (in millions of functional currency units), the Telefónica Group's effective shareholding and the company or companies through which the Group holds a stake.

**Parent Company****Telefónica, S.A.**

| Name and corporate purpose  | Country | Currency | Capital | %Telefónica Group | Holding Company              |
|---|---------|----------|---------|-------------------|------------------------------|
| <b>Telefónica Spain</b><br>Telefónica de España, S.A.U.   | Spain   | EUR      | 1,024   | 100%              | Telefónica, S.A.             |
| Telecommunications service provider<br>Telefónica Móviles España, S.A.U.  | Spain   | EUR      | 209     | 100%              | Telefónica, S.A.             |
| Wireless communications services provider<br>Acens Technologies, S.L.   | Spain   | EUR      | 23      | 100%              | Telefónica de España, S.A.U. |
| Holding housing and telecommunications solutions Service provider<br>Teleinformática y Comunicaciones, S.A.U. (Telyco)                                  | Spain   | EUR      | 8       | 100%              | Telefónica de España, S.A.U. |
| Promotion, marketing and distribution of telephone and telematic equipment and services<br>Telefónica Soluciones de Informática y Com. de España S.A.U. | Spain   | EUR      | 2       | 100%              | Telefónica de España, S.A.U. |
| Telecommunications systems, networks and infrastructure engineering<br>Iberbanda, S.A.  | Spain   | EUR      | 2       | 100%              | Telefónica de España, S.A.U. |

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|   |       |     |    |      |  |
|---|-------|-----|----|------|--|
| Broadband telecommunications operator<br>Telefónica Telecomunicaciones Públicas,<br>S.A.U.  | Spain | EUR | 1  | 100% | Telefónica de España, S.A.U.                                   |
| Installation of public telephones<br>Telefónica Soluciones de Outsourcing, S.A.   | Spain | EUR | 1  | 100% | Telefónica Soluc. De<br>Informática y Com. de<br>España, S.A.U |
| Promotion and networks management<br>Telefónica Servicios Integrales de<br>Distribución S.A.U.  | Spain | EUR | 2  | 100% | Telefónica de España, S.A.U.                                   |
| Logistic service provider<br>Tuenti Technologies, S.L.  | Spain | EUR | -  | 100% | Telefónica Móviles España,<br>S.A.U.                           |
| Telecommunications service provider<br>DTS Distribuidora de Televisión Digital, S.A.<br>Broadcasting satellite TV signal transmission<br>and linkage services | Spain | EUR | 80 | 100% | Telefónica de Contenidos,<br>S.A.U.                            |

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| Name and corporate purpose   | Country | Currency | Capital | %Telefónica Group | Holding Company   |
|--|---------|----------|---------|-------------------|---|
| <b>Telefónica United Kingdom</b>   |         |          |         |                   |   |
| Telefónica Europe plc  | UK      | GBP      | 9       | 100%              | Telefónica, S.A. (99.99%)   |
| Holding company<br>MmO2 plc  | UK      | GBP      | 20      | 100%              | Telefónica Capital, S.A. (0.01%)<br>O2 Secretaries Ltd. (0.01%)<br>Telefónica Europe plc (99.99%) |
| Holding company<br>O2 Holdings Ltd   | UK      | GBP      | 12      | 100%              | Telefónica Europe plc   |
| Holding company<br>Telefónica United Kingdom Ltd.  | UK      | GBP      | 10      | 100%              | O2 Holdings Ltd.  |
| <b>Wireless communications</b>   |         |          |         |                   |   |
| Giffgaff Ltd   | UK      | GBP      | -       | 100%              | Telefónica United Kingdom Ltd.  |
| Wireless communications services<br>provider<br>O2 Networks Ltd.                         | UK      | GBP      | -       | 100%              | O2 Holdings Ltd.  |
| Holding company<br>Cornerstone Telecommunications  | UK      | GBP      | -       | 50%               | O2 Networks (40.00%)<br>O2 Cedar Ltd (10.00%)   |
| <b>Network sharing</b>   |         |          |         |                   |   |
| <b>Telefónica Germany</b>  |         |          |         |                   |   |
| Telefónica Deutschland Holding<br>A.G  | Germany | EUR      | 2,975   | 63.22%            | Telefónica Germany Holdings<br>Limited  |
| Holding company<br>Telefónica Germany GmbH & Co.<br>OHG                                  | Germany | EUR      | 51      | 63.22%            | Telefónica Deutschland Holding<br>A.G (63.21%)<br>T. Germany Management, GmbH<br>(0.01%)          |
| Wireless communications services<br>operator<br>E-Plus Mobilfunk GmbH & Co.<br>KG, GmbHG | Germany | EUR      | 1       | 63.22%            | Telefónica Germany<br>GmbH & Co. OHG  |
| Wireless communications services<br>operator<br>Telefónica Brazil                        |         |          |         |                   | Telefónica Latinoamérica Holding, S.L. (24.18%)   |
| Telefônica Brasil, S.A.  | Brazil  | BRL      | 63,571  | 73.68%            | Telefónica, S.A. (29.77%)   |
| Wireline telephony operator  |         |          |         |                   | Sao Paulo Telecomunicações Participações, Ltda. (19.67%)<br>Telefónica Chile, S.A. (0.06%)        |

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| Name and corporate purpose   | Country   | Currency | Capital | %Telefónica Group | Holding Company   |
|--|-----------|----------|---------|-------------------|---|
| <b>Telefónica Hispanoamérica</b>   |           |          |         |                   |   |
| Compañía Internacional de Telecomunicaciones, S.A.                         | Argentina | ARS      | 799     | 100%              | Telefónica Holding de Argentina, S.A. (43.58%)<br>Telefónica Móviles Argentina Holding, S.A. (46.41%)<br>Telefónica International Holding, B.V. (10.01%)<br>Compañía Internacional de Telecomunicaciones, S.A. (51.97%) |
| Holding company  |           |          |         |                   | Telefónica Móviles Argentina, S.A. (30.47%)   |
| Telefónica de Argentina, S.A.  | Argentina | ARS      | 1,044   | 100%              | Telefónica Latinoamérica Holding, S.L. (15.01%)<br>Telefónica, S.A. (1.67%)<br>Telefónica International Holding, B.V. (0.88%)<br>Telefónica, S.A. (75.00%)  |
| Telecommunications service provider  |           |          |         |                   | Telefónica Internacional, S.A.U. (25.00%)<br>Latin America Cellular Holdings, S.L. (97.04%)<br>Comtel Comunicaciones Telefónica, S.A. (2.87%)   |
| Telefónica Móviles Argentina Holding, S.A.                                 | Argentina | ARS      | 1,323   | 100%              | Telefónica, S.A. (0.09%)<br>Inversiones Telefónica Móviles Holding Limitada.  |
| Holding company  |           |          |         |                   | Inversiones Telefónica Móviles Holding Limitada   |
| Telefónica Venezolana, C.A.  | Venezuela | VEF      | 79,634  | 100%              | Telefónica, S.A.  |
| Wireless communications operator   |           |          |         |                   | Telefónica Latinoamérica Holding, S.L. (50.26%)<br>Latin American Cellular Holdings, S.L. (48.31%)  |
| Telefónica Móviles Chile, S.A.   | Chile     | CLP      | 581,632 | 100%              |   |
| Wireless communications services operator                                  |           |          |         |                   |   |
| Telefónica Chile, S.A.   | Chile     | CLP      | 578,099 | 99.03%            |   |
| Local and international long distance telephony services provider          |           |          |         |                   |   |
| Telefónica Chile Holdings, S.L.  | Chile     | CLP      | -       | 100%              |   |
| Holding Company  |           |          |         |                   |   |
| Telefónica del Perú, S.A.A.  | Peru      | PEN      | 2,954   | 98.57%            |   |
| Local, domestic and international long distance telephone service provider |           |          |         |                   |   |



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|  |                |     |        |        |   |
|--|----------------|-----|--------|--------|---|
| Colombia Telecomunicaciones, S.A.<br>ESP   |                |     |        |        | Telefónica Latinoamérica<br>Holding, S.L.. (30.04%)   |
| Communications services operator<br>Telefónica Móviles México, S.A. de<br>C.V. (MÉXICO)                                | Colombia       | COP | 1,455  | 67.50% | Olympic, Ltda. (18.95%)<br>Telefónica, S.A. (18.51%)  |
|  | Mexico         | MXN | 85,834 | 100%   | Telefónica, S.A.  |
| Holding Company<br>Compañía Señales del Norte, S.A. de<br>C.V  | Mexico         | MXN | 98     | 100%   | Telefónica, S.A.  |
| Other business support services<br>Telefónica Móviles del Uruguay, S.A.  |                |     |        |        |   |
| Wireless communications and services<br>operator<br>Telefónica Móviles Panamá, S.A.                                    | Uruguay        | UYU | 1,107  | 100%   | Telefónica Latinoamérica<br>Holding, S.L.   |
| Wireless telephony services<br>Telefónica Móviles El Salvador, S.A.<br>de C.V.   | Panama         | USD | 45     | 60%    | Telefónica Centroamérica<br>Inversiones, S.L.   |
|  | El<br>Salvador | USD | 42     | 59.58% | Telefónica Centroamérica<br>Inversiones S.L. (59.46%)   |
| Provision of wireless and international<br>long distance communications services<br>Telefónica Móviles Guatemala, S.A. |                |     |        |        | Telefónica Multiservicios S.A. de<br>C.V. (0.12%)<br>Telefónica Centroamérica<br>Inversiones S.L. (0.01%) |
| Wireless, wireline and radio paging<br>communications services provider  | Guatemala      | GTQ | 1,396  | 60%    | Guatemala Cellular Holdings,<br>B.V. (59.99%)   |

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| Name and corporate purpose   | Country     | Currency | Capital | %Telefónica Group | Holding Company                                    |
|--|-------------|----------|---------|-------------------|--|
| Telefónica Hispanoamérica (cont.)  |             |          |         |                   |  |
| Telefonía Celular de Nicaragua, S.A.   | Nicaragua   | NIO      | 247     | 60%               | Telefónica Centroamérica Inversiones S.L. (59.99%) |
| Wireless telephony services  |             |          |         |                   | Guatemala Cellular Holdings, B.V. (0.01%).         |
| Otecel, S.A.   |             |          |         |                   | Ecuador Cellular Holdings,                         |
| Wireless communications services provider  | Ecuador     | USD      | 183     | 100%              | B.V.   |
| Telefónica de Costa Rica TC, S.A.  | Costa Rica  | CRC      | 203,511 | 100%              | Telefónica, S.A.                                   |
| Wireless communications  |             |          |         |                   |  |
| Telefónica Holding Atticus, B.V.   | Netherlands | EUR      | -       | 100%              | Telefónica Latinoamérica Holding, S.L.             |
| Holding company  |             |          |         |                   |  |
| <b>Other Companies</b>   |             |          |         |                   |  |
| O2 International Holdings Ltd.   | UK          | GBP      | -       | 100%              | O2 (Europe) Ltd.                                   |
| Holding company  |             |          |         |                   |  |
| Telefónica Germany Holdings Ltd.   | UK          | EUR      | -       | 100%              | O2 Europe Ltd.                                     |
| Holding company  |             |          |         |                   |  |
| O2 (Europe) Ltd.   | UK          | EUR      | 1,239   | 100%              | Telefónica, S.A.                                   |
| Holding company  |             |          |         |                   |  |
| Telefónica International Holding, B.V  | Netherlands | EUR      | -       | 100%              | Telefónica Latinoamérica Holding, S.L.             |
| Holding company  |             |          |         |                   |  |
| Telefónica Latinoamérica Holding, S.L.   | Spain       | EUR      | 198     | 100%              | Telefónica, S.A.                                   |
| Holding company  |             |          |         |                   |  |
| Telxius Telecom, S.A.U.  | Spain       | EUR      | 250     | 100%              | Telefónica, S.A.                                   |
| Holding company  |             |          |         |                   |  |
| Telefónica International Wholesale Services America, S.A.                            | Uruguay     | USD      | 429     | 100%              | Telxius Telecom, S.A.U                             |
| Provision of high bandwidth communications services                                  |             |          |         |                   |  |
| Telxius Cable España, S.L.U.   |             |          |         |                   |  |
| Any type of infrastructures and/or communications networks institution and operation | Spain       | EUR      | 5       | 100%              | Telxius Telecom, S.A.U.                            |
| Telxius Torres Latam, S.L.U.   | Spain       | EUR      | 5       | 100 %             | Telxius Telecom, S.A.U.                            |

Any type of infrastructures and/or  
communications networks institution and  
operation  
Telxius Torres España, S.L.U.

Any type of infrastructures and/or  
communications networks institution and  
operation  
Telxius Towers Germany, GmbH.

Any type of infrastructures and/or  
communications networks institution and  
operation  
Latin American Cellular Holdings, S.L.

Holding Company  
Telefónica Datacorp, S.A.U

Holding Company  
Telefónica International Wholesale  
Services, S.L.

International services provider  
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|         |     |     |       |  |
|---------|-----|-----|-------|--|
| Spain   | EUR | 10  | 100 % | Telxius Telecom, S.A.U.                  |
| Germany | EUR | 10  | 100 % | Telxius Telecom, S.A.U.                  |
| Spain   | EUR | -   | 100%  | Telefónica Latinoamérica<br>Holding,S.L. |
| Spain   | EUR | 700 | 100%  | Telefónica, S.A.                         |
| Spain   | EUR | 230 | 100%  | Telefónica, S.A.                         |

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| Name and corporate purpose  | Country   | Currency | Capital | %Telefónica Group | Holding Company  |
|---|-----------|----------|---------|-------------------|--|
| Other companies (cont.)<br>Telefónica International Wholesale Services México, S.A.                       | Mexico    | MXN      | 31      | 100 %             | Telefónica International Wholesale Services, S.L.  |
| Telecommunications research activities and projects<br>Telefónica Digital España, S.L.                    | Spain     | EUR      | 13      | 100%              | Telefónica Digital Holdings, S.L.  |
| Developer Telco Services Holding Company<br>Wayra Investigación y Desarrollo S.L                          | Spain     | EUR      | 2       | 100%              | Telefónica Digital Holdings, S.L.  |
| Talent identification and development in ICT.<br>Telefónica Digital Inc.                                  | US        | USD      | -       | 100%              | Telefónica Digital Ltd   |
| IP telephony platform<br>Wayra Chile Tecnología e Innovación Limitada                                     | Chile     | CLP      | 23,016  | 100%              | Wayra Investigación y Desarrollo, S.L.   |
| Technological innovation based business project development<br>Wayra Brasil Aceleradora de Projetos Ltda. | Brazil    | BRL      | 33      | 100%              | Wayra Investigación y Desarrollo S.L.  |
| Technological innovation based business project development<br>WY Telecom, S.A. de C.V.                   | Mexico    | MXN      | 116     | 100%              | Wayra Investigación y Desarrollo, S.L.   |
| Talent identification and development in ICT<br>Wayra Argentina, S.A.                                     | Argentina | ARS      | 44      | 100%              | Telefónica Móviles Argentina, S.A. (90.00%)<br>Telefónica Móviles Argentina Holding, B.V. (10.00%) |
| Talent identification and development in ICT<br>Wayra Colombia, S.A.S.                                    | Colombia  | COP      | 3,182   | 100%              | Wayra Investigación y Desarrollo, S.L.   |
| Technological innovation based business project development<br>Proyecto Wayra, C.A.                       | Venezuela | VEF      | 487     | 100%              | Telefónica Venezolana, C.A.  |
| Commercial, industrial and mercantile activities<br>Wayra Perú Aceleradora de Proyectos, S.A.C.           | Peru      | PEN      | 18      | 100%              | Wayra Investigación y Desarrollo, S.L.   |

|  |           |     |     |      |   |
|--|-----------|-----|-----|------|---|
| Technological innovation based business project development<br>Wayra UK Ltd                |           |     |     |      |   |
| Technological innovation based business project development<br>Wayra Ireland Ltd           | UK        | GBP | -   | 100% | Wayra Investigación y Desarrollo, S.L           |
| Technological innovation based business project development<br>Terra Networks Brasil, S.A. | Ireland   | EUR | -   | 100% | Wayra Investigación y Desarrollo, S.L           |
| ISP and portal<br>Terra Networks México, S.A. de C.V.                                      | Brazil    | BRL | 146 | 100% | Sao PauloTelecomunicaçoes Participaçoes, Ltda.  |
| ISP, portal and real-time financial information services<br>Terra Networks Perú, S.A.      | Mexico    | MXN | 305 | 100% | Terra Networks México Holding, S.A. de C.V.     |
| ISP and portal<br>Terra Networks Argentina, S.A.   | Peru      | PEN | 10  | 100% | Telefónica Latinoamérica Holding, S.L..         |
| ISP and portal<br>Axonix Ltd   | Argentina | ARS | 7   | 100% | Telefónica Latinoamérica Holding, S.L. (99.99%) |
| Digital and mobile advertising<br>Eyeos, S.L   | UK        | USD | -   | 78%  | Telefónica International Holding, B.V. (0.01%)  |
| Cloud Computing<br>F-123   | Spain     | EUR | -   | 100% | Telefónica Digital España, S.L.                 |

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| Name and corporate purpose   | Country     | Currency | Capital | %Telefónica Group | Holding Company                            |
|--|-------------|----------|---------|-------------------|--|
| Other companies (cont.)<br>Telfisa Global, B.V.  |             |          |         |                   |  |
| Integrated cash management, consulting and financial support for Group companies<br>Telefónica Global Activities Holding, B.V. | Netherlands | EUR      | -       | 100%              | Telefónica, S.A.                           |
| Holding Company<br>Telefónica Global Services, GmbH  | Netherlands | EUR      | -       | 100%              | Telfisa Global, B.V.                       |
| Purchasing services<br>Telefónica Global Roaming, GmbH   | Germany     | EUR      | -       | 100%              | Group 3G UMTS Holding, GmbH                |
| Optimization of network traffic<br>Group 3G UMTS Holding GmbH  | Germany     | EUR      | -       | 100%              | Telefónica Global Services, GmbH           |
| Holding Company<br>Telefónica Compras Electrónicas, S.L.   | Germany     | EUR      | 250     | 100%              | Telefónica Global Activities Holdings B.V. |
| Development and provision of information Society services<br>Telefónica de Contenidos, S.A.U.                                  | Spain       | EUR      | -       | 100%              | Telefónica Global Services, GmbH           |
| Organization and operation of multimedia service-related business<br>Telefónica Studios S.L.                                   | Spain       | EUR      | 226     | 100%              | Telefónica, S.A.                           |
| Audiovisual Productions<br>Telefónica Servicios Audiovisuales, S.A.U.  | Spain       | EUR      | -       | 100%              | Telefónica de Contenidos, S.A.U.           |
| Provision of all type of audiovisual telecommunications services<br>Telefónica On The Spot Services, S.A.U.                    | Spain       | EUR      | 6       | 100%              | Telefónica de Contenidos, S.A.U.           |
| Provision of telemarketing services<br>Telefónica Broadcast Services, S.L.U.   | Spain       | EUR      | -       | 100%              | Telefónica de Contenidos, S.A.U.           |
| DSNG-based transmission and operation services<br>Telefónica Educación Digital, S.L.   | Spain       | EUR      | -       | 100%              | Telefónica Servicios Audiovisuales, S.A.U. |
| Vertical e learning portal<br>Telfin Ireland Ltd.  | Spain       | EUR      | 1       | 100%              | Telefónica Digital España, S.L.            |
| Intragroup financing<br>Telefónica Ingeniería de Seguridad, S.A.U.   | Ireland     | EUR      | -       | 100%              | Telefónica, S.A.                           |
| Security services and systems  | Spain       | EUR      | 12      | 100%              | Telefónica, S.A.                           |

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|  |        |     |     |        |  |
|--|--------|-----|-----|--------|--|
| Telefónica Engenharia de Segurança do Brasil Ltda                            |        |     |     |        | Telefónica Ingeniería de Seguridad, S.A. |
| Security services and systems  | Brazil | BRL | 114 | 99.99% |  |
| Telefónica Capital, S.A.U.   |        |     |     |        |  |
|  | Spain  | EUR | 7   | 100%   | Telefónica, S.A.                         |
| Finance company  |        |     |     |        |  |
| Lotca Servicios Integrales, S.L.   |        |     |     |        |  |
|  | Spain  | EUR | 17  | 100%   | Telefónica, S.A.                         |
| Aircraft ownership and operation   |        |     |     |        |  |
| Fonditel Pensiones, Entidad Gestora de Fondos de Pensiones, S.A              |        |     |     |        |  |
|  | Spain  | EUR |     | 1670%  | Telefónica Capital, S.A.                 |
| Administration of pension funds  |        |     |     |        |  |
| Fonditel Gestión, Soc. Gestora de Instituciones de Inversión Colectiva, S.A. |        |     |     |        |  |
|  | Spain  | EUR | 2   | 100%   | Telefónica Capital, S.A.                 |
| Administration and representation of collective investment schemes           |        |     |     |        |  |
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| Name and corporate purpose  | Country     | Currency | Capital | %Telefónica Group | Holding Company                                |
|---|-------------|----------|---------|-------------------|--|
| Other companies (cont.)<br>Telefónica Investigación y Desarrollo, S.A.U.  | Spain       | EUR      | 6       | 100%              | Telefónica, S.A.                               |
| Telecommunications research activities and projects<br>Media Networks Latin America, S.A.C  | Peru        | PEN      | 111     | 100%              | Telefónica Internacional, S.A                  |
| Telecommunications research activities and projects<br>Telefónica Luxembourg Holding, S.à.r.L.  | Luxembourg  | EUR      | 3       | 100%              | Telefónica, S.A.                               |
| Holding company<br>Casiopea Reaseguradora, S.A.   | Luxembourg  | EUR      | 4       | 100%              | Telefónica Luxembourg Holding, S.à.r.L.        |
| Reinsurance<br>Nova Casiopea RE S.A.  | Luxembourg  | EUR      | 15      | 100%              | Telefónica Luxembourg Holding, S.à.r.L.        |
| Reinsurance<br>Telefónica Insurance, S.A.   | Luxembourg  | EUR      | 8       | 100%              | Telefónica Luxembourg Holding, S.à.r.L.        |
| Direct insurance transactions<br>Seguros de Vida y Pensiones Antares, S.A.  | Spain       | EUR      | 51      | 100%              | Telefónica, S.A.                               |
| Life insurance, pensions and health insurance<br>Telefónica Finanzas, S.A.U.  | Spain       | EUR      | 3       | 100%              | Telefónica, S.A.                               |
| Integrated cash management, consulting and financial support for Group companies<br>Pléyade Peninsular, Correduría de Seguros y Reaseguros del Grupo Telefónica, S.A. | Spain       | EUR      | -       | 100%              | Telefónica Finanzas, S.A.U. (TELFISA) (83.33%) |
| Distribution, promotion or preparation of insurance contracts<br>Fisatel México, S.A. de C.V.   | Mexico      | MXN      | 3,505   | 100%              | Telefónica, S.A. (16.67%)                      |
| Integrated cash management, consulting and financial support for Group companies<br>Telefónica Europe, B.V.   | Netherlands | EUR      | -       | 100%              | Telefónica, S.A.                               |
| Fund raising in capital markets<br>Telefónica Emisiones, S.A.U.   | Spain       | EUR      | -       | 100%              | Telefónica, S.A.                               |
| Financial debt instrument issuer<br>Telefónica Global Technology, S.A.U.  | Spain       | EUR      | 16      | 100%              | Telefónica, S.A.                               |



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|   |             |     |     |        |  |  |
|---|-------------|-----|-----|--------|--|--|
| Global management and operation of IT systems             |             |     |     |        |  | Telefónica S.A. (50.00%)                       |
| Aliança Atlântica Holding B.V.                            | Netherlands | EUR | 150 | 100%   |  |  |
| Holding company   |             |     |     |        |  | Telefônica Brasil, S.A. (50.00%)               |
| Telefónica Gestión de Servicios Compartidos de Chile, S.A | Chile       | CLP | -   | 100%   |  | Telefónica Chile, S.A                          |
| Management and administrative services rendered           |             |     |     |        |  |  |
| Telefónica Gestión de Servicios Compartidos               |             |     |     |        |  | Telefónica Servicios Globales, S.L.U. (99.48%) |
| Perú, S.A.C.  | Peru        | PEN | 1   | 100%   |  | Telefónica del Perú, S.A.A.(0.52%)             |
| Management and administrative services rendered           |             |     |     |        |  |  |
| Telefónica Transportes e Logística Ltda.                  | Brazil      | BRL | -   | 99.99% |  | Telefónica Data, S.A. (Brasil)                 |
| Logistics services rendered                               |             |     |     |        |  |  |
| Telefónica Serviços Empresariais do BRASIL, Ltda.         | Brazil      | BRL | 35  | 99.99% |  | Telefónica Servicios Globales, S.L.U.          |
| Management and administrative services rendered           |             |     |     |        |  |  |
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| Name and corporate purpose                                       | Country  | Currency | Capital | %Telefónica Group | Holding Company                                |
|--|----------|----------|---------|-------------------|--|
| Other companies (cont.)  |          |          |         |                   |  |
| Telefónica Gestión de Servicios Compartidos México, S.A. de C.V. | Mexico   | MXN      | 50      | 100%              | Telefónica Servicios Globales, S.L.U.          |
| Management and administrative services rendered                  |          |          |         |                   |  |
| Telefónica Gestión Logística, S.A.C                              | Peru     | PEN      | 15      | 100%              | Telefónica Servicios Globales, S.L.U. (99.49%) |
| Logistic service provider  |          |          |         |                   | Telefónica del Perú, S.A.A. (0.51%)            |
| Telefónica Gestión Integral de Edificios y Servicios, S.L.       | Spain    | EUR      | -       | 100%              | Telefónica Servicios Globales, S.L.U.          |
| Management and administrative services rendered                  |          |          |         |                   |  |
| Tempotel, Empresa de Trabajo Temporal, S.A.                      | Spain    | EUR      | -       | 100%              | Telefónica Servicios Globales, S.L.U.          |
| Temporary employment agency                                      |          |          |         |                   |  |
| O2 Worldwide Limited   | UK       | GBP      | -       | 100%              | Telefónica, S.A.                               |
| Wireless telecommunications activities                           |          |          |         |                   |  |
| Synergic Partners, S.L.  | Spain    | EUR      | -       | 100%              | Telefónica Digital España, S.L.                |
| Technological and consulting services in Big Data provider       |          |          |         |                   |  |
| Telefónica Innovación Alpha, S.L.                                | Spain    | EUR      | -       | 100%              | Telefónica, S.A.                               |
| Electronic communications and audiovisual services provider      |          |          |         |                   |  |
| Telefónica Servicios Globales, S.L.U.                            | Spain    | EUR      | 1       | 100%              | Telefónica, S.A.                               |
| Holding Company  |          |          |         |                   |  |
| Saluspot Spain, S.L.   | Spain    | EUR      | -       | 65%               | Telefónica Digital España, S.L.                |
| Medical services and articles through internet provider          |          |          |         |                   |  |
| Companies accounted for using the equity method                  |          |          |         |                   |  |
| Telefónica Factoring España, S.A.                                |          |          |         |                   |  |
| Factoring services provider                                      | Spain    | EUR      | 5       | 50%               | Telefónica, S.A. (40.00%)                      |
| Telefónica Factoring Do Brasil, Ltd.                             | Brazil   | BRL      | 5       | 50%               | Telefónica Factoring España, S.A. (10.00%)     |
| Factoring services provider                                      |          |          |         |                   | Telefónica, S.A. (40.50%)                      |
| Telefónica Factoring México, S.A. de C.V.                        |          |          |         |                   |  |
| SOFOM ENR  | Mexico   | MXN      | 34      | 50%               | Telefónica Factoring España, S.A. (9.50%)      |
| Factoring services provider                                      |          |          |         |                   | Telefónica, S.A. (40.50%)                      |
| Telefónica Factoring Perú, S.A.C.                                | Peru     | PEN      | 6       | 50%               | Telefónica Factoring España, S.A. (9.50%)      |
| Factoring services provider                                      |          |          |         |                   | Telefónica, S.A. (40.50%)                      |
| Telefónica Factoring Colombia, S.A.                              | Colombia | COP      | 4,000   | 50%               | Telefónica Factoring España, S.A. (9.50%)      |
| Factoring services provider                                      |          |          |         |                   |  |

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|  |                     |   |
|--|---------------------|---|
| Mobile Financial Services Holding SPRL |                     | Telefónica Internacional Holding, B.V<br>(26.28%) |
| Financial services                     | Belgium USD 180 50% | Telefónica Holding Atticus, B.V<br>(23.72%)       |
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| Name and corporate purpose  | Country | Currency | Capital | %Telefónica Group | Holding Company                 |
|---|---------|----------|---------|-------------------|---------------------------------|
| Companies accounted for using the equity method (cont.)<br>Telefónica Consumer Finance, |         |          |         |                   |                                 |
| Establecimiento Financiero de Crédito, S.A.   | Spain   | EUR      | 5       | 50%               | Telefónica, S.A.                |
| Specialised credit institution  |         |          |         |                   |                                 |
| Tesco Mobile Ltd.<br>Wireless telephony services  | UK      | GBP      | -       | 50%               | O2 Communication Ltd.           |
| The Smart Steps Data Technology Company   |         |          |         |                   |                                 |
| Big data services in China  | China   | CNY      | -       | 45%               | Telefónica Digital España, S.L. |

Main changes in the scope of consolidation for the year

**Constitution of new companies**

| Companies/Segment/Subsidiaries  | Country | Date of inclusion | % Acquisition |
|---|---------|-------------------|---------------|
| <b>Telefónica Spain</b><br>Telecomunicaciones Personalizadas, S.L.U   | Spain   | 09/30/2016        | 100%          |
| Telecommunications service provider   |         |                   |               |
| <b>Other companies</b><br>Telxius Torres Latam, S.L.U.  | Spain   | 04/30/2016        | 100%          |
| Any type of infrastructures and/or communications networks institution and operation<br>Telxius Torres España, S.L.U. | Spain   | 02/29/2016        | 100%          |
| Any type of infrastructures and/or communications networks institution and operation<br>Telxius Towers Germany, GmbH. | Spain   | 02/29/2016        | 100%          |
| Any type of infrastructures and/or communications networks institution and operation                                  | Germany | 02/29/2016        | 100%          |

**Acquired companies**

| Company/Segment/Subsidiaries                     | Country    | Date of inclusion | % Acquisition |
|--|------------|-------------------|---------------|
| <b>Telefónica Spain</b><br>Nova Casiopea RE S.A. | Luxembourg | 04/01/2016        | 100%          |
| Reinsurance                                      |            |                   |               |

Saluspot Spain, S.L. (\*)

Spain 05/31/1016 65.00%

Medical services and articles through internet provider

(\*) In 2016 Healthcommunity, S.L., in which the Group holds a 50% stake and which is consolidated using the equity method, was spun off into two companies: Saluspot Spain, S.L and Salupro Spain, S.L. After completing the spin off process, the Group held 65% of the equity in Saluspot Spain, S.L and transferred its stake to Salupro Spain, S.L. Saluspot Spain, S.L is was included in the scope of consolidation using the full consolidation method.

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| Company/Segment/Subsidiaries                                | Country   | Date of deconsolidated | % Sold |
|---|-----------|------------------------|--------|
| <b>Telefónica Spain</b>                                     |           |                        |        |
| Telecomunicaciones Personalizadas, S.L.U                    | Spain     | 12/31/2016             | 100%   |
| Telecommunications service provider                         |           |                        |        |
| <b>Other companies</b>                                      |           |                        |        |
| Televisión Federal S.A.- TELEFE                             | Argentina | 11/30/2016             | 100%   |
| Provision and operation TV and radio broadcasting-services  |           |                        |        |
| Atlántida Comunicaciones, S.A.                              | Argentina | 11/30/2016             | 100%   |
| Participation in public media                               |           |                        |        |
| Telefónica Media Argentina, S.A.                            | Argentina | 11/30/2016             | 100%   |
| Participation in public media                               |           |                        |        |
| Vocem 2013 Teleservicios, S.A.                              | Venezuela | 06/31/2016             | 100%   |
| Call center services  |           |                        |        |
| Telefónica Gestión de Servicios Compartidos Argentina, S.A. | Argentina | 03/31/2016             | 100%   |
| Management and administrative services rendered             |           |                        |        |
| Telefónica Gestión de Servicios Compartidos España, S.A.    | Spain     | 03/31/2016             | 100%   |
| Management and administrative services rendered             |           |                        |        |

**Merged companies**

| Company/Segment/Subsidiaries     | Country | Date       | Surviving company                      |
|----------------------------------|---------|------------|--|
| <b>Telefónica Brazil</b>         |         |            |  |
| GVT Participações                | Brazil  | 01/30/2016 | Telefônica                             |
| Holding company                  |         |            | Brasil, S.A.                           |
| <b>Other companies</b>           |         |            |  |
| Telefónica Internacional, S.A.U. | Spain   | 10/31/2016 | Telefónica Latinoamérica Holding, S.L. |
| Holding Company                  |         |            |  |
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## Appendix II: Board and Senior Management Compensation

**TELEFÓNICA, S.A.**

(Amounts in euros)

| <b>Directors</b>                                  | <b>Salary<sup>1</sup></b> | <b>Fixed compensation<sup>2</sup></b> | <b>Attendance fees<sup>3</sup></b> | <b>Short-term variable compensation<sup>4</sup></b> | <b>Compensation for belonging to Committees of the Board<sup>5</sup></b> | <b>Other items<sup>6</sup></b> | <b>Total</b> |
|---|---------------------------|---------------------------------------|------------------------------------|---|--|--------------------------------|--------------|
| Mr. José María Álvarez-Pallete López              | 1,923,100-                | -                                     | -                                  | 3,461,580   | -  | 5,803                          | 5,390,483    |
| Mr. Isidro Fainé Casas                            | -                         | 200,000                               | -                                  | -   | 80,000   | 6,000                          | 286,000      |
| Mr. José María Abril Pérez                        | -                         | 200,000                               | 3,000                              | -   | 91,200   | -                              | 294,200      |
| Mr. Julio Linares López                           | -                         | 200,000                               | 20,000                             | -   | 37,333   | -                              | 257,333      |
| Mr. César Alierta Izuel                           | 607,273                   | 538,554                               | -                                  | 4,015,440   | 20,000   | 1,338                          | 5,182,605    |
| Ms. Eva Castillo Sanz                             | -                         | 120,000                               | 20,000                             | -   | 33,600   | -                              | 173,600      |
| Mr. Juan Ignacio Cirac Sasturain <sup>7</sup>     | -                         | 30,000                                | -                                  | -   | -  | -                              | 30,000       |
| Mr. José Javier Echenique Landiribar <sup>7</sup> | -                         | 90,000                                | 7,000                              | -   | 76,800   | -                              | 173,800      |
| Mr. Peter Erskine                                 | -                         | 120,000                               | 24,000                             | -   | 117,333  | -                              | 261,333      |
| Ms. Sabina Fluxà Thienemann <sup>7</sup>          | -                         | 90,000                                | 4,000                              | -   | 7,467  | -                              | 101,467      |
| Mr. Luiz Fernando Furlán                          | -                         | 120,000                               | -                                  | -   | -  | -                              | 120,000      |
| Mr. Gonzalo Hinojosa Fernández de Angulo          | -                         | 120,000                               | 28,000                             | -   | 143,467  | 6,000                          | 297,467      |
| Mr. Pablo Isla Álvarez de Tejera                  | -                         | 120,000                               | 5,000                              | -   | 11,200   | -                              | 136,200      |
| Mr. Peter Löscher <sup>7</sup>                    | -                         | 90,000                                | 6,000                              | -   | 7,467  | -                              | 103,467      |
| Mr. Antonio Massanell Lavilla                     | -                         | 120,000                               | 18,000                             | -   | 56,000   | 7,000                          | 201,000      |
|   | -                         | 120,000                               | 22,000                             | -   | 33,600   | -                              | 175,600      |

Mr. Ignacio  
Moreno Martínez

Mr. Francisco

|               |   |         |        |   |         |       |         |
|---------------|---|---------|--------|---|---------|-------|---------|
| Javier de Paz | - | 120,000 | 25,000 | - | 122,933 | 6,000 | 273,933 |
|---------------|---|---------|--------|---|---------|-------|---------|

Mancho

|                   |  |         |   |   |   |   |         |
|-------------------|--|---------|---|---|---|---|---------|
| Mr. Wang Xiaochu- |  | 120,000 | - | - | - | - | 120,000 |
|-------------------|--|---------|---|---|---|---|---------|

1 Salary: The amount for Mr. José María Álvarez-Pallete López includes compensation amounts that are not variable in nature and that the Director received for his executive work. Mr. César Alierta Izuel held the position of Executive Chairman of the Company through April 8, 2016, including through such date the amount of compensation that is not variable in nature and that the Director received for his for his executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Board, regardless of the actual attendance by the Director at meetings of the Board.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the Advisory or Control Committees.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016. As regards the bonus for 2016 and which will be paid in 2017, the Executive Director Mr. José María Álvarez-Pallete López will receive 3,430,430 euros.

5 Compensation for belonging to Committees of the Board: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Executive Commission and the Advisory or Control Committees, regardless of the actual attendance by the Director at meetings of the Advisory or Control Committees.

6 Other items: Includes, among other things, the amounts received for belonging to the Territorial Advisory Boards in Spain (Valencia, Andalusia and Catalonia) and other in-kind compensation (general medical insurance and dental coverage) paid by Telefónica, S.A. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Territorial Advisory Boards in Spain were eliminated.

7. Mr. Juan Ignacio Cirac Sasturain, Mr. José Javier Echenique Landiribar, Ms. Sabina Fluxà Thienemann, and Mr. Peter Löscher were appointed as Directors of the Company on April 8, 2016, thus reflecting the compensation received as from such date.

Furthermore, Mr. José Fernando de Almansa Moreno-Barreda, Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero and Mr. Santiago Fernández Valbuena ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.



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| <b>Directors</b>                            | <b>Salary<sup>1</sup></b> | <b>Fixed compensation<sup>2</sup></b> | <b>Attendance fees<sup>3</sup></b> | <b>Short-term variable compensation<sup>4</sup></b> | <b>Compensation for belonging to Committees of the Board<sup>5</sup></b> | <b>Other items<sup>6</sup></b> | <b>Total</b> |
|---|---------------------------|---------------------------------------|------------------------------------|---|--|--------------------------------|--------------|
| Mr. José Fernando de Almansa Moreno-Barreda | -                         | 30,000                                | 8,000                              | -   | 8,400  | 3,333                          | 49,733       |
| Mr. Calos Colomer Casellas                  | -                         | 30,000                                | 14,000                             | -   | 36,800   | 4,333                          | 85,133       |
| Mr. Alfonso Ferrari Herrero                 | -                         | 30,000                                | 17,000                             | -   | 39,600   | 3,333                          | 89,933       |
| Mr. Santiago Fernández Valbuena             | -                         | -                                     | -                                  | -   | -  | -                              | -            |

1 Salary: Includes compensation amounts that are not variable in nature and that the Director received for his executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Board, regardless of the actual attendance by the Director at meetings of the Board.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the Advisory or Control Committees.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016.

5 Compensation for belonging to Committees of the Board: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Executive Commission and the Advisory or Control Committees, regardless of the actual attendance by the Director at meetings of the Advisory or Control Committees.

6 Other items: Includes, among other things, the amounts received for belonging to the Territorial Advisory Boards in Spain (Valencia, Andalusia and Catalonia) and other in-kind compensation (general medical insurance and dental coverage) paid by Telefónica, S.A. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Territorial Advisory Boards in Spain were eliminated.

To break down the amounts included in the table above, set forth below is the specific compensation received by Telefónica's Directors for belonging to the various Advisory or Control Committees during fiscal year 2016, including both the fixed amount and the attendance fees.

In this regard, it is noted that the Board of Directors, at its meeting held on April 27, 2016, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, approved a new configuration for the organization, structure and composition of the Advisory and Control Committees of the Company in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A.'s corporate governance structure.

Within this context, the Board of Directors unanimously adopted the following resolutions: i) To reorganize the then-existing Regulation and Institutional Affairs Committees, which became a single Committee called the Regulation and Institutional Affairs Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees; and ii) To reorganize the then-existing Strategy and Innovation Committees, which became a single Committee called the Strategy and Innovation Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees.

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Table of Contents**ADVISORY OR CONTROL COMMITTEES OF TELEFÓNICA, S.A.**

(Amounts in euros)

| <b>Directors</b>                                | <b>Audit and Control</b> | <b>Nominating, Compensation and Corporate Governance</b> | <b>Service Quality and Customer Service</b> | <b>Strategy and Innovation</b> | <b>Regulation and Institutional Affairs</b> | <b>TOTAL 2016</b> |
|---|--------------------------|--|---|--------------------------------|---|-------------------|
| Mr. José María Álvarez-Pallete López            | -                        | -  | -   | -                              | -   | -                 |
| Mr. Isidro Fainé Casas                          | -                        | -  | -   | -                              | -   | -                 |
| Mr. José María Abril Pérez                      | -                        | -  | -   | 14,200                         | -   | 14,200            |
| Mr. Julio Linares López <sup>1</sup>            | -                        | -  | 9,467                                       | 15,466                         | 32,400                                      | 57,333            |
| Mr. César Alierta Izuel                         | -                        | -  | -   | -                              | -   | -                 |
| Ms. Eva Castillo Sanz                           | -                        | -  | 15,200                                      | 21,200                         | 17,200                                      | 53,600            |
| Mr. Juan Ignacio Cirac Sasturain                | -                        | -  | -   | -                              | -   | -                 |
| Mr. José Javier Echenique Landiribar            | 23,800                   | -  | -   | -                              | -   | 23,800            |
| Mr. Peter Erskine                               | -                        | 21,200   | -   | 40,133                         | -   | 61,333            |
| Ms. Sabina Fluxà Thienemann                     | -                        | 11,467   | -   | -                              | -   | 11,467            |
| Mr. Luiz Fernando Furlán                        | -                        | -  | -   | -                              | -   | -                 |
| Mr. Gonzalo Hinojosa Fernández de Angulo        | 18,200                   | 19,200   | 13,200                                      | 16,200                         | 24,667                                      | 91,467            |
| Mr. Pablo Isla Álvarez de Tejera                | -                        | 16,200   | -   | -                              | -   | 16,200            |
| Mr. Peter Löscher                               | -                        | -  | -   | 13,467                         | -   | 13,467            |
| Mr. Antonio Massanell Lavilla                   | 22,200                   | -  | 26,400                                      | 11,200                         | 14,200                                      | 74,000            |
| Mr. Ignacio Moreno Martínez                     | 23,200                   | -  | 15,200                                      | -                              | 17,200                                      | 55,600            |
| Mr. Francisco Javier de Paz Mancho <sup>1</sup> | 13,467                   | 23,800   | 5,733                                       | -                              | 24,933                                      | 67,933            |
| Mr. Wang Xiaochu                                | -                        | -  | -   | -                              | -   | -                 |

<sup>1</sup> In the case of Mr. Linares, includes the amount received for belonging to the former Strategy Committee until April 27, 2016, and in the case of Mr. de Paz includes the amount received for belonging to the Service Quality and Customer Service Committee until April 27, 2016.

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Mr. José Fernando de Almansa Moreno-Barreda, Mr. Carlos Colomer Casellas and Mr. Alfonso Ferrari Herrero ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.

| <b>Directors</b>                            | <b>Audit and Control</b> | <b>Nominating, Compensation and Corporate Governance</b> | <b>Regulation</b> | <b>Service Quality and Customer Service</b> | <b>Innovation</b> | <b>Strategy</b> | <b>Institutional Affairs</b> | <b>TOTAL 2016</b> |
|---|--------------------------|--|-------------------|---|-------------------|-----------------|------------------------------|-------------------|
| Mr. José Fernando de Almansa Moreno-Barreda | -                        | -  | 3,800             | -   | -                 | 6,800           | 5,800                        | 16,400            |
| Mr. Carlos Colomer Casellas                 | 11,600                   | 5,800  | -                 | 4,800                                       | 8,600             | -               | -                            | 30,800            |
| Mr. Alfonso Ferrari Herrero                 | 7,800                    | 8,600  | 3,800             | 3,800                                       | -                 | 6,800           | 5,800                        | 36,600            |

The following table also breaks down on an individualized basis the amounts received by the Company's Directors from companies of the Telefónica Group other than Telefónica, S.A. for the performance of executive duties or for belonging to the Boards of Directors and/or Advisory Committees of such companies:

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Table of Contents**OTHER COMPANIES OF THE TELEFÓNICA GROUP**

(Amounts in euros)

| <b>Directors</b>                         | <b>Salary<sup>1</sup></b> | <b>Fixed compensation<sup>2</sup></b> | <b>Attendance fees<sup>3</sup></b> | <b>Short-term variable compensation<sup>4</sup></b> | <b>Compensation for belonging to Committees of the Board<sup>5</sup></b> | <b>Other items<sup>6</sup></b> | <b>Total</b> |
|--|---------------------------|---------------------------------------|------------------------------------|---|--|--------------------------------|--------------|
| Mr. José María Álvarez-Pallete López     | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Isidro Fainé Casas                   | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. José María Abril Pérez               | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Julio Linares López                  | -                         | -                                     | -                                  | -   | -  | 30,000                         | 30,000       |
| Mr. César Alierta Izuel                  | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Ms. Eva Castillo Sanz                    | -                         | 60,000                                | -                                  | -   | -  | -                              | 60,000       |
| Mr. Juan Ignacio Cirac Sasturain         | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. José Javier Echenique Landiribar     | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Peter Erskine                        | -                         | -                                     | -                                  | -   | -  | 53,066                         | 53,066       |
| Ms. Sabina Fluxà Thienemann              | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Luiz Fernando Furlán                 | -                         | 86,656                                | -                                  | -   | -  | 30,000                         | 116,656      |
| Mr. Gonzalo Hinojosa Fernández de Angulo | -                         | 19,254                                | -                                  | -   | -  | 30,000                         | 49,254       |
| Mr. Pablo Isla Álvarez de Tejera         | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Peter Löscher                        | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Antonio Massanell Lavilla            | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Ignacio Moreno Martínez              | -                         | -                                     | -                                  | -   | -  | -                              | -            |
| Mr. Francisco Javier de Paz Mancho       | -                         | 181,394                               | -                                  | -   | -  | 30,000                         | 211,394      |
| Mr. Wang Xiaochu                         | -                         | -                                     | -                                  | -   | -  | -                              | -            |

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1 Salary: Compensation amounts that are not variable in nature and that the Director received from other companies of the Telefónica Group for his/her executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the boards of directors of other Companies of the Telefónica Group.

It is noted that Ms. Eva Castillo accrued an amount of 60,000 euros during fiscal year 2016 for belonging to the Supervisory Board of Telefónica Deutschland Holding, A.G. Such amount had not been paid as of the date of preparation of this document. Mr. Peter Erskine also accrued an amount of 12,403 euros during fiscal year 2016 for belonging to the Supervisory Board of Telefónica Deutschland Holding, A.G. Such amount had not been paid as of the date of preparation of this document.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the boards of directors of other Companies of the Telefónica Group.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016, by other companies of the Telefónica Group.

5 Compensation for belonging to Committees of the Board of other companies of the Telefónica Group: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time and accrued by the Director for belonging to the Committees of boards of directors of other Companies of the Telefónica Group.

6 Other items: Includes, among other things, the amounts received for belonging to other Regional and Business Advisory Boards (Spain, UK and Latam) and other in-kind compensation (general medical insurance and dental coverage) paid by other companies of the Telefónica Group. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Regional and Business Boards were eliminated.

Furthermore, Mr. José Fernando de Almansa Moreno-Barreda, Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero and Mr. Santiago Fernández Valbuena ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.

| Directors                                   | Salary <sup>1</sup> | Fixed compensation <sup>2</sup> | Attendance fees <sup>3</sup> | Short-term variable compensation <sup>4</sup> | Compensation for belonging to Committees of the Board <sup>5</sup> | Other items <sup>6</sup> | Total     |
|---|---------------------|---------------------------------|------------------------------|---|--|--------------------------|-----------|
| Mr. José Fernando de Almansa Moreno-Barreda | -                   | 95,944                          | -                            | -   | -  | 30,000                   | 125,944   |
| Mr. Carlos Colomer Casellas                 | -                   | -                               | -                            | -   | -  | -                        | -         |
| Mr. Alfonso Ferrari Herrero                 | -                   | 84,865                          | -                            | -   | -  | 30,000                   | 114,865   |
| Mr. Santiago Fernández                      | 319,223-            | -                               | -                            | 1,149,205                                     | -  | 9,218                    | 1,477,646 |

Valbuena<sup>7</sup>

1 Salary: Compensation amounts that are not variable in nature and that the Director received from other companies of the Telefónica Group for his/her executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the boards of directors of other Companies of the Telefónica Group.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the boards of directors of other Companies of the Telefónica Group.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016, by other companies of the Telefónica Group.

5 Compensation for belonging to Committees of the Board of other companies of the Telefónica Group: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time and accrued by the Director for belonging to the Committees of boards of directors of other Companies of the Telefónica Group.

6 Other items: Includes, among other things, the amounts received for belonging to other Regional and Business Advisory Boards (Spain, UK and Latam) and other in-kind compensation (general medical insurance and dental coverage) paid by other companies of the Telefónica Group. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Regional and Business Boards were eliminated.

7 It is noted that Executive Director Mr. Santiago Fernández Valbuena collected his remuneration in Brazilian reais and, accordingly, the stated amounts of his compensation in euros may vary depending on the exchange rate applicable at any particular time.

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Also as stated in the section on Compensation Policy, the Executive Directors have a number of Benefits. Set forth below is a breakdown of the contributions made by the Company to the long-term savings plans (Pension Plans and Benefits Plan) during fiscal year 2016:

**LONG-TERM SAVINGS SYSTEMS**

(Amounts in euros)

| <b>Directors</b>                     | <b>Contributions for fiscal year 2016</b> |
|--------------------------------------|---|
| Mr. José María Álvarez-Pallete López | 673,085                                   |
| Mr. César Alierta Izuel              | 44,912                                    |

The breakdown of the long-term saving systems includes contributions to Pension Plans, to the Benefit Plan and to the Unit link-type Insurance, as set out below:

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(Amounts in euros)

| <b>Directors</b>                     | <b>Contributions to Pension Plans</b> | <b>Contributions to Benefits Plan<sup>1</sup></b> | <b>Contributions to Unit link-type Insurance/Pension Plan Surplus</b> |
|--------------------------------------|---------------------------------------|---|---|
| Mr. José María Álvarez-Pallete López | 6,060                                 | 540,968   | 126,057   |
| Mr. César Alierta Izuel              | 5,377                                 | -   | 39,535  |

<sup>1</sup> Contributions to the Executive Benefits Plan in 2006, funded solely by the Company, to supplement the Pension Plan in effect, which entails defined contributions equal to a particular percentage of the Officer's fixed compensation based on professional levels within the Telefónica Group's organization.

It is noted that in 2015 applicable law reduced the financial and tax limits of the contributions to Pension Plans; for this reason, in order to compensate for the difference in favor of the Beneficiaries, a Unit-link type group insurance policy was arranged to channel such differences that occur during each fiscal year.

This Unit-link type insurance is arranged with the entity Seguros de Vida y Pensiones Antares, S.A., and covers the same contingencies as those of the "Pension Plan" and the same exceptional liquidity events in case of serious illness or long-term unemployment.

The 2016 amounts for life insurance premiums were as follows:

**LIFE INSURANCE PREMIUMS**

(Amounts in euros)

| <b>Directors</b>                     | <b>Life insurance premiums</b> |
|--------------------------------------|--------------------------------|
| Mr. José María Álvarez-Pallete López | 17,111                         |
| Mr. César Alierta Izuel              | 62,959                         |

As regards share-based compensation plans (in which only the Executive Directors participate), there were three long-term variable compensation plans in effect during fiscal year 2016:

**1.-** The first “Performance & Investment Plan” (“PIP”) made up of three cycles (2011-2014; 2012-2015; 2013-2016), was approved at the Ordinary General Shareholders’ Meeting held on May 18, 2011. Pursuant to the general terms and conditions thereof, there was no delivery of shares from the third cycle of the Plan (2013-2016), for which reason no shares were delivered to the Executive Directors who participated in this cycle.

**2.-** The second Plan, also called “Performance & Investment Plan” (“PIP”), was approved at the Ordinary General Shareholders’ Meeting held on May 30, 2014. The first cycle of this Plan began in 2014 and will end in October 2017. The second cycle of this Plan began in 2015 and will end in October 2018. As regards the third cycle of this Plan (2016-2019), the Board of Directors of the Company, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, resolved not to execute or implement this cycle after finding that it was not sufficiently aligned with the strategic planning of the Telefónica Group, taking into account the circumstances and the macroeconomic environment.

Set out below is the maximum number of theoretical shares allocated (without co-investment), as well as the maximum number of theoretical shares allocated upon compliance with the “co-investment” requirement established in such second Plan and maximum completion of the TSR target set for the first and second cycle of the Plan.

**SECOND PIP - First Cycle / 2014-2017**

| <b>Directors</b>                     | <b>Theoretical shares allocated<br/>(without co-investment)</b> | <b>Maximum number of shares (*)</b> |
|--------------------------------------|---|-------------------------------------|
| Mr. José María Álvarez-Pallete López | 192,000   | 300,000                             |
| Mr. César Alierta Izuel              | 324,000   | 506,250                             |

(\*) Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target.

Table of Contents**SECOND PIP - Second Cycle / 2015-2018**

| <b>Directors</b>                     | <b>Theoretical shares allocated<br/>(without co-investment)</b> | <b>Maximum number of shares (*)</b> |
|--------------------------------------|---|-------------------------------------|
| Mr. José María Álvarez-Pallete López | 192,000   | 300,000                             |
| Mr. César Alierta Izuel              | 324,000   | 506,250                             |

(\*) Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target.

In any event, it is noted that no shares have been delivered to the Executive Directors under either the first or the second cycle of the second PIP and that the table above only reflects the number of shares potentially deliverable under various scenarios, without in any way meaning that all or part thereof will actually be delivered.

In fact, the number of shares of Telefónica, S.A. that always, within the maximum limit and that could be delivered, where appropriate, to the Participants is subject to and determined by the Total Shareholder Return (“TSR”) of the Telefónica, S.A. shares during the cycle (3 years), as compared to TSRs experienced by certain companies within the telecommunications sector, weighted according to their relevance to Telefónica, S.A. which shall constitute the comparison group (hereinafter, the “Comparison Group”) for purposes of the Plan. The companies included in the Comparison Group are the following: America Movil, BT Group, Deutsche Telekom, Orange, Telecom Italia, Vodafone Group, Proximus, Royal KPN, Millicom, Oi, Swisscom, Telenor, TeliaSonera, and Tim Participações.

The achievement scale approved by the Board is the following: if the TSR performance of Telefónica, S.A. shares is within at least the median of the Comparison Group, the number of shares to be delivered will be 30% of the maximum. If performance falls in the third quartile of the Comparison Group, the number of shares to be delivered shall be 100% of the maximum. Those cases falling between the median and the third quartile shall be calculated by linear interpolation. If the TSR of Telefónica, S.A. falls within the ninth decile or higher, the delivery rate will be higher than 100%, up to a maximum of 125%, calculated by linear interpolation between said third quartile and the ninth decile.

**3.-** The Telefónica, S.A. Incentive Share Purchase Plan (2015-2017) directed towards all employees of the Group at the international level (including executive personnel as well as the Executive Chairmen), called the “Global Employee Incentive Share Purchase Plan” (“GESP”), the third edition of which was approved by the shareholders at the Ordinary General Shareholders’ Meeting of the Company held on May 30, 2014.

This Plan is intended to strengthen Telefónica’s nature as a global employer, creating a common remuneration culture throughout the Company, incentivize participation in capital by all employees of the Group, and encourage their motivation and loyalty.

Through this Plan, employees are offered the possibility of acquiring shares of Telefónica, S.A. for a maximum period of twelve months (purchase period), with the Company's commitment to deliver to the participants therein a certain number of shares free of charge, provided that certain requirements are met. Each employee can allocate a maximum amount of 1,800 euros, and a minimum amount of 300 euros. If the employee remains with the Telefónica Group and maintains the shares for an additional year after the purchase period (vesting period), they will have the right to receive one free share for each share that they have acquired and maintained through the end of the vesting period.

Mr. Álvarez-Pallete and Mr. Alierta Izuel participated in this Plan with the maximum contribution, i.e., 150 euros monthly, for twelve months. At December 31, 2016, they had acquired a total of 178 shares under this Plan, having the right to receive an equivalent number of shares free of charge, provided that the shares acquired have been kept for the vesting period (twelve months from the end of the purchase period), among other conditions.

It should also be noted that the external Directors of the Company have not received and will not receive during 2016 any compensation as pensions or life insurance, and will also not participate in compensation plans linked to the listing price of the shares (except as described for Mr. Alierta and Mr. Linares in the tables above).

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The Company does not grant, and has not granted during 2016, any advance, loan or credit to any of the Directors or to its Senior Management, in compliance with the requirements of the Sarbanes-Oxly Act in the United States, which applies to Telefónica as a company listed on such market.

**Compensation of the Senior Management of the Company.**

For their part, the Officers who in 2016 were members of the Company's Senior Management<sup>[1]</sup> excluding those forming part of the Board of Directors, received the total amount of 9,838,615 euros during fiscal year 2016.

It is noted that Mr. Santiago Fernández Valbuena received an amount of 10,560,000 euros in compensation as a result of his cessation as an Officer of Telefónica, S.A. in May 2016.

In addition, as to the long-term savings plans, the contributions made by the Telefónica Group during 2016 to the Benefits Plan described in the note on "Income and expenses" as regards these Officers was 1,414,777 euros; the contributions for the Pension Plan was 137,650 euros; and the contributions to the Unit-Link Insurance-Pension Plan Surplus were 133,351 euros.

Furthermore, amounts relating to in-kind compensation (including life insurance and other insurance premiums as well as general medical insurance, dental coverage, and vehicle) were 131,665 euros.

And as regards share-based compensation plans, there were three long-term variable compensation plans in effect during fiscal year 2016:

1.- First "Performance & Investment Plan" ("PIP") made up of three cycles (2011-2014; 2012-2015; 2013-2016), approved at the Ordinary General Shareholders' Meeting held on May 18, 2011. Pursuant to the general terms and conditions thereof, there was no delivery of shares from the third cycle of the Plan (2013-2016), for which reason no shares were delivered to the Officers.

2.- Second "Performance & Investment Plan" ("PIP") made up of three cycles (2014-2017; 2015-2018; 2016-2019), approved at the Ordinary General Shareholders' Meeting held on May 30, 2014. The number of theoretical shares assigned (without co-investment) to the beginning of the cycle to all Officers within the company's Senior Management and the maximum number of shares assigned<sup>2</sup> is 453,580 and 706,975, respectively, in the first cycle (2014-2017), and 349,650 and 544,563, respectively, in the second cycle (2015-2018).

As regards the third cycle of this Plan (2016-2019), the Board of Directors of the Company, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, resolved not to execute or implement this cycle after finding that it was not sufficiently aligned with the strategic planning of the Telefónica Group, taking into account the circumstances and the macroeconomic environment.

3.- “Global Employee Incentive Share Purchase Plan” (“GESP”) (2015-2017), the third edition of which was approved by the shareholders at the Ordinary General Shareholders’ Meeting of the Company held on May 30, 2014. All Officers within the Company’s Senior Management have decided to participate therein with the maximum contribution (i.e., 150 euros monthly, for twelve months). At December 31, 2016, the Officers within the Senior Management had acquired a total of 1,033 shares under this Plan, having the right to receive an equivalent number of shares free of charge, provided that the shares acquired are kept for the vesting period (twelve months from the end of the purchase period), among other conditions.

<sup>1</sup> With Senior Management being understood for these purposes as those persons who, *de facto* or *de jure*, perform senior management duties while reporting to the Board of Directors or the Executive Commissions or Chief Operating Officers of the Company, including in all cases the head of Internal Audit.

<sup>2</sup> Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target. In any event, it is noted that no shares have been delivered to the Executive Directors under either the first or the second cycle of the second PIP and that the table above only reflects the number of shares potentially deliverable under various scenarios, without in any way meaning that all or part thereof will actually be delivered.

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## Appendix III: Debentures and bonds

The detail and key features of outstanding debentures and bonds at December 31, 2016 are as follows (in millions of euros):

## Total Telefónica and its instrumental companies

| Debentures and bonds               | Currency | % Interest rate          | Maturity (nominal) |      |       |       |       | Subsequent years | Total |
|------------------------------------|----------|--------------------------|--------------------|------|-------|-------|-------|------------------|-------|
|                                    |          |                          | 2017               | 2018 | 2019  | 2020  | 2021  |                  |       |
| Exchangeable Bond Telefónica, S.A. | EUR      | 6.000%                   | 750                | –    | –     | –     | –     | –                | 750   |
| T. EUROPE BV SEP_00 BOND GLOBAL D  | USD      | 8.250%                   | –                  | –    | –     | –     | –     | 1,186            | 1,186 |
| TEBV FEB_03 EMTN FIXED TRANCHE B   | EUR      | 5.875%                   | –                  | –    | –     | –     | –     | 500              | 500   |
| Telefónica Europe, B.V.            |          |                          | –                  | –    | –     | –     | –     | 1,686            | 1,686 |
| EMTN O2 GBP                        | GBP      | 5.375%                   | –                  | 877  | –     | –     | –     | –                | 877   |
| EMTN O2 GBP                        | GBP      | 5.375%                   | –                  | –    | –     | –     | –     | 585              | 585   |
| TELEF EMISIONES JUNE 06 TRANCHE D  | USD      | 7.045%                   | –                  | –    | –     | –     | –     | 1,898            | 1,898 |
| TELEF EMISIONES JUNE 14            | USD      | USDL3M+0,65%             | 474                | –    | –     | –     | –     | –                | 474   |
| TELEF EMISIONES JANUARY 07 A       | EUR      | 1 x EURIBOR6M + 0,83000% | –                  | –    | –     | –     | 55    | –                | 55    |
| TELEF EMISIONES JANUARY 07 B       | EUR      | 1 x EURIBOR3M + 0,70000% | –                  | 24   | –     | –     | –     | –                | 24    |
| TELEF EMISIONES APRIL 2014         | EUR      | 1 x EURIBOR3M + 0,75000% | 200                | –    | –     | –     | –     | –                | 200   |
| TELEF EMISIONES JULY C 07          | USD      | 6.221%                   | 664                | –    | –     | –     | –     | –                | 664   |
| TELEF EMISIONES MAY 2014           | EUR      | 2.242%                   | –                  | –    | –     | –     | –     | 1,250            | 1,250 |
| TELEF EMISIONES JULY 15, 2019      | USD      | 5.877%                   | –                  | –    | 949   | –     | –     | –                | 949   |
| TELEF EMISIONES NOVEMBER 11, 2019  | EUR      | 4.693%                   | –                  | –    | 1,750 | –     | –     | –                | 1,750 |
| EMTN GBP 12/09/2022 650 GBP        | GBP      | 5.289%                   | –                  | –    | –     | –     | –     | 760              | 760   |
| TELEF EMISIONES JUNE 2014          | EUR      | 1 x EURIBOR3M +0,75%     | 100                | –    | –     | –     | –     | –                | 100   |
| TELE EMISIONES APRIL 3 2010        | USD      | 5.134%                   | –                  | –    | –     | 1,328 | –     | –                | 1,328 |
| TELEF EMISIONES SEPTEMBER 2010     | EUR      | 3.661%                   | 1,000              | –    | –     | –     | –     | –                | 1,000 |
| EMTN GBP 10/08/2029 400 GBP        | GBP      | 5.445%                   | –                  | –    | –     | –     | –     | 468              | 468   |
| TELEF EMISIONES FEBRUARY 2011      | EUR      | 4.750%                   | 1,200              | –    | –     | –     | –     | –                | 1,200 |
| TELEF EMISIONES FEBRUARY 2011      | USD      | 5.462%                   | –                  | –    | –     | –     | 1,423 | –                | 1,423 |
| TELEF EMISIONES MARCH 2011         | EUR      | 4.750%                   | 100                | –    | –     | –     | –     | –                | 100   |
| TELEF. EMISIONES FEBRUARY 2012     | EUR      | 4.750%                   | 120                | –    | –     | –     | –     | –                | 120   |

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|                                    |     |        |        |        |   |        |       |       |
|------------------------------------|-----|--------|--------|--------|---|--------|-------|-------|
| TELEF.<br>EMISIONES FEBRUARY 2012  | EUR | 4.797% | -      | 1,500- | - | -      | -     | 1,500 |
| TELEF. EMISIONES FEBRUARY<br>2012  | GBP | 5.597% | -      | -      | - | 818    | -     | 818   |
| TELEF. EMISIONES MARCH 2012        | CZK | 3.934% | 46     | -      | - | -      | -     | 46    |
| TELEF. EMISIONES JUNE 2013         | JPY | 4.250% | -      | 81     | - | -      | -     | 81    |
| TELEF. EMISIONES SEPTEMBER<br>2012 | EUR | 5.811% | 1,000- | -      | - | -      | -     | 1,000 |
| TELEF. EMISIONES OCTOBER<br>2012   | EUR | 4.710% | -      | -      | - | 1,200- | -     | 1,200 |
| TELEF. EMISIONES DECEMBER<br>2012  | CHF | 2.718% | -      | 233    | - | -      | -     | 233   |
| TELEF. EMISIONES DECEMBER<br>2012  | CHF | 3.450% | -      | -      | - | -      | 140   | 140   |
| TELEF EMISIONES JANUARY<br>2013    | EUR | 3.987% | -      | -      | - | -      | 1,500 | 1,500 |

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|   |                             |       |        |       |        |        |        |
|---|-----------------------------|-------|--------|-------|--------|--------|--------|
| TELEF. EMISIONES MARCH 2013                           | EUR 3.961%                  | -     | -      | -     | -      | 1,000- | 1,000  |
| TELEF EMISIONES APRIL 2013                            | USD 3.192%                  | -     | 1,186- | -     | -      | -      | 1,186  |
| TELEF EMISIONES APRIL 2013                            | USD 4.570%                  | -     | -      | -     | -      | 712    | 712    |
| TELEF. EMISIONES MAY 2013                             | EUR 2.736%                  | -     | -      | 750   | -      | -      | 750    |
| TELEF. EMISIONES OCT 2014                             | EUR 2.932%                  | -     | -      | -     | -      | 800    | 800    |
| TELEF. EMISIONES OCT 2013                             | CHF 2.595%                  | -     | -      | -     | 210    | -      | 210    |
| TELEF. EMISIONES JUNE 2015                            | EUR 1 x EURIBOR3M<br>+0,33% | 300   | -      | -     | -      | -      | 300    |
| TELEF. EMISIONES DECEMBER 2015                        | EUR 1 x EURIBOR3M<br>+0,53% | 100   | -      | -     | -      | -      | 100    |
| TELEF EMISIONES JULY 2015                             | EUR 1 x EURIBOR6M<br>+0,83% | -     | -      | -     | -      | 67     | 67     |
| TELEF. EMISIONES SEPTEMBER 2015                       | EUR 1.477%                  | -     | -      | -     | -      | 1,000- | 1,000  |
| TELEF EMISIONES APRIL 2016                            | EUR 0.750%                  | -     | -      | -     | -      | 1,400  | 1,400  |
| TELEF EMISIONES APRIL 2016                            | EUR 1.460%                  | -     | -      | -     | -      | 1,350  | 1,350  |
| TELEF. EMISIONES OCT 2016                             | EUR 0.318%                  | -     | -      | -     | 1,250- | -      | 1,250  |
| TELEF. EMISIONES OCT 2016                             | EUR 1.930%                  | -     | -      | -     | -      | 750    | 750    |
| TELEF. EMISIONES DEC 2016                             | EUR 4.000%                  | -     | -      | -     | -      | 150    | 150    |
| Telefónica Emisiones, S.A.U.                          |                             | 5,304 | 3,901  | 3,449 | 4,806  | 3,478  | 11,830 |
| Exchangeable Bond                                     | EUR 4.900%                  | 71    | -      | -     | -      | -      | 71     |
| Exchangeable Bond MARCH 2016                          | EUR -                       | -     | -      | -     | -      | 600    | 600    |
| Telefónica Participaciones                            |                             | 71    | -      | -     | -      | 600    | 671    |
| Total Telefónica, S.A. and its instrumental companies |                             | 6,125 | 3,901  | 3,449 | 4,806  | 4,078  | 13,516 |
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## Foreign operators

| Debentures and bonds                            | Currency | % Interest rate     | Maturity |      |      |      |      | Subsequent years | Total |
|---|----------|---------------------|----------|------|------|------|------|------------------|-------|
|   |          |                     | 2017     | 2018 | 2019 | 2020 | 2021 |                  |       |
| Bond Q  | CLP      | 5.750%              | -        | -    | 66   | -    | -    | -                | 66    |
| USD Bond  | USD      | 3.875%              | -        | -    | -    | -    | -    | 471              | 471   |
| Telefónica Chile, S.A.                          |          |                     | -        | -    | 66   | -    | -    | 471              | 537   |
| Bond F  | UF       | 3.600%              | -        | -    | -    | -    | -    | 111              | 111   |
| Bond G  | UF       | 2.200%              | -        | -    | -    | 75   | -    | -                | 75    |
| Bond I  | UF       | 1.950%              | -        | -    | -    | 75   | -    | -                | 75    |
| Bond K  | CLP      | 4.900%              | -        | -    | -    | -    | 134  | -                | 134   |
| Telefónica Móviles Chile, S.A.                  |          |                     | -        | -    | -    | 150  | 134  | 111              | 395   |
| T. Finanzas Mex 0710 FIX                        | MXN      | 8.070%              | -        | -    | -    | 92   | -    | -                | 92    |
| Telefónica Finanzas México, S.A.                |          |                     | -        | -    | -    | 92   | -    | -                | 92    |
| Bond T. Peru 5th Program (33th Series A) N. SOL |          | 6.813%              | 17       | -    | -    | -    | -    | -                | 17    |
| Bond T. Peru 4th Program (19th Series A) N. SOL |          | VAC +<br>3.6250%    | -        | -    | -    | -    | -    | 23               | 23    |
| Bond T. Peru 4th Program (36th Series A) N. SOL |          | VAC +<br>3.6875%    | 57       | -    | -    | -    | -    | -                | 57    |
| Bond T. Peru 4th Program (12th Series A) N. SOL |          | VAC +<br>3.6875%    | -        | -    | 23   | -    | -    | -                | 23    |
| Bond T. Peru 4th Program (36th Series B) N. SOL |          | VAC +<br>3.3750%    | -        | 19   | -    | -    | -    | -                | 19    |
| Bond T. Peru 4th Program (19th Series B) N. SOL |          | VAC +<br>2.8750%    | -        | -    | -    | -    | -    | 18               | 18    |
| Bond T. Peru 4th Program (37th Series A) N. SOL |          | VAC +<br>3.1250%    | -        | -    | -    | -    | -    | 18               | 18    |
| Bond T. Peru 4th Program (19th Series C) N. SOL |          | VAC +<br>3.1875%    | -        | -    | -    | -    | -    | 7                | 7     |
| Bond T. Peru 5th Program (22nd Series Aa)       | N. SOL   | VAC +<br>3.5000%    | 9        | -    | -    | -    | -    | -                | 9     |
| Bond T. Peru 5th Program (22nd Series Ab)       | N. SOL   | VAC +<br>3.5000%    | -        | -    | 4    | -    | -    | -                | 4     |
| Bond T. Peru 5th Program (22nd Series Ac)       | N. SOL   | VAC +<br>3.5000%    | -        | -    | -    | -    | 9    | -                | 9     |
| Bond T. Peru 6th Program (11th)                 | N. SOL   | 6.656%              | -        | -    | -    | -    | -    | 74               | 74    |
| Commercial Papaer T. Peru 4th Program (3rd)     | N. SOL   | 5.890%              | 19       | -    | -    | -    | -    | -                | 19    |
| Bond T.M.Peru 2nd Program (11th Series A)       | N. SOL   | 7.750%              | 20       | -    | -    | -    | -    | -                | 20    |
| Bond T.M.Peru 2nd Program (11th Series B)       | N. SOL   | 7.375%              | -        | 17   | -    | -    | -    | -                | 17    |
| Bond T.M.Peru 2nd Program (27th Series A)       | N. SOL   | 5.531%              | -        | -    | 14   | -    | -    | -                | 14    |
| Telefónica del Perú, S.A.                       |          |                     | 122      | 36   | 41   | -    | 9    | 140              | 348   |
| Nonconvertible bonds                            | BRL      | 1,0 XCDI +<br>0,75% | 582      | -    | -    | -    | -    | -                | 582   |
| Nonconvertible bonds                            | BRL      | 1,0 XCDI +<br>0,68% | -        | 378  | -    | -    | -    | -                | 378   |
| Nonconvertible bonds                            | BRL      | IPCA + 4%           | -        | -    | 10   | -    | -    | -                | 10    |

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|   |     |             |       |       |       |       |       |        |        |
|---|-----|-------------|-------|-------|-------|-------|-------|--------|--------|
| Convertible bonds ( Telemig) I                              | BRL | IPCA + 0,5% | -     | 2     | -     | -     | -     | -      | 2      |
| Convertible bonds ( Telemig) II                             | BRL | IPCA + 0,5% | -     | 5     | 1     | 1     | 1     | 1      | 9      |
| Convertible bonds ( Telemig) III                            | BRL | IPCA + 0,5% | -     | 9     | 2     | 2     | 2     | 2      | 17     |
| Telefônica Brasil, S.A.                                     |     |             | 582   | 394   | 13    | 3     | 3     | 3      | 998    |
| BOND R144-A   | USD | 5.375%      | -     | -     | -     | -     | -     | 710    | 710    |
| Colombia Telecomunicaciones, S.A, ESP                       |     |             | -     | -     | -     | -     | -     | 710    | 710    |
| Bond  | EUR | 1.875%      | -     | 600   | -     | -     | -     | -      | 600    |
| Bond  | EUR | 2.375%      | -     | -     | -     | -     | 500   | -      | 500    |
| O2 Telefónica Deutschland<br>Finanzierungs, GmbH            |     |             | -     | 600   | -     | -     | 500   | -      | 1,100  |
| Total Outstanding Debentures and Bonds<br>Foreign operators |     |             | 704   | 1,030 | 120   | 245   | 646   | 1,435  | 4,180  |
| Total Outstanding Debentures and Bonds<br>F-139             |     |             | 6,829 | 4,931 | 3,569 | 5,051 | 4,724 | 14,951 | 40,055 |

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The main debentures and bonds issued by the Group in 2016 are as follows:

| Item  | Date     | Maturity Date | Nominal (millions) |          | Currency of issuance | Coupon |
|---|----------|---------------|--------------------|----------|----------------------|--------|
|   |          |               | Euros              | Currency |                      |        |
| <b>Telefónica Emisiones, S.A.U.</b>             |          |               |                    |          |                      |        |
| EMTN Bond                                       | 04/13/16 | 04/13/22      | 1,400              | 1,400    | EUR                  | 0.75%  |
|   | 04/13/16 | 04/13/26      | 1,350              | 1,350    | EUR                  | 1.46%  |
|   | 10/17/16 | 10/17/20      | 1,250              | 1,250    | EUR                  | 0.318% |
|   | 10/17/16 | 10/17/31      | 750                | 750      | EUR                  | 1.93%  |
|   | 12/28/16 | 12/28/51      | 150                | 150      | EUR                  | 4.00%  |
| <b>Telefónica Participaciones, S.A.U.</b>       |          |               |                    |          |                      |        |
| Cash-settled equity-link bonds non-dilutive (*) | 03/09/16 | 03/09/31      | 600                | 600      | EUR                  | 0%     |
| <b>Telefónica Móviles Chile, S.A.</b>           |          |               |                    |          |                      |        |
| Bond  | 09/28/16 | 09/13/21      | 94,410             | 134      | CLP                  | 4.90%  |

(\*) Referenced to the trading price of Telefónica, S.A.

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## Appendix IV: Financial instruments

The detail of the type of financial instruments arranged by the Group (notional amount) by currency and interest rates at December 31, 2016 is as follows:

| Millions of Euros         | 2017    | 2018    | 2019    | 2020    | 2021    | Subsequent years | Notional | Fair value<br>Underlying debt | Associated derivatives | TOTAL  |
|---------------------------|---------|---------|---------|---------|---------|------------------|----------|-------------------------------|------------------------|--------|
| Euro                      | 3,914   | 5,135   | 5,066   | 6,350   | 8,309   | 13,637           | 42,412   | 32,873                        | 10,018                 | 42,891 |
| Floating rate             | 522     | 2,107   | 2,716   | 453     | 5,295   | 4,670            | 15,763   | 5,402                         | 10,428                 | 15,830 |
| Spread                    | 0.31%   | 0.24%   | (0.03)% | (0.22)% | 0.00%   | 0.23%            | 0.1%     | –                             | –                      | –      |
| Fixed rate                | 3,392   | 3,028   | 2,350   | 5,897   | 3,014   | 8,967            | 26,649   | 27,471                        | (410)                  | 27,061 |
| Interest rate             | 6.35%   | 4.66%   | 5.05%   | 3.35%   | 2.36%   | 2.36%            | 4%       | –                             | –                      | –      |
| Rate cap                  | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| Other european currencies |         |         |         |         |         |                  |          |                               |                        |        |
| Instruments in CZK        | –       | –       | –       | –       | –       | –                | –        | 49                            | (48)                   | 1      |
| Floating rate             | 148     | –       | –       | –       | –       | –                | 148      | –                             | 148                    | 148    |
| Spread                    | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| Fixed rate                | (148)   | –       | –       | –       | –       | –                | (148)    | 49                            | (196)                  | (147)  |
| Interest rate             | (1.23)% | –       | –       | –       | –       | –                | (1.23)%  | –                             | –                      | –      |
| Rate cap                  | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| Instruments in GBP        | 1,070   | 804     | (355)   | (467)   | –       | 1,812            | 2,864    | 3,722                         | (724)                  | 2,998  |
| Floating rate             | 71      | 526     | (497)   | (514)   | (269)   | 1,280            | 597      | 7                             | 608                    | 615    |
| Spread                    | –       | –       | –       | –       | –       | –                | 0.00%    | –                             | –                      | –      |
| Fixed rate                | 999     | 278     | 142     | 47      | 269     | 415              | 2,150    | 3,598                         | (1,332)                | 2,266  |
| Interest rate             | 0.18%   | 12.98%  | (0.46)% | 65.03%  | 1.44%   | 8.90%            | 5.05%    | –                             | –                      | –      |
| Rate cap                  | –       | –       | –       | –       | –       | 117              | 117      | 117                           | –                      | 117    |
| Instruments in CHF        | –       | –       | –       | –       | –       | –                | –        | 637                           | (636)                  | 1      |
| Floating rate             | –       | –       | –       | –       | –       | –                | –        | 270                           | (271)                  | (1)    |
| Spread                    | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| Fixed rate                | –       | –       | –       | –       | –       | –                | –        | 367                           | (365)                  | 2      |
| Interest rate             | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| Rate cap                  | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
| America                   |         |         |         |         |         |                  |          |                               |                        |        |
| Instruments in USD        | (1,147) | (214)   | 208     | (135)   | (1,878) | 3,695            | 528      | 16,034                        | (15,300)               | 734    |
| Floating rate             | (728)   | (48)    | 174     | (155)   | (1,898) | 2,841            | 186      | 835                           | (622)                  | 213    |
| Spread                    | (0.79)% | (2.53)% | 0.12%   | (0.22)% | (0.06)% | 0.01%            | 4.88%    | –                             | –                      | –      |
| Fixed rate                | (419)   | (166)   | 34      | 20      | 20      | 854              | 342      | 15,199                        | (14,678)               | 521    |
| Interest rate             | (5.71)% | 398.64% | 58.89%  | 92.36%  | 129.86% | 17.00%           | 47.15%   | –                             | –                      | –      |
| Rate cap                  | –       | –       | –       | –       | –       | –                | –        | –                             | –                      | –      |
|                           | (17)    | –       | –       | –       | –       | –                | (17)     | (9)                           | (9)                    | (18)   |

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|                    |       |    |   |   |   |     |       |       |     |       |
|--------------------|-------|----|---|---|---|-----|-------|-------|-----|-------|
| Instruments in UYU |       |    |   |   |   |     |       |       |     |       |
| Floating rate      | -     | -  | - | - | - | -   | -     | -     | -   | -     |
| Spread             | -     | -  | - | - | - | -   | -     | -     | -   | -     |
| Fixed rate         | (17)  | -  | - | - | - | -   | (17)  | (9)   | (9) | (18)  |
| Interest rate      | 1.42% | -  | - | - | - | -   | -     | -     | -   | -     |
| Rate cap           | -     | -  | - | - | - | -   | -     | -     | -   | -     |
| Instruments in ARS | (224) | 19 | 1 | - | - | (8) | (212) | (199) | -   | (199) |
| Floating rate      | -     | -  | - | - | - | -   | -     | -     | -   | -     |
| Spread             | -     | -  | - | - | - | -   | -     | -     | -   | -     |
| Fixed rate         | (224) | 19 | 1 | - | - | (8) | (212) | (199) | -   | (199) |
| F-141              |       |    |   |   |   |     |       |       |     |       |

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|                    |         |        |        |       |       |         |         |       |       |       |
|--------------------|---------|--------|--------|-------|-------|---------|---------|-------|-------|-------|
| Interest rate      | 21.73%  | 17.88% | 9.00%  | –     | –     | 0.00%   | 21%     | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in BRL | 393     | 787    | 248    | 124   | 86    | 61      | 1,698   | 631   | 1,090 | 1,721 |
| Floating rate      | (642)   | 631    | 185    | 84    | 73    | (38)    | 292     | (152) | 407   | 255   |
| Spread             | (3.11)% | 0.93%  | 2.10%  | 2.78% | 1.73% | (3.55)% | –       | –     | –     | –     |
| Fixed rate         | 1,035   | 156    | 63     | 40    | 13    | 99      | 1,406   | 783   | 683   | 1,466 |
| Interest rate      | 6.89%   | 9.31%  | 8.59%  | 0.37% | 5.43% | 8.81%   | –       | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in CLP | 73      | 44     | 67     | 142   | 274   | 428     | 1,028   | (33)  | 1,048 | 1,015 |
| Floating rate      | 68      | (91)   | 67     | –     | 140   | 439     | 623     | (6)   | 635   | 629   |
| Spread             | –       | –      | 1.12%  | –     | 0.62% | (0.29)% | 0.05%   | –     | –     | –     |
| Fixed rate         | 5       | 135    | –      | 142   | 134   | (11)    | 405     | (27)  | 413   | 386   |
| Interest rate      | 35.16%  | 4.65%  | –      | 5.09% | 4.90% | 0.00%   | 5.36%   | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in UFC | –       | –      | –      | –     | –     | –       | –       | 275   | (290) | (15)  |
| Floating rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Spread             | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Fixed rate         | –       | –      | –      | –     | –     | –       | –       | 275   | (290) | (15)  |
| Interest rate      | –       | –      | –      | –     | –     | –       | 0.00%   | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in PEN | 488     | 71     | 13     | –     | –     | 74      | 646     | 169   | 465   | 634   |
| Floating rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Spread             | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Fixed rate         | 488     | 71     | 13     | –     | –     | 74      | 646     | 169   | 465   | 634   |
| Interest rate      | 6.21%   | 6.47%  | 6.13%  | –     | –     | 6.66%   | 6.29%   | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in VAC | 66      | 19     | 27     | –     | 9     | 66      | 187     | 187   | –     | 187   |
| Floating rate      | 66      | 19     | 27     | –     | 9     | 66      | 187     | 187   | –     | 187   |
| Spread             | 3.66%   | 3.38%  | 3.66%  | –     | 3.50% | 3.24%   | 3.47%   | –     | –     | –     |
| Fixed rate         | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Interest rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in COP | 757     | 133    | 202    | 132   | 146   | 1,077   | 2,446   | 1,545 | 841   | 2,386 |
| Floating rate      | 75      | 85     | 120    | 132   | 146   | 1,077   | 1,634   | 1,595 | 542   | 1,637 |
| Spread             | 5.84%   | 4.45%  | 4.49%  | 4.76% | 5.03% | 7.43%   | 6.56%   | –     | –     | –     |
| Fixed rate         | 682     | 48     | 82     | –     | –     | –       | 812     | (50)  | 799   | 749   |
| Interest rate      | 6.44%   | 8.87%  | 13.03% | –     | –     | –       | 7.24%   | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in VEB | (26)    | 8      | –      | –     | –     | (3)     | (20)    | (20)  | –     | (20)  |
| Floating rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Spread             | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Fixed rate         | (26)    | 8      | –      | –     | –     | (3)     | (20)    | (20)  | –     | (20)  |
| Interest rate      | 1.59%   | 11.30% | –      | –     | –     | 0.00%   | (2.39)% | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Instruments in UDI | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Floating rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Spread             | –       | –      | –      | –     | –     | –       | 0%      | –     | –     | –     |
| Fixed rate         | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Interest rate      | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |
| Rate cap           | –       | –      | –      | –     | –     | –       | –       | –     | –     | –     |

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Instruments in MXN 199 27 42 24 40 456 787 559 233 792  
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|                                 |        |       |       |        |       |       |        |        |          |        |
|---------------------------------|--------|-------|-------|--------|-------|-------|--------|--------|----------|--------|
| Floating rate                   | 19     | 6     | 7     | 8      | 10    | 107   | 157    | 158    | –        | 158    |
| Spread                          | 4.94%  | 6.04% | 6.05% | 6.08%  | 6.07% | 5.37% | 5.45%  | –      | –        | –      |
| Fixed rate                      | 180    | 21    | 35    | 16     | 30    | 349   | 630    | 401    | 233      | 634    |
| Interest rate                   | 10.27% | 6.08% | 5.72% | 11.73% | 6.56% | 7.31% | 8.10%  | –      | –        | –      |
| Rate cap                        | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| Instruments in GTQ              | (7)    | –     | –     | 30     | –     | –     | 23     | 23     | –        | 23     |
| Floating rate                   | (7)    | –     | –     | –      | –     | –     | (7)    | (7)    | –        | (7)    |
| Spread                          | 0.01%  | –     | –     | –      | –     | –     | 0.01%  | –      | –        | –      |
| Fixed rate                      | –      | –     | –     | 30.0   | –     | –     | 30     | 30     | –        | 30     |
| Interest rate                   | –      | –     | –     | 4.00%  | –     | –     | 3.99%  | –      | –        | –      |
| Rate cap                        | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| Instruments in NIO              | (6)    | –     | –     | –      | –     | 5     | (1)    | (1)    | –        | (1)    |
| Floating rate                   | (6)    | –     | –     | –      | –     | –     | (6)    | (6)    | –        | (6)    |
| Spread                          | 0.01%  | –     | –     | –      | –     | –     | 0.01%  | –      | –        | –      |
| Fixed rate                      | –      | –     | –     | –      | –     | 5     | 5      | 5      | –        | 5      |
| Interest rate                   | –      | –     | –     | –      | –     | –     | 11.90% | 11.90% | –        | –      |
| Rate cap                        | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| Asia                            |        |       |       |        |       |       |        |        |          |        |
| Instruments in JPY              | –      | –     | –     | –      | –     | –     | –      | 75     | (89)     | (14)   |
| Floating rate                   | –      | –     | –     | –      | –     | –     | –      | –      | (1)      | (1)    |
| Spread                          | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| Fixed rate                      | –      | –     | –     | –      | –     | –     | –      | 75     | (88)     | (13)   |
| Interest rate                   | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| Rate cap                        | –      | –     | –     | –      | –     | –     | –      | –      | –        | –      |
| TOTAL                           |        |       |       |        |       |       | 52,369 | 56,517 | (3,401)  | 53,116 |
| Floating rate                   |        |       |       |        |       |       | 19,574 | 8,283  | 11,374   | 19,657 |
| Fixed rate                      |        |       |       |        |       |       | 32,678 | 48,117 | (14,775) | 33,342 |
| Rate cap                        |        |       |       |        |       |       | 117    | 117    | –        | 117    |
| Currency Options and Others (*) |        |       |       |        |       |       | –      | –      | 9        | 9      |

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The table below is an extract of the previous table that shows the sensitivity to interest rates originated by our position on interest rate swaps categorized into instruments entered into for trading purposes and instruments entered into for purposes other than trading at December 31, 2016:

| Interest rate swaps   |          |         |         |         |         |                  |          |            |
|-----------------------|----------|---------|---------|---------|---------|------------------|----------|------------|
| Millions of euros     | Maturity |         |         |         |         |                  | Total    | Fair value |
| Trading purposes      | 2017     | 2018    | 2019    | 2020    | 2021    | Subsequent years |          |            |
| EUR                   |          |         |         |         |         |                  |          | (78)       |
| Fixed to fix          | –        | –       | –       | –       | –       | –                | –        | 2          |
| Receiving leg         | (150)    | (90)    | (25)    | –       | –       | –                | (265)    | (266)      |
| Average Interest Rate | –        | –       | –       | –       | –       | –                | –        | –          |
| Paying leg            | 150      | 90      | 25      | –       | –       | –                | 265      | 268        |
| Average Interest Rate | 0.59%    | 0.83%   | 0.85%   | –       | –       | –                | 0.70%    | –          |
| Fixed to floating     | (34)     | –       | –       | –       | –       | –                | (34)     | (1,693)    |
| Receiving leg         | (9,933)  | (8,457) | (7,016) | (8,950) | (6,862) | (3,612)          | (44,830) | (29,011)   |
| Average Interest Rate | 1.24%    | 1.06%   | 1.41%   | 1.57%   | 2.05%   | 1.64%            | 1.45%    | –          |
| Paying leg            | 9,899    | 8,457   | 7,016   | 8,950   | 6,862   | 3,612            | 44,796   | 27,318     |
| Average Spread        | 0.27%    | 0.42%   | 0.62%   | 0.41%   | 0.60%   | –                | 0.41%    | –          |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | –        | 1,613      |
| Receiving leg         | (6,399)  | (3,280) | (2,314) | (5,834) | (3,303) | (3,687)          | (24,817) | (24,559)   |
| Average Spread        | 2.15%    | –       | 0.01%   | 0.00%   | –       | –                | 0.56%    | –          |
| Paying leg            | 6,399    | 3,280   | 2,314   | 5,834   | 3,303   | 3,687            | 24,817   | 26,172     |
| Average Interest Rate | 1.27%    | 1.96%   | 2.68%   | 2.40%   | 2.75%   | 1.17%            | 1.94%    | –          |
| USD                   |          |         |         |         |         |                  |          | 9          |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | –        | (13)       |
| Receiving leg         | (1,028)  | (728)   | (323)   | (323)   | (323)   | (446)            | (3,171)  | (1,573)    |
| Average Interest Rate | 1.51%    | 1.45%   | 1.40%   | 1.52%   | 1.61%   | 2.35%            | 1.61%    | –          |
| Paying leg            | 1,028    | 728     | 323     | 323     | 323     | 446              | 3,171    | 1,560      |
| Average Spread        | 0.37%    | 0.62%   | 1.52%   | 1.61%   | 1.68%   | –                | 0.75%    | –          |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | –        | 22         |
| Receiving leg         | (1,054)  | (472)   | –       | –       | –       | (446)            | (1,972)  | (1,941)    |
| Average Spread        | –        | –       | –       | –       | –       | –                | –        | –          |
| Paying leg            | 1,054    | 472     | –       | –       | –       | 446              | 1,972    | 1,963      |
| Average Interest Rate | 2.94%    | 2.87%   | –       | –       | –       | 2.14%            | 2.74%    | –          |
| GBP                   |          |         |         |         |         |                  |          | (65)       |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | –        | (105)      |
| Receiving leg         | (193)    | (761)   | (29)    | (23)    | (257)   | (544)            | (1,807)  | (1,914)    |
| Average Interest Rate | 1.52%    | 1.61%   | 2.25%   | 2.36%   | 1.76%   | 3.27%            | 2.14%    | –          |
| Paying leg            | 193      | 761     | 29      | 23      | 257     | 544              | 1,807    | 1,809      |
| Average Spread        | –        | –       | –       | –       | –       | –                | –        | –          |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | –        | 40         |
| Receiving leg         | (129)    | (818)   | –       | (70)    | (175)   | (199)            | (1,391)  | (1,395)    |
| Average Spread        | –        | –       | –       | –       | –       | –                | –        | –          |
| Paying leg            | 129      | 818     | –       | 70      | 175     | 199              | 1,391    | 1,435      |
| Average Interest Rate | 1.08%    | 1.38%   | –       | 0.73%   | 2.56%   | 1.84%            | 1.54%    | –          |
| CZK                   |          |         |         |         |         |                  |          | (1)        |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | –        | (1)        |

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|                       |       |       |   |   |   |   |       |       |
|-----------------------|-------|-------|---|---|---|---|-------|-------|
| Receiving leg         | (46)  | -     | - | - | - | - | (46)  | (196) |
| Average Interest Rate | 1.60% | -     | - | - | - | - | 1.60% | -     |
| Paying leg            | 46    | -     | - | - | - | - | 46    | 195   |
| Average Spread        | -     | -     | - | - | - | - | -     | -     |
| Floating to fixed     | -     | -     | - | - | - | - | -     | -     |
| Receiving leg         | -     | (46)  | - | - | - | - | (46)  | (47)  |
| Average Spread        | -     | -     | - | - | - | - | -     | -     |
| Paying leg            | -     | 46    | - | - | - | - | 46    | 47    |
| Average Interest Rate | -     | 1.25% | - | - | - | - | 1.25% | -     |

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| Interest rate swaps   |          |         |         |         |         |                  |                   |
|-----------------------|----------|---------|---------|---------|---------|------------------|-------------------|
| Millions of euros     | Maturity |         |         |         |         |                  |                   |
| Non trading purposes  | 2017     | 2018    | 2019    | 2020    | 2021    | Subsequent years | Total Fair value  |
| EUR                   |          |         |         |         |         |                  | 481               |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | (228)             |
| Receiving leg         | (250)    | (200)   | –       | –       | (1,300) | (1,650)          | (3,400) (3,627)   |
| Average Interest Rate | 0.79%    | 0.93%   | –       | –       | 1.29%   | 1.46%            | 1.31% –           |
| Paying leg            | 250      | 200     | –       | –       | 1,300   | 1,650            | 3,400 3,399       |
| Average Spread        | –        | –       | –       | –       | –       | –                | –                 |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | 709               |
| Receiving leg         | (1,682)  | (1,720) | (1,259) | (3,334) | (699)   | (1,960)          | (10,654) (6,970)  |
| Average Spread        | 0.27%    | 0.26%   | 1.32%   | 0.05%   | –       | –                | 0.25% –           |
| Paying leg            | 1,682    | 1,720   | 1,259   | 3,334   | 699     | 1,960            | 10,654 7,679      |
| Average Interest Rate | 2.15%    | 2.83%   | 1.57%   | 2.85%   | 2.71%   | 1.43%            | 2.31% –           |
| USD                   |          |         |         |         |         |                  | (1,156)           |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | (1,156)           |
| Receiving leg         | (1,283)  | (1,541) | (1,269) | (2,004) | (1,698) | (4,567)          | (12,362) (12,559) |
| Average Interest Rate | 3.49%    | 1.18%   | 3.46%   | 3.03%   | 3.45%   | 3.38%            | 3.08% –           |
| Paying leg            | 1,283    | 1,541   | 1,269   | 2,004   | 1,698   | 4,567            | 12,362 11,403     |
| Average Spread        | 0.56%    | –       | –       | 0.22%   | –       | –                | 0.09% –           |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | –                 |
| Receiving leg         | –        | –       | –       | –       | –       | –                | –                 |
| Average Spread        | –        | –       | –       | –       | –       | –                | –                 |
| Paying leg            | –        | –       | –       | –       | –       | –                | –                 |
| Average Interest Rate | –        | –       | –       | –       | –       | –                | –                 |
| MXN                   |          |         |         |         |         |                  | (5)               |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | (3)               |
| Receiving leg         | –        | –       | –       | (92)    | –       | –                | (92) (97)         |
| Average Interest Rate | –        | –       | –       | 8.07%   | –       | –                | 8.07% –           |
| Paying leg            | –        | –       | –       | 92      | –       | –                | 92 94             |
| Average Spread        | –        | –       | –       | 0.61%   | –       | –                | 0.61% –           |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | (2)               |
| Receiving leg         | –        | –       | –       | (92)    | –       | –                | (92) (94)         |
| Average Spread        | –        | –       | –       | 0.61%   | –       | –                | 0.61% –           |
| Paying leg            | –        | –       | –       | 92      | –       | –                | 92 92             |
| Average Interest Rate | –        | –       | –       | 6.62%   | –       | –                | 6.62% –           |
| GBP                   |          |         |         |         |         |                  | (254)             |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | (254)             |
| Receiving leg         | –        | (526)   | –       | (818)   | –       | (1,053)          | (2,397) (2,652)   |
| Average Interest Rate | –        | 1.43%   | –       | 1.87%   | –       | 3.47%            | 2.47% –           |
| Paying leg            | –        | 526     | –       | 818     | –       | 1,053            | 2,397 2,398       |
| Average Spread        | –        | –       | –       | –       | –       | –                | –                 |
| Floating to fixed     | –        | –       | –       | –       | –       | –                | –                 |
| Receiving leg         | –        | –       | –       | –       | –       | –                | –                 |
| Average Spread        | –        | –       | –       | –       | –       | –                | –                 |
| Paying leg            | –        | –       | –       | –       | –       | –                | –                 |
| Average Interest Rate | –        | –       | –       | –       | –       | –                | –                 |
| JPY                   |          |         |         |         |         |                  | (1)               |
| Fixed to floating     | –        | –       | –       | –       | –       | –                | (1)               |

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|                       |   |       |   |   |   |   |       |      |
|-----------------------|---|-------|---|---|---|---|-------|------|
| Receiving leg         | - | (81)  | - | - | - | - | (81)  | (82) |
| Average Interest Rate | - | 0.32% | - | - | - | - | 0.32% | -    |

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|                       |       |       |       |       |       |       |       |       |
|-----------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Paying leg            | -     | 81    | -     | -     | -     | -     | 81    | 81    |
| Average Spread        | -     | -     | -     | -     | -     | -     | -     | -     |
| CLP                   |       |       |       |       |       |       |       | -     |
| Fixed to floating     | -     | -     | -     | -     | -     | -     | -     | (3)   |
| Receiving leg         | -     | -     | (67)  | -     | -     | -     | (67)  | (72)  |
| Average Interest Rate | -     | -     | 5.75% | -     | -     | -     | 5.75% | -     |
| Paying leg            | -     | -     | 67    | -     | -     | -     | 67    | 69    |
| Average Spread        | -     | -     | 1.12% | -     | -     | -     | 1.12% | -     |
| Floating to fixed     | -     | -     | -     | -     | -     | -     | -     | 3     |
| Receiving leg         | (28)  | (91)  | -     | (28)  | 1     | -     | (146) | (92)  |
| Average Spread        | 3.31% | -     | -     | -     | -     | -     | 0.64% | -     |
| Paying leg            | 28    | 91    | -     | 28    | (1)   | -     | 146   | 95    |
| Average Interest Rate | -     | 5.05% | -     | 3.31% | -     | -     | 3.75% | -     |
| CHF                   |       |       |       |       |       |       |       | (24)  |
| Fixed to floating     | -     | -     | -     | -     | -     | -     | -     | (24)  |
| Receiving leg         | -     | (233) | -     | (210) | -     | (140) | (583) | (606) |
| Average Interest Rate | -     | 0.28% | -     | 0.95% | -     | 0.75% | 0.63% | -     |
| Paying leg            | -     | 233   | -     | 210   | -     | 140   | 583   | 582   |
| Average Spread        | -     | -     | -     | -     | -     | -     | -     | -     |
| BRL                   |       |       |       |       |       |       |       | (32)  |
| Fixed to floating     | -     | -     | -     | -     | -     | -     | -     | -     |
| Receiving leg         | -     | -     | -     | -     | -     | -     | -     | -     |
| Average Interest Rate | -     | -     | -     | -     | -     | -     | -     | -     |
| Paying leg            | -     | -     | -     | -     | -     | -     | -     | -     |
| Average Spread        | -     | -     | -     | -     | -     | -     | -     | -     |
| Floating to fixed     | (8)   | (2)   | 42    | -     | -     | -     | 32    | (32)  |
| Receiving leg         | (108) | (83)  | -     | -     | -     | -     | (191) | (420) |
| Average Spread        | 2.59% | 2.03% | -     | -     | -     | -     | 2.35% | -     |
| Paying leg            | 100   | 81    | 42    | -     | -     | -     | 223   | 388   |
| Average Interest Rate | -     | -     | -     | -     | -     | -     | -     | -     |
| COP                   |       |       |       |       |       |       |       | 2     |
| Fixed to floating     | -     | -     | -     | -     | -     | -     | -     | 2     |
| Receiving leg         | -     | (5)   | (10)  | (10)  | (10)  | (5)   | (40)  | (40)  |
| Average Interest Rate | -     | 7.25% | 7.25% | 7.25% | 7.25% | 7.25% | 7.25% | -     |
| Paying leg            | -     | 5     | 10    | 10    | 10    | 5     | 40    | 42    |
| Average Spread        | -     | 2.80% | 2.80% | 2.80% | 2.80% | 2.80% | 2.80% | -     |

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Foreign exchange and interest rate options, by maturity, are as follows:

| Currency options<br>Millions of euros | Maturities |      |      |      |      |                  |
|---------------------------------------|------------|------|------|------|------|------------------|
|                                       | 2017       | 2018 | 2019 | 2020 | 2021 | Subsequent years |
| <b>Currency Puts (EURUSD, USDEUR)</b> |            |      |      |      |      |                  |
| Notional amount of options bought     | 1,861      | 179  | -    | -    | -    | -                |
| Strike                                | 1.36       | 1.57 | -    | -    | -    | -                |
| Notional amount of options sold       | 1,545      | -    | -    | -    | -    | -                |
| Strike                                | 1.27       | -    | -    | -    | -    | -                |

| Interest rate options<br>Millions of euros | Maturities |      |      |      |      |                  |
|--|------------|------|------|------|------|------------------|
|  | 2017       | 2018 | 2019 | 2020 | 2021 | Subsequent years |
| <b>Collars</b>                             |            |      |      |      |      |                  |
| Notional amount of options bought          | -          | 800  | -    | -    | -    | 877              |
| Strike Cap                                 | -          | 4.35 | -    | -    | -    | 4.92             |
| Strike Floor                               | -          | 3.05 | -    | -    | -    | 4.15             |
| <b>Caps</b>                                |            |      |      |      |      |                  |
| Notional amount of options bought          | -          | -    | -    | -    | -    | -                |
| Strike                                     | -          | -    | -    | -    | -    | -                |
| Notional amount of options sold            | -          | -    | -    | -    | -    | 877              |
| Strike                                     | -          | -    | -    | -    | -    | 5.53             |
| <b>Floors</b>                              |            |      |      |      |      |                  |
| Notional amount of options bought          | -          | -    | -    | -    | -    | 877              |
| Strike                                     | -          | -    | -    | -    | -    | 1.17             |
| Notional amount of options sold            | -          | -    | -    | -    | -    | -                |
| Strike                                     | -          | -    | -    | -    | -    | -                |

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Cash flows receivable or payable on derivative financial instruments to be settled via the swap of nominals, categorized by currency of collection/payment, along with contractual maturities are as follows:

| Millions of euros     | 2017 | 2018    | 2019    | 2020    | 2021    | Subsequent years | Total    |
|-----------------------|------|---------|---------|---------|---------|------------------|----------|
| <b>Currency swaps</b> |      |         |         |         |         |                  |          |
| Receive               | ARS  | -       | -       | -       | -       | -                | -        |
| Pay                   | ARS  | -       | -       | -       | -       | -                | -        |
| Receive               | BRL  | 68      | -       | -       | -       | 1                | 69       |
| Pay                   | BRL  | (484)   | (61)    | (54)    | -       | -                | (599)    |
| Receive               | CLP  | 68      | -       | -       | -       | 439              | 507      |
| Pay                   | CLP  | (135)   | -       | -       | (142)   | (140)            | (877)    |
| Receive               | COP  | -       | -       | -       | -       | -                | -        |
| Pay                   | COP  | (285)   | (48)    | (2)     | -       | -                | (335)    |
| Receive               | CZK  | -       | -       | -       | -       | -                | -        |
| Pay                   | CZK  | -       | -       | -       | -       | -                | -        |
| Receive               | EUR  | 649     | 33      | 36      | -       | -                | 718      |
| Pay                   | EUR  | (1,397) | (1,556) | (1,565) | (3,001) | (3,087)          | (11,827) |
| Receive               | GBP  | -       | -       | 585     | 1,286   | -                | 1,871    |
| Pay                   | GBP  | -       | -       | -       | -       | -                | -        |
| Receive               | JPY  | -       | 81      | -       | -       | -                | 81       |
| Pay                   | JPY  | -       | -       | -       | -       | -                | -        |
| Receive               | MAD  | -       | -       | -       | -       | -                | -        |
| Pay                   | MAD  | -       | -       | -       | -       | -                | -        |
| Receive               | MXN  | -       | -       | -       | -       | -                | -        |
| Pay                   | MXN  | -       | -       | -       | -       | -                | -        |
| Receive               | PEN  | -       | -       | -       | -       | -                | -        |
| Pay                   | PEN  | (15)    | (7)     | (1)     | -       | 1                | (22)     |
| Receive               | UFC  | -       | -       | -       | 149     | -                | 373      |
| Pay                   | UFC  | -       | -       | -       | -       | (112)            | (112)    |
| Receive               | USD  | 2,407   | 1,640   | 1,149   | 1,815   | 3,738            | 12,996   |
| Pay                   | USD  | (447)   | -       | -       | -       | (1)              | (923)    |
| Receive               | UDI  | -       | -       | -       | -       | 2                | 2        |
| Pay                   | UDI  | -       | -       | -       | -       | -                | -        |
| Receive               | CHF  | -       | 233     | -       | 210     | -                | 583      |
| Pay                   | CHF  | -       | -       | -       | -       | -                | -        |
| TOTAL                 |      | 429     | 315     | 148     | 317     | 511              | 368      |

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| Millions of<br>euros | 2017    | 2018 | 2019 | 2020 | 2021 | Subsequent years | Total   |
|----------------------|---------|------|------|------|------|------------------|---------|
| Forwards             |         |      |      |      |      |                  |         |
| Receive ARS          | -       | -    | -    | -    | -    | -                | -       |
| Pay ARS              | -       | -    | -    | -    | -    | -                | -       |
| Receive BRL          | 59      | -    | -    | -    | -    | -                | 59      |
| Pay BRL              | (596)   | -    | -    | -    | -    | -                | (596)   |
| Receive CLP          | 166     | -    | -    | -    | -    | -                | 166     |
| Pay CLP              | (486)   | -    | -    | -    | -    | -                | (486)   |
| Receive COP          | 11      | -    | -    | -    | -    | -                | 11      |
| Pay COP              | (468)   | -    | -    | -    | -    | -                | (468)   |
| Receive CZK          | 46      | -    | -    | -    | -    | -                | 46      |
| Pay CZK              | -       | -    | -    | -    | -    | -                | -       |
| Receive EUR          | 5,336   | -    | -    | -    | -    | -                | 5,336   |
| Pay EUR              | (2,413) | -    | -    | -    | -    | -                | (2,413) |
| Receive GBP          | 1,009   | -    | -    | -    | -    | -                | 1,009   |
| Pay GBP              | (2,633) | -    | -    | -    | -    | -                | (2,633) |
| Receive MXN          | 52      | -    | -    | -    | -    | -                | 52      |
| Pay MXN              | (467)   | -    | -    | -    | -    | -                | (467)   |
| Receive PEN          | 88      | -    | -    | -    | -    | -                | 88      |
| Pay PEN              | (537)   | -    | -    | -    | -    | -                | (537)   |
| Receive UFC          | -       | -    | -    | -    | -    | -                | -       |
| Pay UFC              | -       | -    | -    | -    | -    | -                | -       |
| Receive USD          | 2,700   | -    | -    | -    | -    | -                | 2,700   |
| Pay USD              | (1,991) | -    | -    | -    | -    | -                | (1,991) |
| Receive UYU          | 9       | -    | -    | -    | -    | -                | 9       |
| Pay UYU              | -       | -    | -    | -    | -    | -                | -       |
| TOTAL                | (115)   | -    | -    | -    | -    | -                | (115)   |

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## Appendix V: Interest-bearing debt

The main financing transactions at December 31, 2016 and 2015 and their nominal amounts are as follows:

| Descriptive name summary             | Contractual limit amount<br>(millions) | Currency | Outstanding<br>principal balance<br>(millions of<br>euros) |          | Arrangement<br>date | Maturity<br>date |
|--------------------------------------|--|----------|--|----------|---------------------|------------------|
|                                      |  |          | 12/31/16   | 12/31/15 |                     |                  |
| Telefónica, S.A                      |  |          |  |          |                     |                  |
| Structured Financing (*)             | 200                                    | USD      | 190  | 226      | 05/03/2011          | 07/30/2021       |
| Structured Financing (*)             | 669                                    | USD      | 635  | 722      | 02/22/2013          | 01/31/2023       |
| Structured Financing (*)             | 532                                    | USD      | 505  | 447      | 08/01/2013          | 10/31/2023       |
| Syndicated facility <sup>(1)</sup>   | 3,000                                  | EUR      | -  | 700      | 02/18/2014          | 02/18/2021       |
| Bilateral                            | 1,500                                  | EUR      | 1,500  | 1,500    | 06/26/2014          | 06/26/2018       |
| Syndicated facility <sup>(2)</sup>   | 2,500                                  | EUR      | 550  | 500      | 02/19/2015          | 02/19/2022       |
| Bilateral                            | 200                                    | EUR      | 200  | 200      | 06/30/2015          | 06/30/2020       |
| Syndicated facility <sup>(3)</sup>   | 1,500                                  | EUR      | -  | -        | 11/17/2015          | 02/15/2019       |
| Structured Financing (*)             | 737                                    | USD      | 324  | -        | 12/11/2015          | 03/11/2026       |
| Structured Financing (*)             | 492                                    | EUR      | 240  | -        | 12/11/2015          | 03/11/2026       |
| Bilateral loan                       | 100                                    | EUR      | 100  | -        | 02/23/2016          | 02/23/2019       |
| Bilateral loan                       | 100                                    | EUR      | 100  | -        | 02/23/2016          | 02/23/2021       |
| Loan                                 | 300                                    | EUR      | 300  | -        | 03/08/2016          | 03/08/2021       |
| Bilateral loan                       | 300                                    | EUR      | 300  | -        | 10/24/2016          | 03/19/2019       |
| Telefónica Móviles Chile, S.A.       |  |          |  |          |                     |                  |
| Syndicated                           | 150                                    | USD      | 142  | -        | 04/15/2016          | 15/04/2021       |
| Telefónica Germany GmbH &<br>Co. OHG |  |          |  |          |                     |                  |
| Syndicated                           | 750                                    | EUR      | 50   | -        | 03/22/2016          | 03/22/2021       |
| EIB Financing <sup>(4)</sup>         | 450                                    | EUR      | 250  | -        | 06/13/2016          | 06/13/2025       |
| Telefónica Europe, B.V.              |  |          |  |          |                     |                  |
| Structured Financing (*)             | 1,500                                  | EUR      | -  | -        | 11/28/2016          | 11/28/2024       |

(1) Extended for 12 additional months of the syndicated facility signed in February 2014.

(2) Extended for 12 additional months of the syndicated facility signed in February 2015.

(3) On November 15, 2016 an amendment was signed extending the maturity for 12 additional months of the syndicated facility and an early repayment of 1,500 million euros was made.

(4) This financing is split in 5 tranches with a maturity to as late as 2025.

(\*) Facility with amortization schedule.

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Appendix VI: Key regulatory issues and concessions held by the Telefónica Group and licenses

**Regulations**

As a digital telecommunications operator, the Telefónica Group is subject to sector-specific telecommunications regulations, general competition law and a variety of other regulations, including privacy and security, which can have a direct and material effect on the Group's business areas. The extent to which regulations apply to the Telefónica Group depends largely on the nature of our activities in a particular country, with traditional fixed telephony services and fixed broadband usually subject to strict regulations.

In order to provide services and operate its networks, and to use spectrum, the Telefónica Group must obtain general authorizations, concessions and/or licenses from the pertinent authorities in each country in which the Group operates (hereinafter referred to as national regulatory authority, NRAs). The Group is also required to obtain radio frequency licenses for its mobile operations.

In this section it is described the legislative framework and the recent legislative key developments in the most relevant countries and regions in which the Group has significant interests. Many of the legislative changes and the adoption of regulatory measures by sectorial regulators, which are described in this section, are in the approval process and therefore have not concluded.

**Electronic Communication Regulation in the European Union**

The European Union's legal framework for electronic communications services was developed with the aim of promoting competition and improving the harmonized functioning of the European market for electronic communications networks and services. The European Union's legal framework was last modified in 2009, in response to market and technological and changes in the industry. It is currently under a process of review, although the new modifications of it are not expected to entry into force before 2018.

In each Member State a national regulatory authority, or NRAs, is responsible for enforcing national telecommunications laws incorporating the EU framework. Companies may challenge the decisions of their national regulatory authorities before their domestic courts. Such legal proceedings may lead to a decision by the European Court of Justice or ECJ, which is the ultimate authority on the correct application of EU legislation.

**EU competition law**

The European Union's competition rules have the force of law in all EU Member States and are, therefore applicable to the Telefónica Group's operations in those countries.

The Treaty for the functioning of the EU (TFEU) prohibits "concerted practices" and all agreements between entities that may affect trade between Member States and which restrict or are intended to restrict, competition within the internal market. The Treaty also prohibits any abuse of a dominant competitive position within the EU, or any substantial part of it that may affect trade between Member States.

The EU Merger Regulation requires that all mergers, acquisitions and joint ventures involving participants meeting certain turnover thresholds be submitted to the EU Commission for review, rather than to the national competition authorities. Under the amended EU Merger Regulation, market concentrations will be prohibited if they significantly impede effective competition in the EU common market. The European Commission is granted the authority to apply the EU competition framework.

Similar competition rules are set forth in each EU Member State, with the corresponding national competition authorities overseeing compliance with these regulations. All the European countries in which the Telefónica Group operates and referred to below are Member States of the European Union.

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**Recent developments**

Currently, the regulatory debate in the European Union is basically focused on the development of the Telecom Single Market (TSM) Package and the new European Digital Single Market (DSM) Strategy.

**Telecom Single Market**

The Regulation (EU) 2015/2120 of the European Parliament and of the Council of November 25, 2015, lays down measures basically concerning open internet access (Net Neutrality) and roaming on public mobile communications networks within the Union.

**Roaming:** from April 30, 2016, until June 15, 2017, operators can only charge an additional fee on domestic prices. Thus, extra charges are for calls €0.05 / minute, €0.02 per SMS sent and €0.05 per megabits data (excluding VAT). During this period, the sum of the domestic retail price and any surcharge applied shall not exceed €0.19 per minute, €0.06 per SMS message and €0.20 per megabyte used. Those extra charges will disappear from June 15, 2017, when retail roaming surcharges should be abolished. In addition, the European Commission published last December 15, 2016, detailed rules on the application of fair use policy and on the methodology for assessing the sustainability of the abolition of retail roaming surcharges as of June 15, 2017. Final wholesale roaming caps have been agreed by the Council and Parliament as well as maximum wholesale caps at the following limits:

·0.01€/sms,

·0.032€/minute,

Data services glide path: 7.7€/GB (June – December 2017); 6€/GB (2018); 4.5€/GB (2019); 3.5€/GB (2020); 3€/GB (2021) and 2.5€/GB (2022).

**Net Neutrality:** provisions entered into force on April 30, 2016. BEREC issued Guidelines for a consistent implementation of the rules by August 30, 2016, in Member States. As a general principle all traffic has to be treated equally. However, reasonable traffic management is allowed, different types of traffic can be treated differently in certain cases. National regulatory authorities shall monitor the traffic management practices and the effect of their commercial practices on consumer's rights.

**Digital Single Market**

During 2016 the European Commission has issued many initiatives within the policy known as Digital Single Market which was adopted last May 6, 2015.

Among the most relevant initiatives, we can find the following:

**Package of measures to boost the Connectivity in the Single Digital Market - towards the European Gigabit Society.** This package was published by the European Commission on September 14, 2016, which includes the proposal for a **European Code of Electronic Communications**. Once transposed to the respective national frameworks will produce effects from 2018 at the earliest.

**Network and Information Security:** Directive 2016/1148 of the European Parliament and of the Council of July 6, 2016 concerning measures for a high common level of security of network and information systems across the Union entered into force on August 9, Member States have 21 months to transpose this Directive into their national laws and 6 additional months to identify operators of essential services (traditional critical infrastructures). According to the Directive, the providers of essential facilities are obliged to take appropriate security measures and report incidents to the national authorities.

**Audiovisual Package:** On May 25, the European Commission launched a proposal for a Directive on the provision of audiovisual media services. It includes among others: some specific obligations for video on demand services (VOD) related to the configuration of the VOD catalogue and the possibility of Member States to impose financing obligations on VOD service providers. In addition, the European Commission put forward a Proposal for a Regulation on cross-border Portability of online content services in the internal market, which is expected to be adopted in the first quarter of 2017.

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**Copyright:** The EC presented a package of legislative proposals including one aimed at: (a) promoting the cross-border provision of online services that are ancillary to broadcasting, where the principle of the country of origin is proposed to be applied to remuneration rights; and (b) facilitating retransmissions in closed networks (such as IPTV and mobile networks), TV and radio programs originated in other Member States.

In relation with data protection & Privacy, in Europe the new General Data Protection Regulation ("GDPR") of April 27, 2016, will be directly applicable in all member States from May 25, 2018. The GDPR introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching the new data protection rules.

On January 10, 2017, the European Commission has put forward its Proposal for a Regulation on ePrivacy, which will replace the current Directive 2002/58/EC on privacy in the electronic communications sector and will complement the recently approved GDPR; this Commission proposal (the first step in the legislative process) also introduces administrative fines of up to 4% of an undertaking's annual global turnover.

In October 2015, the Court of Justice of the European Union declared invalid the decision of the European Commission as regards the "Safe Harbor Agreement" relating to the transfer of personal data from the EU to the United States. Subsequently, the European Commission adopted a new decision on Privacy Shield on July 12, 2016, which considers that there is an adequate level of protection of personal data transferred from the EU to US self-certified companies complying with the Privacy Shield principles. Telefónica USA, Inc. has self-certified itself as Privacy Shield compliant. The Privacy Shield has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending.

Regarding spectrum, on December 14, 2016, the European Institutions reached an agreement on how to coordinate the use of the 700 MHz band facilitating the introduction of 5G as of 2020. The 700 MHz band should be assigned to mobile operators and made available for wireless broadband use by June 30, 2020, at the latest in all EU Member states. Duly justified exceptions – on grounds defined in the Decision – are possible until June 30, 2022. Member States will adopt and make public their national plans for releasing this band by June 30, 2018.

## **Spain**

### **General regulatory framework**

The legal framework for the regulation of the telecommunications sector in Spain is governed by the General Telecommunications Law (9/2014) of May 9. The main modifications of this Law compared to the previous one are the reduction of administrative burdens to boost networks deployments, as well as the adoption of complementary measures for boosting investment in telecommunications sector.



The Market and Competition National Commission, or CNMC, created by the Law 3/2013, assumed in 2013 its role as telecommunications and audiovisual service regulator in Spain. This new organism is also the competition authority in Spain and the national regulatory authority for transport, postal services and energy.

## **Market analysis**

Following, obligations imposed by the national regulator in the most relevant markets -in which Telefónica is deemed to have Significant Market Power (“SMP”) are detailed.

### **Fixed markets**

#### *Wholesale fixed access and call origination market*

On January 17, 2017, CNMC approved the definition and the analysis of the market for access and call origination on fixed networks. Considering that Telefónica have SPM, the CNMC imposed specific obligations to Telefónica regarding the provision of origination services, preselection and wholesale access service to the telephone line on a cost-oriented production, and to implement an accounting system. Telefónica was imposed, among others, the obligation of no discrimination, transparency and separation of accounts.

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*Fixed call termination market on individual networks*

In October 2014, the CNMC carried out a market analysis in terminated fixed networks, and concluded that every single provider, including Telefónica de España, are dominants in terminating fixed networks and, as a consequence, are obliged to provide the terminating service applying cost-orientation and non-discrimination obligations to the rest of operators, according to a purely incremental costs model. Finally in fixed call termination market on IP networks, Telefónica de España is required to submit an “Interconnection Reference Offer” (OIR).

**Mobile market**

*Mobile network call termination*

In May 2012, the ANR adopted a measure establishing the wholesale price at 0.0109 €/minute, as from July 2013. In July 2016, the National Regulatory Authority has conducted a public consultation about the long-term incremental costs model to set the voice termination cost on mobile networks. Market analysis is expected to be opened by 2017 and a final decision could take place by the end of 2017.

*Mobile Virtual Network Operators*

The consideration of Telefónica Móviles Spain, along with Vodafone and Orange, as a company with significant market power in access services and origination in public mobile telephone networks remains in force since February 2, 2006. As a consequence of this regulation Telefónica Móviles Spain has an obligation to attend any reasonable access request to its network. On July 1, 2016, the ANR reviewed this market. The NRA has considered that the market is competitive, and therefore, there is no need for ex ante regulation, and proposed that the current obligations for Telefónica regarding the obligation of meeting a reasonable access offer should be abolished. This proposed Decision is expected to be adopted during the second quarter of 2017.

**Wholesale (physical) to network infrastructure access and wholesale broadband access**

In February 2016, the CNMC adopted a Resolution which established the elimination of the 30 Mbps limit and the incorporation of geographical segmentation to the regulation for the residential customers, so that Telefónica is not obliged to offer wholesale broadband services access (bitstream) in the most competitive areas (66 cities). In this sense, Telefónica de España is only obliged to offer its wholesale broadband access services (bitstream) for residential segment, in non-competitive areas. The price of fiber access services will be calculated under a model of economic

replicability of Telefónica's retail offerings in the residential and business segments. The price of access services to the copper network will continue to be cost oriented. For the business segment, the consultation obliges Telefónica de España to offer its wholesale broadband access services both on the copper and fiber network, throughout the national territory. Additionally, on January 18, 2016, the CNMC adopted a resolution which approved the reference offer of the new wholesale unbundled virtual access service to Telefónica's new broadband Ethernet service (local NEBA). The NEBA service should be operative in 12 months from the date of the resolution's adoption.

### **Universal service obligations**

Telefónica de España has been designated the operator responsible for the provision of the connection to the public electronic communications network for a three-year maximum period (1st January 2017-31st December 2019), with the possibility of establishing broadband data connection with a descending speed no less than 1Mbit per second, and the provision of the public telephone service available from a fixed location. In addition, Telefónica de España has also been designated the operator responsible for the preparation and delivery of public telephone directories to the telephone subscribers for one-year period (1st January -31st December 2017). It is possible an extension for an additional year Telefónica Telecomunicaciones Públicas, S.A.U. has been designated as the operator responsible for the provision of a sufficient supply of public payphones for one-year period (1st January -31st December 2017). It is also possible an extension for an additional year.

### **Contribution to RTVE funding**

In August 2009, the Radio and Television Corporation Finance Law “(Ley de Financiación de la Corporación de Radio y Television Española)” was approved establishing that: (i) telecommunication operators, which operate nationwide or at least in more than one region, have to make a fixed annual provision of 0.9% of the invoiced operating income of the year (excluding the revenues of the wholesale reference market) and, (ii) on the other hand, the concessionaire companies and providers of TV services which operate nationwide or at least in more than one region should make an annual contribution fixed as follows: (a) 3% on the gross revenue of the year for open concessionaire companies or TV services providers, and (b) 1.5% on the gross revenue of the year for concessionaire companies to provide Pay TV services.

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In Spain, self-settlement of the contributions made has been appealed by Telefónica España and Telefónica Móviles España as well as, the Royal Decree 1004/2010, which approves the Regulation developing the abovementioned law.

### **Acquisition of Distribuidor Oficial de Televisión, S.A. (DTS)**

Under the April 22, 2015, resolution the CNMC authorized the acquisition of the exclusive control of DTS (Distribuidor Oficial de Televisión, S.A.) by Telefónica de Contenidos, S.A.U. As a result of such authorization the new entity assumed a set of obligations for 5 years (commitments), which briefly are: i) the obligation to make available a wholesale offer of channels with premium content, that allows the replicability of Telefónica retail Pay TV offer; ii) prohibition of including period of permanence clause in contracts for Pay TV packages; iii) the prohibition of attract DTS customers for a period of two months; iv) the obligation to keep at least three international routes uncongested with three Internet Connectivity Providers; and v) the prohibition of formalizing exclusive contracts exceeding three years with content providers.

### **Germany**

#### **General regulatory framework**

The European Union legislative framework was implemented in Germany at the end of June 2004, by the approval of Telecommunications Act (Telekommunikationsgesetz). Following the adaptation of the 2009 EU Telecom Package, the Telecom Act was repeatedly amended over the last years. The national regulatory authority responsible for regulation of electronic communication networks and services is the Bundesnetzagentur, or BNetzA. At the end of July 2016, the Act for better information exchange when combating international terrorism entered into force. This act *inter alia* amends 111 TKG which rules which customer data need to be collected and stored prior to access activation.

#### **Spectrum**

Following its decision of July 4, 2014, concerning the frequency aspects of the Telefónica Deutschland Holding AG merger with E-Plus Mobilfunk GmbH & Co. KG (E-Plus), BNetzA has started to perform a frequency distribution analysis particularly in the area of the 2GHz spectrum band. The end of the analysis is expected end of 2017 at the earliest. In addition, on December 2016, BNetzA published the key orientation points of the demand-oriented allocation of new frequencies for the further rollout of digital infrastructures. The paper names as areas of activity the timely allocation of the 2 GHz spectrum expiring end of 2020 and 2025 (so called UMTS spectrum) and further spectrum (*inter alia* 3.5 GHz).

## **Market reviews**

### *Mobile termination rates (MTR)*

The MTR of 0.0166 euro/minute expired end of November 2016. On August 30, 2016, BNetzA adopted a regulatory decision which considers with pure LRIC (LRIC = Long Run Incremental Costs) a new cost model for the calculation of MTR. Telefónica Deutschland has appealed the decision in court which has not yet been decided. BNetzA has approved new MTR on November 30, 2016, in a provisional decision which sets the rates to 0.011 euro/minute as of December 1, 2016, to 0.0107 euro/minute as of December 1, 2017, and to 0.095 euro/minute as of December 1, 2018, until the end of November 2019. Before taking a final decision, the new MTR are consulted nationally and notified to the EU Commission.

### *Fixed termination rates (FTR)*

The actual FTR of 0.0024 euro/minute expired on December 31, 2016. A draft regulatory decision has been consulted nationally and notified to the EU Commission which considers pure LRIC as new cost calculation method that may also lead to significant price reductions. The provisional decision of new FTR for all alternative operators – including Telefónica Deutschland – was approved end of January with a rate at 0.0010 €/min. Such decisions, once finally adopted, it will be applicable with retroactive effect as of January 1, 2017.

## **BNetzA adopts final decision on local loop access for local vectoring**

BNetzA in cooperation with the EU Commission has finalized the proceeding regards access to Deutsche Telekom's local loop for local vectoring. It adopted its final decision on September 1, 2016, which extends the propagation of vectoring in Deutsche Telekom's fixed network significantly. Telefónica Deutschland may benefit from this decision when converting from its own local loop platform to Deutsche Telekom's future-proof wholesale bitstream access model. Local vectoring allows for internet surfing speeds of up to 100 Mbit/s; going forward, transmission rates of up to 250 Mbit/s (super vectoring) will even be possible.

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**United Kingdom**

**General legislative framework**

The EU Regulatory Framework was implemented in the United Kingdom by the Communications Act in 2003. The Office of Communications, or Ofcom, is designated as the NRA responsible for the regulation of electronic communications networks and services.

**Wholesale price regulation**

Following a market review, mobile termination rates for all mobile providers, including the four national mobile communications operators (Vodafone, Telefónica United Kingdom, EE and H3G) are subject to controls based on the pure long-run incremental cost (pure LRIC) approach. The present mobile wholesale termination rate is 0.503 ppm and this will be reduced to 0.495 ppm from April 1, 2017. Ofcom will conduct another market review in 2017, to determine the regulatory regime from April 1, 2018.

**Licenses**

Telefónica United Kingdom has an obligation in its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the populations of each of England, Wales, Scotland and Northern Ireland) and an obligation in its 900/1800 MHz spectrum license to provide voice and text services to 90% of the UK landmass, both by the end of 2017, to be maintained, thereafter. Inherent with these obligations is a risk of Telefónica UK not meeting the required targets. Telefónica UK is actively working towards mitigating the risk through the continuous investment in an infrastructure improvement program, upgrading its 2G and 3G Networks and continued roll-out of its 4G Network.

On November 21, 2016, Ofcom issued a consultation document setting out an analysis of the forthcoming auction of 2.3 GHz and 3.4 GHz spectrum. Ofcom has proposed to establish maximum limits in the 2.3 GHz spectrum, which prevents BT/EE from bidding for such spectrum. Responses to Ofcom's consultation document were due in by January 31, 2017, and Ofcom is expected to publish its decision on the second quarter of 2017.

**Brazil**

## **General legislative framework**

The delivery of telecommunications services in Brazil is subject to regulation under the regulatory framework provided in the General Telecommunications Law (LGT) enacted in July 1997. The National Agency for Telecommunications, (Agência Nacional de Telecomunicações or ANATEL), is the principal regulatory authority for the Brazilian telecommunications sector.

Brazilian competition regulation is based on Law No. 12529 of November 30, 2011. The Administrative Council for Economic Defense, or CADE, is the agency in charge of enforcing the competition rules.

The new antitrust law establishes a pre-merger notification regime for concentration transactions, with new turnover thresholds (one participant with gross revenue of BRL750 million in Brazil and other participant with gross revenue of BRL75 million in Brazil) and maximum time length for merger review procedure (240 days, extendable to 330 days).

On October 18, 2016, CADE issued the Resolution No 17, which changed the rules concerning the mandatory notification of associative agreements. The new regulation tends to reduce notifications of associative agreements that do not raise antitrust concerns.

## **Licenses**

In Brazil, concessions are awarded for providing services under the public regime, while authorizations are granted for providing private regime services. The only service currently provided under both regimes is the Fixed Switched Telephony Service (“STFC”). All other services are provided under the private system only.

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In the state of São Paulo, Telefônica Brazil provides local and national long-distance Fixed Switched Telephony Service under the public regime, through a concession agreement. The current concession agreement dated from December 22, 2005, was renewed on January 1, 2006, and is valid until December 31, 2025. In principle, the assets assigned to the provision of the services described in the public concession agreement are considered reversible assets.

However, on December 6, 2016, the Senate approved a Bill of Law, which amends the LGT and reformulates the entire sector by establishing new rules for telecommunications services provisioning. During the last months, a Bill amending the regulatory framework in Brazil has been processed, establishing, among others, that such assets will no longer be reversible under the new licenses regime in exchange for significant broadband investment commitment. Recently, the processing at the Senate of such Bill has been challenged before the Federal Supreme Court and, consequently, the Senate's governing board has decided to send the Telecom bill for voting in Plenary. With the Bill being sent to the plenary, it could be understood that there is no more dispute for the Supreme Court to decide upon. In case that the bill is finally approved, ANATEL will be entitled to adopt the pertinent administrative decisions for the transformation of the respective licenses with the consequent modification of the future binding obligations to STFC providers. In addition, a proposal of the General Plan for Universalization of Fixed Switched Telephony Services was approved by ANATEL on December 15, 2016. It is expected that its final decision will be published in 2017.

In the remaining states of Brazil, Telefônica Brazil provides local, and long-distance and international STFC service, personal mobile service, and broadband multimedia communication services (which includes the provision of fixed broadband connections) and Pay TV services, all under the private regime.

Radiofrequencies authorizations, for its turn, are granted for a limited period of time (maximum of 20 years, renewable once). The most important radiofrequencies authorizations held by Telefônica Brazil are those associated with the exploitation of mobile services and are described in the licenses section.

In 2014, ANATEL auctioned Radiofrequencies licenses in the 700MHz frequency and Telefônica Brazil acquired the license to use one of the bands. According to the bidding notice, the winning parties were required to incorporate an independent entity that will manage the whole reframing process of the 700MHz (currently, the band occupied by the free-to-air analog broadcasters). Winning parties shall also provide such entity with the financial and operational resources to provide equipment and support for the broadcasters and the final users (which, subject to certain conditions, will be entitled to receive Digital TV receivers). Federal regulation establishes a timeline to implement such reframing which is scheduled to be concluded by December 2018.

### **Interconnection, tariffs and prices**

Interconnection among public networks is mandatory in Brazil. Generally, parties can freely negotiate the terms and conditions about technical points, economic discounts and rights/obligations, of the interconnection agreements.



Interconnection rates for fixed network operator identified as operator with significant market power (SMP) (Res. 588/2012) are defined by ANATEL; the interconnection rates for the use of mobile operators networks (Res. 438/2006), may be agreed between the parties. However, if the parties fail to reach a consensus, particularly regarding charges to fixed operators (Res. 576/2011), ANATEL imposes the rates to be used. The mobile termination market shall be based on the model of incremental costs and, pursuant to applicable laws, reductions of VU-M must be reflected in VC1 (retail price paid by users for local fixed-mobile calls) and VC2 and VC3 (retail price paid by users for national long distance fixed-mobile calls).

The Telefónica Group, including VIVO, has been identified as an operator with SMP in the following markets: (i) fixed network infrastructure access for data transmission in copper pairs or coaxial cables at speeds up to 10 Mbps in the region of São Paulo; (ii) wholesale fixed network infrastructure to transport local and long distance transmission at speeds up to 34 Mbps in the region of São Paulo; (iii) passive towers, ducts and trenches infrastructure throughout Brazil; (iv) call termination on mobile network in Brazil; and (v) national roaming market throughout Brazil.

Operators without SMP are entitled to charge fixed termination fees up to 20% higher than the highest fee adopted by fixed operators with SMP in the same region (despite the fact that there is a pending administrative proceeding before ANATEL challenging such disposition). Operators without SMP are entitled to charge mobile termination fees (VU-M) up to 20% higher than the highest VU-M adopted by mobile operators with SMP in the same region.

Further, ANATEL's Resolution No. 649 of February 12, 2015, changed Article 42 of the Appendix I of the PGMC, and established a decreasing Bill and Keep between SMP and the non-SMP operators: 65/35% between 2016 and 2017, 55/45 % between 2017 and 2018, 50/50 % between 2018 and 2019 and Full billing in 2019 when the definitive cost-oriented-model fees shall be in force. Such Resolution has been challenged in courts without a definitive outcome. Accordingly, the VU-M values (in Brazilian reais) for 2016 applicable to Telefônica Brazil were the following: i) Region I: 0.09317 ii) Region 2: 0.10309 iii) Region 3: 0.11218.

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On December 5, 2016, ANATEL issued a public consultation for the revision of the General Plan of Competition Goals (PGMC), which may address changes in the relevant markets regulated by the PGMC and in VIVO's identification as an operator with SMP in the regulated markets. The mentioned public consultation is available for comments until March 22, 2017.

## **Mexico**

### **General regulatory framework**

In Mexico, the provision of telecommunication services is governed by the Constitution and the Federal Telecommunication and Broadcasting Law ("LFTy R"), published on July 14, 2014, among others.

The Federal Telecommunications Institute (IFT) is the authority responsible for the regulation, promotion and supervision of the use, development and exploitation of radio spectrum, networks and the provision of broadcasting services and telecommunications as well as the antitrust authority for broadcasting and telecommunications sectors. Furthermore, on August 26, 2015, was established by the Consumers Affairs Authority a special division on Telecommunications affairs to monitor, coordinate, control, substantiate and resolve conciliation, arbitration and infringements, review, modification and grant the use of adhesion contracts in terms of Federal Consumer Act.

IFT as the Mexican national authority in communications and broadcasting sectors, declared in 2014 the "América Móvil Group" a preponderant operator in the telecommunications market, imposing it specific measures asymmetric obligations in order to avoid damaging competition and free competition within these measures the obligation not charge for calls terminating on its network and a set of Reference Offers for: leasing of dedicated links, access and shared use of passive infrastructure in fixed and mobile networks, mobile virtual network operators (MVNOs), Roaming and local loop unbundling. In this sense, on November 17, 2016, Telefónica México and América Móvil Group signed an agreement in order to América Móvil provides the wholesale service of national roaming in the areas where Telefónica México currently has no coverage, this in the light of the specific measures with asymmetric obligations imposed by IFT to the Preponderant Economic Agent. The Federal Law of Economic Competition published on May 23, 2014, its regulations and the "Regulatory Provisions of the Federal Law of Economic Competition for telecommunications and broadcasting published by the IFT on January 12, 2015, constitute the applicable regulatory framework by the IFT in terms of economic competition for the broadcasting and telecommunications sectors.

### **Licenses**

The main licenses and concessions to use spectrum are shown in the table at the end of this Annex.

Pegaso PCS, SA de C.V. (Pegaso PCS) has multiple licenses to use a Public Telecommunications Network and the use of spectrum for the provision of mobile local service nationwide, while the Grupo de Telecomunicaciones Mexicanas, SA de C.V. (GTM) has concessions to install, operate and explore a public telecommunications network long distance, national and international (July 6, 2003); changing the title of the network to provide basic local services and public telephony (March 28, 2006); concession to provide pay television service (DTH) and data transmission via satellite in the KU band (January 6, 2011) as well as data transmission services via satellite, KA Band (August 6, 2012); and, finally, granting rights to exploit the transmission and reception of signals of frequency bands associated with foreign satellites -WILDBLUE 1, ANIK F2- (August 6, 2012) and Amazonas-3. (December 19, 2013).

On December 2016 the merger between GTM and Pegaso PCS was formalized. By effect of this merger Pegaso PCS absorbed GTM, therefore, Pegaso PCS is now the owner of the licenses originally granted to GTM.

On October 7, 2015, GTM executed an agreement whereby such company assigned to Telefónica International Wholesale Services México, S.A. de C.V. (formerly Media Networks México Soluciones Digitales, S.A. de C.V.) all rights and obligations derived from the concession to grant the restricted televisión service (DTH) and transmission of data through satellite in KU band (January 6, 2011), subject to the corresponding authorization of the authority. The IFT granted the authorization on April 27, 2016, and from August 8, it is on record the registration in the public registry of concessions in favor of Telefónica International Wholesale Services México, S.A. de C.V.

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On October 15, 2015, executed a license exchange agreement (swaps) of frequency bands pursuant to articles 104 and 106 last paragraph of LFTy R, in which AT & T Norte, S. de RL de CV held, AT & T Digital, S. de RL de CV and AT&T Desarrollo en Comunicaciones de México, S. de R.L. de C.V. (Concesionarios AT & T) Pegaso PCS gave six blocks of 5 + 5 MHz in the range 1850-1910 MHz / 1930-1990 MHz concession in Regions 2, 3, 4, 6, 7 and 9, in turn gave Pegaso PCS the AT & T Dealers six blocks of 5 + 5 MHz concession in the range 1735-1740 MHz / 2135-2140 MHz in Regions 2, 3, 4, 6, 7 and 9, which continue use by the Concesionarios AT & T under a lease agreement for migrate its users. The IFT granted the authorization on December 15, 2015. In August 2016, the Concesionarios AT&T notified the intention of returning the leased spectrum, which was handed back on December 31, 2016.

### **Prices and tariffs**

Tariffs charged to customers are not regulated. They are set by mobile operating companies and must be registered with IFT, in order to be enforced.

### **Interconnection**

On October 3, 2016, the IFT published the MTR that shall be used to solve the conflicts regarding the MTR for 2017 (\$0.1906 Mexican pesos per minute), this rate was calculated using the same method that was used in 2016 but adjusting the exchange rate in the cost model.

On June 21, 2012, CIADI Secretary-General declared admissible the international arbitration presented by Telefónica, S.A. against Mexican United States. Telefónica, S.A. formulated their lawsuit memorial, on September 20, 2013, by virtue of which claim for damages incurred as a consequence of the resolutions to interconnections disputes, issued by different Mexican regulatory and administrative bodies, of mobile termination rates. Mexican United States answered on February 28, 2014. The parties agreed to suspend the process in two consecutive occasions for 6 months each one, therefore this process is suspended until March 16, 2017.

### **Foreign ownership/restrictions on transfer of ownership**

Since the amendments to the Constitution published in June 2013 foreign investment (FDI) up to one hundred percent in telecommunications is allowed.

### **Chile**

## **General regulatory framework**

The General Telecommunications Law No. 18168 of 1982, as amended, establishes the legal framework for the provision of telecommunications services in Chile. The main regulatory authority in Chile is SUBTEL (the Under-Secretary of Telecommunications). On February 13, 2014, the Regulation on Telecommunications Services was published and came into force on June 14, 2014, and regulated a number of new services as Internet, Pay TV, etc.

In May 2014, law No. 20750 that allows the introduction of DTT was published in the Official Journal. The main provisions set an extensible deadline of 5 years for the blackout analog; it sets that the concessions of free-to-air broadcasting could be nationwide, regional, local and European coverage; it also sets the entering of “Granted Retransmission” when the requirements of digital coverage for the 85% of the total population in service area and “must carry” of, at less 4 regional channels (whenever is technologically feasible, and the service area remains equal) is fulfilled. Football matches of Chile National Soccer Team will be broadcast by free-to-air channels. On April 15, 2015, SUBTEL published in Official Journal the Digital Broadcasting TV Plan.

The principal regulation concerning competition in Chile is Decree No. 211 of 1973, whose current text was established in Law Decree N° 1 of 2005 (Ministry of Economía, Fomento y Reconstrucción). The Competition Tribunal deals with infringements of competition law. The Law N° 20.945 was published on August 30, 2016. The law increases the administrative fines up to 30% of the sales relating to the product line or services associated with the infringement during the period in which it took place, or up to the double of the economic profit reached by the infringement.

## **Licenses**

The main licenses and concessions to use spectrum are shown in the table at the end of this Annex.

Additionally, Telefónica Chile has been granted licenses of public local phone services, Voice Over Internet Protocol services, concessions of long distance and concessions to install and exploit the national fiber optic network and mobile satellite. 2.6 GHz concession established an obligation for TMCH to provide a wholesale service to Mobile Virtual Operators, for what the latter had to published a completely Facilities Offer (including prices), available in non-discriminatory terms.

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In September 2015, it was published in the Official Journal the Decree No. 71/2015 of the Ministry of Transport and Telecommunications, which granted to TMCH a service concession for transmitting data on 713-748 MHz and 768-803 MHz frequency bands was awarded a block of frequencies at a national level of 2x10 MHz through a bidding procedure. The deadline for project start commercial services expires on September 14, 2017 and for locations, routes and compulsory schools expires on March 14, 2017.

### **Prices and tariffs**

Public Telecommunication Services Prices and prices for Intermediate Telecommunication Services are freely established by operators, unless there is an express resolution by Chile's Competition Court on existing conditions in the market that confirms that there is not enough competition. Additionally, maximum prices for interconnection services (access charges for network use, mainly) are subject to tariff regulation for all operators, being set by stipulated procedures.

The Ministries set maximum tariffs under efficient operator model basis.

Maximum tariffs for telephony services are set every five years by the Ministry of Transport and Telecommunications and the Ministry of Economy.

### **Interconnection**

Interconnection is obligatory for all license holders with the same type of public telecommunications services and between telephony public services and intermediate services that provide long distance services. Every five years, SUBTEL sets the applicable tariffs for services provided through the interconnected networks.

A Tariff Decree regarding fixed termination rate was adopted for the period 2014-2019. The new tariff came into force on May 8, 2014, and it apply a reduction of 37% from the one demanded the previous period. Regarding the mobile network, a Tariff Decree has been approved for the period 2014-2019. Such Tariff Decree came into force on January 25, 2014, and it imply a reduction of 76.4% from the previous tariffs.

### **Argentina**

## General regulatory framework

The basic legal framework for the provision of telecommunications services in Argentina is set forth in the Law “Argentina Digital” No. 27078 issued on January 7, 2015. This legal framework declared of public interest the development and regulation of Information Technology, Communications and its associated resources (hereinafter TIC`s). Thus, this law became the specific regulatory regime for the free market, including rules on interconnection, universal service and radio spectrum, and setting out the principles of network neutrality and giving to the technological, informational and communicational companies the possibility of providing broadcasting services (except satellite infrastructure), and setting a single license system.

Additionally, the Government approved the Decree N° 267/2015, published in the Official Gazette on January 4, 2016, which amended the Argentina Digital Act creating the National Communication Agency (ENACOM), which is the continuation of the Federal Authority for ICTs and Communications. Additionally, the Decree N° 1340/2016, which was published on January 2, 2017 instructs the Ente Nacional de Comunicaciones for the issuance of new regulations during 2017 which ensure the allocation of new frequency bands for provision of wireless or fixed wireless services and enables the reassignment of frequencies previously granted to other provider. Furthermore, it confirms the authorization to Telefónica de Argentina and Telefónica Móviles Argentina for providing the broadcasting service by subscription, from January 1, 2018, for the cities of Buenos Aires, Córdoba y Rosario; while a mechanism is established for the rest of the country on the protection of small and medium-size providers and cooperatives. Finally, some standards are set for the establishment of the Interconnection Regulation, such as the asymmetric rates regime and the automatic roaming service.

Furthermore, “Law on Defense of Competition” No. 25156 prohibits any acts or behaviors contrary to the law. The enforcement authority will be assisted by the National Commission for the Defense of Competition created by Law No. 22262.

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**Licenses**

The main licenses and concessions to use spectrum are shown in the table at the end of this Annex.

Additionally, Telefónica de Argentina has licenses for an indefinite period of time; for the provision of communications services; local telephone services; long-distance national and international, telex, international communication and data transfer services; national and international value-added services, and other telecommunication services provided by the different license agreements concluded with the National State, and administrative acts concluded with the National State.

From the promulgation of the “Argentina Digital” legal framework N° 27078, the licenses system has become a license-only system, without prejudice the corresponding inscription of each service in the terms that Authority of Application determines, and will have national scope. For this purpose the legal framework prescribes a period of grace that grant the old license given to, at the moment of the promulgation of that Act that were called “Single Telecommunication Service License” will be considered, by the effects of the new regime, as “Single Argentina Digital License” with the same content, scope and effects.

Otherwise, N° 27078 Argentina Digital Act ruled that the Telecommunication Licensees may require a license to provide Subscription Television Services, except those provided through satellite link. Nevertheless, from the promulgation of the Decree N° 267/2015, amending the aforementioned Act, some Telecommunication Licensee, including Telefónica de Argentina S.A. and Telefónica Móviles Argentina S.A., might provide the Broadcasting service by subscription after 2 years as from January 1, 2016, renewable for another year.

**Prices and tariffs**

Additionally, the “Argentina Digital” legal framework establish that providers of TIC’s services may freely set rates and/or prices for their service which shall be reasonable and fair, covering all the operation costs and a consequent reasonable profit margin. It also brings to the Authority of Application the possibility to regulate the tariffs and prices of essential public services and those the same authority determines. However, until the Secretary of Communications determines that there is effective competition for telecommunications services, or until the secondary legislation is adopted, the “dominant” providers in the relevant areas (which include Telefónica de Argentina) must respect the maximum tariffs established in the general tariff structure.

**Interconnection**



The new Authority of has the power to control prices and tariffs, and also to set them in order to the general costs or other compensation mechanism.

## **Colombia**

### **General regulatory framework**

In Colombia, telecommunications are a public service, subject to state regulation and oversight. Law 1341/09 (Technologies of Information and Communications Law) reformed the legal framework, establishing the general regime for information and communication technologies. Under this law, providers of network and telecommunications services in Colombia must register with the Information and Communication Technologies Minister. In addition, operators must obtain a concession from the National Television Authority (previously a Commission) in order to provide television services. The Colombian telecommunications regulator is the Comisión de Regulación de Comunicaciones or CRC.

The Colombian Competition Law is incorporated in the Law No. 155/59, Decree No. 2153/92 and Law No. 1340/09 on Restrictive Trade Practices. The Superintendent of Industry and Commerce is the Colombian competition authority.

### **Licenses**

The main licenses and concessions to use spectrum are shown in the table at the end of this Annex.

Additionally, Colombia Telecomunicaciones adopted on November 8, 2011, the General Entitled Regime of approval that is set out in law No. 1341 2009, which allows Colombia Telecomunicaciones to continue providing the network and communications services, like added-value services, carrier national services and mobile services, amongst others. In addition, the Company holds a concession in order to provide satellite TV (DBS) or Direct Home TV (DTH) which expired on February 22, 2017, consequently, an extension was requested.

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The ICT Ministry issued Resolution 597 on March 27, 2014, to renew 850 MHz/1900 MHz licenses for 10 additional years. The reversion of assets (other than the radio frequencies, which is clear that must be returned) and its scope, are being discussed in the context of the liquidation of the concession contract , taking into consideration the terms of the contract, and the Constitutional Court’s review of Law 422 of 1998, and Law 1341 of 2009. Discussions on the matter concluded on February 16, 2016. The ITC Ministry convened the Arbitral Tribunal, in accordance with what was agreed upon in the concession contract. The process is still ongoing, having the concession holders filed a response to the claim prompted by the ITC Ministry. Alongside this, the procedural parties’ efforts continue to determine the conditions needed to try to reach a conciliation

**Interconnection**

Mobile and fixed operators in Colombia have the right to interconnect to other operators’ networks. Before the intervention of regulatory authorities, operators must attempt direct negotiations. Interconnection must assure compliance with the objectives of non-discriminatory treatment, transparency, prices based on costs plus a reasonable profit and promotion of competition.

In 2014, the CRC issued a new glide path for the mobile termination rates by Resolution No. 4660 of 2014. 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.

| <b>Value/year/ COP\$</b> | <b>2017</b>  |
|--------------------------|--------------|
| Charge per minute        | 10.99        |
| % Reduction              | 42.2%        |
| Capacity Charge          | 4,273,389.92 |
| % Reduction              | 43.9%        |

The CRC published in November 2016 a regulatory project for public comments. In the project the CRC propose a symmetric termination rate of \$ 11,17 COP per minute and \$4.3 million COP per monthly capacity from 2017 for established operators and an asymmetric termination rate of \$19,01 COP per minute and \$7,6 million COP per monthly capacity for challenger operators in a 5 years period. Also the CRC proposed regulatory measures to promote the entry MVNO’s, including the regulation of prices for the access to the mobile networks. The project is still in debate.

**Prices and tariffs**

The Technologies of Information and Communications Law, provides for free pricing system for communication service, unless there are market failures or quality problems. From 2016 retail tariffs for fix to mobile calls are no longer regulated except for TIGO which still holds a PCS's concession.

### **Television services**

The Company pays the National Television Authority a periodic fee for the license obtained in 2007 to offer television services, initially set as 10% of the gross revenues of the company for television services, reduced to 7% in 2010. Since 2012, it is based on a fixed value of 1,874.32 Colombian pesos per user, updated yearly to the consumer gross price index (IPC) and the number of registered users. With the extension of the concession the periodic compensations will be frozen until the ANTV publishes the contributions regulation.

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**Peru**

**General regulatory framework**

The provision of telecommunications services in Peru is governed by the Telecommunications Law and related regulations. In July 2012, the Peruvian Congress approved the Law of Promotion of the Broad Band and Construction of the National Fiber Optic Backbone, Law No. 29904. This Law declares of Public Necessity: (i) the construction of the National Fiber Optic Backbone which will be entitled to the government to make possible the connectivity by the broad band; and (ii) the access and use of the infrastructure associated with the public services of energy and hydrocarbon to facilitate the display of the telecommunication network for the provision of the broad band. In addition, Law No. 29904 implies that operators of electric, transport and hydrocarbon infrastructure projects will have to install fiber optic that will be entitled to the State and will be given in concession to other telecommunication operators. Also, this law establishes that a percentage of the capacity of the National Fiber Optic Backbone will be reserved for the Government to satisfy its necessities. Additionally, this Law incorporated the obligation to the internet services providers to comply with the Net Neutrality regulations. In this sense OSIPTEL has adopted a regulation aimed at providing clear guidelines on the implementation of the net neutrality regime adopted in Peru in 2012 that is in force since January 1, 2017.

Law No. 30083 was approved in September 2013, which seeks to strengthen competition in the public mobile market service by introducing mobile virtual network operators (MVNOs) and mobile rural infrastructure operators (MRIO). In August 2015, it was published the Regulation of the Act.

The general competition framework in Peru is based on the Legislative Decree No. 1034. This Law it is applied, in the telecommunication sector, by OSIPTEL.

**Licenses**

The main licenses and concessions to use spectrum are shown in the table at the end of this Annex.

Additionally, Telefónica del Perú, S.A.A. provides fixed electronic communications services in the whole country, pursuant to two concession agreements issued by the Transports and Communications Ministry on May 16, 1994. Both agreements will be in force during 20 years, and will be partially renewed for additional periods of 5 years up to a maximum of 20 years. To date, three partial renewals have been approved and thereunder the concession agreements have guaranteed its force until November 27, 2027. In December 2013, Telefónica del Perú, S.A.A. submitted to the Transport and Communications Ministry an application to renew its concessions to provide nationwide fixed telecommunications services, for five years more. The aforementioned proceeding is still pending. The cable

distribution broadcasting service concessions have been renewed in May 2016 until March 2032 and 2033.

### **Prices and tariffs**

Tariffs for fixed telephony services must be approved by OSIPTEL (National Regulatory Authority) and in accordance with a price cap formula based on a productivity factor. Rates charged by mobile providers to their customers have been subject to a free tariff regime supervised by OSIPTEL. Tariffs must be reported to OSIPTEL prior to implementation. On May 19, 2016, OSIPTEL adjusted the tariff maximum rate applicable to local calls made from Telefónica del Perú S.A.A.'s fixed telephones to mobile networks in PEN 0.0017 per second without IGV. This new rate is in force since May 21, 2016.

### **Interconnection**

Mobile service providers are required, upon request, to interconnect with other concession holders. According to the principles of neutrality and non-discrimination contemplated in the Telecommunications Law, the conditions agreed upon in any interconnection agreement will apply to third parties in the event that those conditions are more beneficial than terms and conditions agreed upon separately. On April 1, 2015, OSIPTEL sets new values for the mobile termination rates ending the previous asymmetry between Telefónica del Perú and Claro, but not to the asymmetry with Entel and Viettel. The new MTRs that apply to Telefónica del Perú and Claro until January 2018 are 1.76 cents / min (\$), representing a reduction of 46%.

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Table of Contents**Main concessions and licenses held by the Telefónica Group**

The following tables list the concessions and licenses to use spectrum for mobile services and selected other applications in each country.

| <b>EUROPE</b>         | <b>Frequency</b> | <b>Bandwidth (MHz)</b> | <b>Year of Exp. Date</b> |     |
|-----------------------|------------------|------------------------|--------------------------|-----|
| <b>Spain</b>          | 800 MHz          | 20                     | 2031                     |     |
|                       | 900 MHz          | 29.6                   | 2030                     |     |
|                       | 1800 MHz         | 40                     | 2030                     |     |
|                       | 1900 MHz (TDD)   | 5                      | 2020                     |     |
|                       | 2100 MHz         | 29.6                   | 2020                     | (1) |
|                       | 2600 MHz         | 40                     | 2030                     |     |
|                       | 2600 MHz         | 20                     | (2) 2030                 |     |
|                       | 3.5 GHz          | 40                     | 2020                     | (3) |
| <b>United Kingdom</b> | 800 MHz          | 20                     | Indefinite               | (4) |
|                       | 900 MHz          | 34.8                   | Indefinite               |     |
|                       | 1800 MHz         | 11.6                   | Indefinite               |     |
|                       | 1900 MHz (TDD)   | 5                      | Indefinite               |     |
|                       | 2100 MHz         | 20                     | Indefinite               |     |
| <b>Germany</b>        | 700 MHz          | 20                     | 2033                     |     |
|                       | 800 MHz          | 20                     | 2025                     |     |
|                       | 900 MHz          | 20                     | 2033                     |     |
|                       | 1800 MHz         | 20                     | 2033                     |     |
|                       | 1800 MHz         | 20                     | 2025                     |     |
|                       | 1900 MHz (TDD)   | 5                      | 2025                     |     |
|                       | 1900 MHz (TDD)   | 5                      | 2020                     |     |
|                       | 2000 MHz (TDD)   | 14.2                   | 2025                     |     |
|                       | 2100 MHz         | 39.6                   | 2020                     |     |
|                       | 2100 MHz         | 29.7                   | 2025                     |     |
|                       | 2600 MHz         | 60                     | 2025                     |     |
|                       | 2600 MHz (TDD)   | 20                     | 2025                     |     |
|                       | 3.5 GHz          | 84                     | 2021                     |     |

(1) Expected extension until April 18<sup>th</sup> 2030.

(2) Regional licenses in Madrid and Melilla.

(3) Restricted to Fixed applications; expected extension until 2030.

(4) Initial term 20 years.

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| <b>BRAZIL</b>                 |          | <b>Frequency Bandwidth (MHz)</b> | <b>Year of Exp. Date</b> |     |
|-------------------------------|----------|----------------------------------|--------------------------|-----|
| <b>Brazil</b> <sup>(10)</sup> | 450 MHz  | 14                               | 2027                     | (1) |
|                               | 700 MHz  | 20                               | 2029                     |     |
|                               | 850 MHz  | 25                               | (2) 2020-2028            | (3) |
|                               | 900 MHz  | 5                                | (4) 2023                 | (5) |
|                               | 1800 MHz | 20                               | (6) 2023                 | (5) |
|                               | 1900 MHz | 10                               | (7) 2022                 |     |
|                               | 2100 MHz | 30                               | 2023                     |     |
|                               | 2500 MHz | 40                               | (8) 2027-2031            | (9) |

(1) SP State (towns with CN 13 to 19), MG and North East (AL, CE, PB, PE, PI, RN e SE).

(2) Except regions 2', 4', 6', 7' and 10.

(3) Regional licenses: expiration and renewal dates are dependent on the region. The licenses in Rio de Janeiro and Espirito Santo are due to expire in 2020.

(4) Only in regions 3, 4, 4', 5, 6, 7, 8 and 9. Not in regions 1, 2, 2', 5', 6', 7' and 10.

(5) MG Interior (4') expiration date 2020; the remaining licenses will expire in 2023.

(6) 20 MHz is the most common bandwidth, but it is higher in some regions (up to 50 MHz).

(7) All licenses were disabled and migrated to 2100 MHz frequency (3G technology). The migration is expected to be completed by March 2017 in region 10 and in sectors 22, 25, 30 and 33 of PGO (GPLG), and it depends on Anatel's approval.

(8) 40 MHz is the most common bandwidth, but it is 60 MHz in some regions.

(9) Band X will expire in 2027 and Band P will expire in 2031.

(10) Telefónica Brazil uses high frequency spectrum in all regions of Brazil; the same will apply with low frequency spectrum once the 700 MHz frequency is usable. Until then, the operator uses spectrum in low frequencies spectrum in all regions of Brazil except in region 10 (Northeast of Brazil). Regional codes are included in Annex 1.

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| <b>HISPANOAMÉRICA</b>       | <b>Frequency</b>                         | <b>Bandwidth (MHz)</b> | <b>Year of Exp. Date</b> |      |
|-----------------------------|--|------------------------|--------------------------|------|
| <b>Argentina</b>            | 700 MHz                                  | 20                     | 2032                     | (1)  |
|                             | 850 MHz (AMBA)                           | 30                     | Indefinite               |      |
|                             | 850 MHz (South)                          | 25                     | Indefinite               |      |
|                             | 1900 MHz (AMBA)                          | 20                     | Indefinite               |      |
|                             | 1900 MHz (North)                         | 50                     | Indefinite               |      |
|                             | 1900 MHz (South)                         | 25                     | Indefinite               |      |
|                             | 1700 MHz/2100 MHz                        | 20                     | 2032                     | (1)  |
| <b>Chile</b>                | 3.5 GHz                                  | 50                     | Indefinite               | (2)  |
|                             | 700 MHz                                  | 20                     | 2045                     |      |
|                             | 850 MHz                                  | 25                     | Indefinite               |      |
|                             | 1900 MHz                                 | 30                     | 2032/2033                | (3)  |
|                             | 2600 MHz                                 | 40                     | 2043                     |      |
|                             | 2600 MHz                                 | 12                     | 2038                     | (4)  |
| <b>Colombia</b>             | 3.5 GHz                                  | 50                     | 2037                     | (5)  |
|                             | 850 MHz                                  | 25                     | 2024                     |      |
|                             | 1700 MHz/2100 MHz                        | 30                     | 2023                     |      |
|                             | 1900 MHz                                 | 15                     | 2024                     |      |
| <b>Ecuador</b>              | 1900 MHz                                 | 15                     | 2021                     |      |
|                             | 850 MHz                                  | 25                     | 2023                     |      |
| <b>Mexico<sup>(6)</sup></b> | 1900 MHz                                 | 60                     | 2023                     |      |
|                             | 850 MHz (Reg. 1, 2, 3, 4)                | 20                     | 2025                     |      |
|                             | 850 MHz (Monterrey and surrounding area) | 1.92                   | 2025                     |      |
|                             | 1900 MHz (Reg. 1)                        | 40                     | 2018/2030                | (7)  |
|                             | 1900 MHz (Reg. 2)                        | 50                     | 2018/2030                | (8)  |
|                             | 1900 MHz (Reg. 3 and 7)                  | 60                     | 2018/2025/2030           | (9)  |
|                             | 1900 MHz (Reg. 4)                        | 50                     | 2018/2030                | (10) |
|                             | 1900 MHz (Reg. 5)                        | 50                     | 2018/2025/2030           | (11) |
|                             | 1900 MHz (Reg. 6)                        | 60                     | 2018/2030                | (12) |
|                             | 1900 MHz (Reg. 8)                        | 30                     | 2018/2025                | (13) |
| <b>Peru</b>                 | 1900 MHz (Reg. 9 – Mexico City)          | 70                     | 2018/2025/2030           | (14) |
|                             | 450 MHz                                  | 10                     | 2028                     | (15) |
|                             | 700 MHz                                  | 30                     | 2036                     |      |
|                             | 850 MHz                                  | 25                     | 2030                     | (16) |
|                             | 900 MHz (Lima & Callao)                  | 10                     | 2028                     |      |
|                             | 900 MHz (Rest of provinces)              | 16                     | 2028                     | (17) |
|                             | 1700 MHz/2100 MHz                        | 40                     | 2033                     |      |
|                             | 1900 MHz (Lima & Callao)                 | 25                     | 2030                     |      |
|                             | 1900 MHz (Rest of provinces)             | 25                     | 2018                     |      |
|                             | 3.5 GHz                                  | 50                     | 2027                     | (15) |
| <b>Uruguay</b>              | 850 MHz                                  | 25                     | 2024                     |      |
|                             | 1900 MHz                                 | 20                     | 2022/2024                | (18) |
|                             | 1900 MHz                                 | 40                     | 2033                     |      |
| <b>Venezuela</b>            | 850 MHz                                  | 25                     | 2022                     |      |
|                             | 1900 MHz                                 | 50                     | 2022                     |      |
|                             | 1700 MHz/2100 MHz                        | 20                     | 2022                     |      |
|                             | 2600 MHz                                 | 40                     | 2029                     |      |
|                             | 3.5 GHz                                  | 50                     | 2026                     | (15) |
| <b>Costa Rica</b>           | 850 MHz                                  | 10.6                   | 2026                     |      |
|                             | 1800 MHz                                 | 30                     | 2026                     |      |



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|                    |                   |    |      |      |
|--------------------|-------------------|----|------|------|
|                    | 2100 MHz          | 20 | 2026 |      |
| <b>El Salvador</b> | 850 MHz           | 25 | 2018 |      |
|                    | 1900 MHz          | 30 | 2021 |      |
| <b>Guatemala</b>   | 1900 MHz          | 80 | 2034 |      |
| <b>Nicaragua</b>   | 700 MHz           | 40 | 2023 |      |
|                    | 850 MHz           | 25 | 2023 |      |
|                    | 1900 MHz          | 60 | 2023 |      |
|                    | 1700 MHz/2100 MHz | 40 | 2023 |      |
| <b>Panama</b>      | 700 MHz           | 20 | 2036 |      |
|                    | 850 MHz           | 25 | 2036 | (19) |
|                    | 1900 MHz          | 20 | 2036 | (19) |

(1) Date will be confirmed when the 700 MHz band is released.

(2) Only in 37 locations. Restricted to Fixed applications.

(3) 20 MHz expires in November 2032; 10 MHz in April 2033.

(4) Only in Metropolitan Region.

(5) Only in Aysén and Punta Arenas.

(6) Two different communication licenses, one expires in 2018, the other expires in 2030. Regional codes are included in Annex

(7) 30 MHz expires in 2018; 10 MHz in 2030.

(8) 30 MHz expires in 2018; 20 MHz in 2030.

(9) 10 MHz expires in 2018; 20 MHz expires in 2025; 30 MHz expires in 2030.

(10) 40 MHz expires in 2018; 10 MHz in 2030.

(11) 10 MHz expires in 2018; 20 MHz expires in 2025; 20 MHz expires in 2030.

(12) 30 MHz expires in 2018; 30 MHz expires in 2030.

(13) 10 MHz expires in 2018; 20 MHz expires in 2025.

(14) 30 MHz expires in 2018; 10 MHz expires in 2025; 30 MHz expires in 2030.

(15) Restricted to Fixed applications.

(16) Provinces of Lima and Callao: expiration date of March 2030; rest of provinces in December 2030.

(17) Used in rural areas.

(18) 10 MHz expires in 2022; 10 MHz in 2024.

(19) Renewal agreement reached in February 2014.

Telefónica seeks to use its spectrum in the most efficient way, implementing LTE and LTE-Advanced where possible.

Besides the spectrum assets included in the above tables, Telefónica owns other assets of spectrum used for other services in higher frequency ranges (above 6 GHz), including access transport.

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ANNEX 1

**BRAZIL'S SPECTRUM PORTFOLIO: MEANING OF THE STATES, REGIONS AND SECTORS  
ACRONYMS**

| <b>Acronym</b> | <b>State</b>        |
|----------------|---------------------|
| AC             | Acre                |
| AL             | Alagoas             |
| AP             | Amapá               |
| AM             | Amazonas            |
| BA             | Bahia               |
| CE             | Ceara               |
| DF             | Distrito Federal    |
| ES             | Espírito Santo      |
| GO             | Goiás               |
| MA             | Maranhão            |
| MT             | Mato Grosso         |
| MS             | Mato Grosso do Sul  |
| MG             | Minas Gerais        |
| PA             | Pará                |
| PB             | Paraíba             |
| PR             | Paraná              |
| PE             | Pernambuco          |
| PI             | Piauí               |
| RJ             | Rio de Janeiro      |
| RN             | Rio Grande do Norte |
| RS             | Rio Grande do Sul   |
| RO             | Rondônia            |
| RR             | Roraima             |
| SC             | Santa Catarina      |
| SP             | São Paulo           |
| SE             | Sergipe             |
| TO             | Tocantins           |

**States & towns**

**Regions**

|           | <b>included in the regions</b>      |
|-----------|-------------------------------------|
| <b>1</b>  | SP (City)                           |
| <b>2</b>  | SP (Interior)                       |
| <b>2'</b> | SP - towns of sector 33 of the GPLG |
| <b>3</b>  | RJ y ES                             |
| <b>4</b>  | MG                                  |
| <b>4'</b> | MG - towns of sector 3 of the GPLG  |
| <b>5</b>  | PR y SC                             |
| <b>5'</b> | PR - towns of sector 20 of the GPLG |
| <b>6</b>  | RS                                  |
| <b>6'</b> | RS - towns of sector 30 of the GPLG |
| <b>7</b>  | AC, DF, GO, MS, MT, RO y TO         |
| <b>7'</b> | GO - towns of sector 25 of the GPLG |

- 8** AM, AP, MA, PA y RR
- 9** BA y SE
- 10** AL, CE, PB, PE, PI y RN

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**SectorsGPLG - general plan of the licenses granted (geographic areas that correspond to the sectors)**

- 1** RJ
- 2** MG - except towns included in sector 3  
MG - towns of Araporã, Araújo, Campina Verde, Campo Florido, Campos Altos, Canálopis, Capinópolis, Carmo do Paranaíba, Carneirinhos, Centralina, Comendador Gomes, Conceição das Alagoas, Córrego Danta, Cruzeiro da Fortaleza, Delta, Frutal, Gurinhatã, Ibiraci, Igaratinga, Iguatama, Indianópolis, Ipiacú, Itapagipe, Ituiutaba, Iturama, Lagamar, Lagoa Formosa, Lagoa Grande, Limeira D'Oeste, Luz, Maravilhas, Moema,
- 3** Monte Alegre de Minas, Monte Santo de Minas, Nova Ponte, Nova Serrana, Papagaios, Pará de Minas, Patos de Minas, Pedrinópolis, Pequi, Perdígão, Pirajuba, Pitangui, Planura, Prata, Presidente Olegário, Rio Paranaíba, Santa Juliana, Santa Vitória, São Francisco de Sales, São José da Varginha, Tupaciguara, Uberaba, Uberlândia, União de Minas & Vazante
- 4** ES
- 5** BA
- 6** SE
- 7** AL
- 8** PE
- 9** PB
- 10** RN
- 11** CE
- 12** PI
- 13** MA
- 14** PA
- 15** AP
- 16** AM
- 17** RR
- 18** SC
- 19** PR –except towns included of sector 20
- 20** PR – towns of Londrina and Tamarana
- 21** MS – except the town integrating of sector 22
- 22** MS – town of Paranaíba
- 23** MT
- 24** TO y GO – except towns included in sector 25
- 25** GO – towns of Buriti Alegre, Cachoeira Dourada, Inaciolândia, Itumbiara, Paranaiguara and São Simão
- 26** DF
- 27** RO
- 28** AC
- 29** RS
- 30** RS – towns of Pelotas, Capão do Leão, Morro Redondo and Turuçu
- 31** SP – except towns included in sector 33  
SP – towns of Altinópolis, Aramina, Batatais, Brodosqui, Buritizal, Cajuru, Cássia dos Coqueiros, Colômbia, Franca, Guaíra, Guará, Ipuã, Ituverava, Jardinópolis, Miguelópolis, Morro Agudo, Nuporanga, Orlândia,
- 33** Ribeirão Corrente, Sales de Oliveira, Santa Cruz da Esperança, Santo Antônio da Alegria and São Joaquim da Barra

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**ANNEX 2**

**Mexico spectrum portofolio: meaning of the region numbers**

Region 1 Baja California: Baja California, Baja California Sur, Sonora (San Luis Río Colorado).

Region 2 Sinaloa, Sonora (excluding San Luis Río Colorado).

Region 3 Chihuahua, Durango, Coahuila de Zaragoza (Torreón, San Pedro, Matamoros, Francisco I. Madero, Viesca).

Region 4 Nuevo León, Tamaulipas, Coahuila de Zaragoza (excluding municipalities of the North Region).

Region 5 Chiapas, Tabasco, Yucatán, Quintana Roo, Campeche.

Region 6 Jalisco (excluding municipalities of the Central Region), Michoacán de Ocampo, Nayarit, Colima.

Region 7 Guanajuato, San Luis Potosí, Zacatecas, Querétaro de Arteaga, Aguascalientes, Jalisco (Lagos de Moreno, Encarnación de Díaz, Teocaltiche, Ojuelos de Jalisco, Colotlán, Villa Hidalgo, Mezquitic, Huejuquilla el Alto, Huejúcar, Villa Guerrero, Bolaños, Santa María de los Ángeles).

Region 8 Veracruz-Llave, Puebla, Oaxaca, Guerrero, Tlaxcala.

Region 9 State of México, Distrito Federal, Hidalgo, Morelos.

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