

TELEFONICA S A  
Form 20-F  
April 12, 2006

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

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 20-F**

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

**Commission file number: 1-9531**

**TELEFÓNICA, S.A.**

(Exact name of Registrant as specified in its charter)

**KINGDOM OF SPAIN**

(Jurisdiction of incorporation or organization)

**Gran Vía, 28, 28013 Madrid, Spain**

(Address of principal executive offices)

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
<b>Ordinary Shares, nominal value <math>\square</math>1.00 per share*</b>	<b>New York Stock Exchange</b>
<b>American Depositary Shares, each representing three Ordinary Shares</b>	<b>New York Stock Exchange</b>

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

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

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

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

**Ordinary Shares, nominal value  $\square$ 1.00 per share: 4,921,130,397**

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

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

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

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

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

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

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

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

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

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

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## TABLE OF CONTENTS

	<u>Page</u>
CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS	3
CERTAIN TERMS AND CONVENTIONS	4
PRESENTATION OF CERTAIN FINANCIAL INFORMATION	4
PART I	6
ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS	6
A. DIRECTORS AND SENIOR MANAGEMENT	6
B. ADVISORS	6
C. AUDITORS	6
ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE	6
ITEM 3. KEY INFORMATION	6
A. SELECTED FINANCIAL DATA	6
B. CAPITALIZATION AND INDEBTEDNESS	9
C. REASONS FOR THE OFFER AND USE OF PROCEEDS	9
D. RISK FACTORS	9
ITEM 4. INFORMATION ON THE COMPANY	15
A. HISTORY AND DEVELOPMENT OF THE COMPANY	15
B. BUSINESS OVERVIEW	21
C. ORGANIZATIONAL STRUCTURE	65
D. PROPERTY, PLANT AND EQUIPMENT	65
ITEM 4A. UNRESOLVED STAFF COMMENTS	69
ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS	69
A. OPERATING RESULTS	69
B. LIQUIDITY AND CAPITAL RESOURCES	92
C. RESEARCH AND DEVELOPMENT	96
D. TRENDS AND OUTLOOK	97
E. OFF-BALANCE SHEET ARRANGEMENTS	98
F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS	99
ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES	99
A. DIRECTORS AND SENIOR MANAGEMENT	99
B. COMPENSATION	107
C. BOARD PRACTICES	110
D. EMPLOYEES	110
E. SHARE OWNERSHIP	111
ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS	112
A. MAJOR SHAREHOLDERS	112
B. RELATED PARTY TRANSACTIONS	113
C. INTERESTS OF EXPERTS AND COUNSEL	114
ITEM 8. FINANCIAL INFORMATION	114
ITEM 9. THE OFFERING AND LISTING	120
A. OFFER AND LISTING DETAILS	120
B. PLAN OF DISTRIBUTION	125
C. MARKETS	125
D. SELLING SHAREHOLDERS	125

E.	DILUTION	125
F.	EXPENSES OF THE ISSUE	125
ITEM 10.	ADDITIONAL INFORMATION	125
A.	SHARE CAPITAL	125
B.	MEMORANDUM AND ARTICLES OF ASSOCIATION	125
C.	MATERIAL CONTRACTS	129
D.	EXCHANGE CONTROLS	130
E.	TAXATION	132

F.	DIVIDENDS AND PAYING AGENTS	136
G.	STATEMENTS BY EXPERTS	136
H.	DOCUMENTS ON DISPLAY	136
ITEM 11.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	137
ITEM 12.	DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES	154
PART II		154
ITEM 13.	DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES	154
ITEM 14.	MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS	154
ITEM 15.	CONTROLS AND PROCEDURES	154
ITEM 16		154
A.	AUDIT COMMITTEE FINANCIAL EXPERT	154
B.	CODE OF ETHICS	155
C.	PRINCIPAL ACCOUNTANT FEES AND SERVICES	155
D.	EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES	155
E.	PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS	155
PART III		157
ITEM 17.	FINANCIAL STATEMENTS	157
ITEM 18.	FINANCIAL STATEMENTS	157
ITEM 19.	EXHIBITS	157

### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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

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



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

### **CERTAIN TERMS AND CONVENTIONS**

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

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

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

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

- Fixed Telephony accesses: includes PSTN lines (public switched telephone network), ISDN lines (integrated services digital network) and circuits. For purposes of calculating our number of fixed line accesses, we multiply our lines to service as follows: PSTN (x1); basic ISDN (x1); primary ISDN (x30, 20 or 10); 2/6 digital access (x30);
- Internet and data accesses: includes broadband accesses (wholesale ADSL and retail ADSL lines), narrowband accesses (internet service through the PSTN) and other accesses (unbundled local loops, circuits and other accesses including WiFi and fiber optic cable);
- Pay TV: includes cable TV and Imagenio IP TV (Internet Protocol TV); and
- Mobile accesses: includes mobile telephony.

### **PRESENTATION OF CERTAIN FINANCIAL INFORMATION**

In this Annual Report, references to "dollars" or "\$" are to United States dollars, references to "euro" or "€" are to 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.

Since January 1, 2005, our consolidated annual and interim financial statements, including our consolidated financial statements as of and for the year ended December 31, 2005, are and will be prepared in accordance



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with the International Financial Reporting Standards adopted by the European Union (IFRS). IFRS, as adopted by the European Union and applied by us in our consolidated financial statements as of and for the year ended

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

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

**PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS****A. DIRECTORS AND SENIOR MANAGEMENT**

Not applicable.

**B. ADVISORS**

Not applicable.

**C. AUDITORS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION****A. SELECTED FINANCIAL DATA**

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

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

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

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

6

	<b>As of or for the year ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
	<b>(euro in millions, except per share and ADS data)</b>	
Profit for the year from continuing operations	3,353.62	4,827.06
Profit from discontinued operations after taxes	131.97	□
Profit for the year	3,485.59	4,827.06
Minority interests	(309.92)	(381.21)
Profit for the year attributable to equity holders of the parent	3,175.67	4,445.85
Weighted average number of shares (thousands)	4,987,751	4,870,852
Earnings per share attributable to equity holders of the parent (euros)(1)(2)	0.637	0.913
Earnings per ADS(1)(2)	1.910	2.738
Weighted average number of ADS (thousands)	1,662,584	1,623,617

**Consolidated Balance Sheet Data**

Cash and cash equivalents	914.35	2,213.21
Property, plant and equipment	23,193.37	27,992.60
Total assets	60,078.86	73,173.77
Non-current liabilities	27,742.58	35,126.47
Equity (net)	12,342.47	16,158.43
Book value per ordinary share (euros)	2.475	3.317

**Consolidated Cash Flow Data**

Net cash provided by operating activities	10,131.13	11,139.14
Net cash used in investing activities	(5,808.16)	(9,592.02)
Net cash used in financing activities	(3,936.61)	(434.67)
Cash dividends per ordinary share (euros)	0.400	0.500

**As of or for the year ended December 31,**

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

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Long-term debt	27,771.20	21,778.00	18,310.00	14,881.90	25,167.58
Shareholders' equity	31,470.47	16,667.84	16,888.02	15,872.85	19,221.96
Book value per ordinary share	6.155	3.239	3.274	3.182	3.946

**Consolidated Cash Flow Data**

Net cash provided by operating activities	8,995.8	9,019.5	9,558.7	10,042.7	10,891.44
Net cash used in (provided by) investing activities	(9,528.5)	(5,585.4)	(5,462.8)	(8,543.1)	(9,290.75)
Net cash used in (received from) financing activities	(1,347.0)	(2,082.0)	(4,220.0)	(2,264.6)	(803.53)
Cash dividends per ordinary share (euros)(1)	—	—	0.450	0.400	0.500

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- (1) The per share and per ADS computations for all periods presented have been presented using the weighted average number of shares outstanding for each period, and have been adjusted to reflect the stock dividends which occurred during the periods presented, as if these had occurred at the beginning of the earliest period presented.
  - (2) Each ADS represents the right to receive three ordinary shares. Figures do not include any charges of the Depositary.
  - (3) U.S. GAAP data for the years ended December 31, 2001, 2002, 2003 and 2004 has been restated retroactively to eliminate the monetary adjustment for inflation in hyperinflationary economies. For additional information, please refer to note 23 to our Consolidated Financial Statements included elsewhere in this document.

**Exchange Rate Information**

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

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

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

Source: Federal Reserve Bank of New York.

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

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

Source: Federal Reserve Bank of New York.

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

Our ordinary shares are quoted on the Spanish stock exchanges in euro. Currency fluctuations may affect the dollar equivalent of the euro price of our shares listed on the Spanish stock exchanges and, as a result, the market price of our ADSs, which are listed on the New York Stock Exchange. Currency fluctuations may also affect the dollar amounts received by holders of ADRs on conversion by the 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 (principally the Brazilian real, the Argentine peso, the Chilean peso, the Peruvian nuevo sol, the Mexican dollar, the Venezuelan bolivar, the Czech krana (crown) and the U.S. dollar). See [Item 11]Quantitative and Qualitative Disclosures About Market Risk[.

## **B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable.

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

Not applicable.

## **D. RISK FACTORS**

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

### **Risks Related to our Business**

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

We may enter into, and have recently consummated, acquisition transactions in order to, among other things, provide services in countries in which we do not currently have operations, take advantage of growth opportunities or enhance our product portfolio in a market where we currently have operations, as we have

recently done. Such recent acquisitions include: Telefónica Móviles' acquisition of BellSouth's wireless operations in Latin America;

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

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

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

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

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

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

**Risks Relating to our Industry**

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

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

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

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

- greater name recognition;



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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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



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

## **Other Risks**

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

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

## **ITEM 4. INFORMATION ON THE COMPANY**

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

#### **Overview**

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

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

The following significant events occurred in 2005:

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

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

*Business Lines*

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

In 2005, our principal business lines were:

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

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

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

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





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

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

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

### **Capital Expenditures and Divestitures**

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

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

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

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

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

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

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

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

**Year Ended December 31, 2003**

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

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

**Financial Investments and Divestitures**

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

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

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

**Public Takeover Offers**

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

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

2006, after the expiration of our tender offer for O2, we owned an aggregate of approximately 98.6% of O2 plc's issued share capital. We will consolidate O2 in our Consolidated Financial Statements as from January 31, 2006.

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

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

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

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

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

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

## Recent Developments

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

- On April 7, 2006, Telefónica announced that it has won the auction conducted by the Colombian government for a majority stake in Colombia Telecom (representing 50% plus one of the company's outstanding shares) for 853,577 million Colombian pesos (approximately \$368 million). Telefónica expects the acquisition of such shares to occur on or about April 24, 2006. Colombia Telecom is a Colombian fixed line telecommunications company.
- On March 1, 2006, Cesky Group announced the approval of its board of directors' intention to integrate its fixed line and mobile operations into a new, integrated telecommunications operator (Telefónica O2 Czech Republic, a.s.).

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

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

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

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

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

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

- On February 28, 2006, the Board of Directors of Telefónica resolved to explore strategic alternatives in relation to Telefónica's holding in the share capital of Telefónica Publicidad e Información, S.A. (TPI), which operates our directories business, including a possible total or partial divestiture of its holdings in that company. Telefónica intends to explore such a sale with potential buyers.
- The Board of Directors of Telefónica, S.A. at its meeting held on February 28, 2006, approved the distribution of an interim dividend from 2005 net income of €0.25 for each outstanding share with the right to receive dividends of the Company. The payment of this dividend will be effected on May 12, 2006. It is also the Board's intention to pay a further dividend of the same amount per share in the course of 2006, in accordance with the shareholder remuneration policy approved by the Company's Board of Directors. See "Cautionary Statement Requiring Forward-Looking Statements".
- On February 22, 2006, at each of the Telesp Celular Participações S.A. (TCP), Tele Centro Oeste Celular Participações S.A. (TCO), Tele Sudeste Celular Participações S.A. (TSD), Tele Leste Celular Participações S.A. (TLE) and Celular CRT Participações S.A. (CRTPart) general shareholders' meetings a restructuring was approved that will be effected by (i) exchanging TCO shares for TCP shares in order for TCO to consequently become a wholly owned subsidiary of TCP and (ii) the absorption of TSD, TLE and CRTPart by TCP.
- Following the expiration of our tender offer for O2, we now own substantially all of the shares of O2. O2 is a leading provider of mobile communications services in Europe, providing services in the United Kingdom, Germany, Ireland and the Isle of Man. For information on O2's business, see "B. Business Overview—O2".

## B. BUSINESS OVERVIEW

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





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

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

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

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

#### **Telefónica de España Spanish Fixed Line Business**

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

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

The principal services offered by Telefónica de España are:

- Traditional fixed line telecommunication services, principally including PSTN (public switched telephone network) lines; ISDN (integrated services digital network) access; public telephone services; local, domestic and international long distance and fixed-to-mobile communications services; corporate

communications services; supplementary value-added services (including call waiting, call forwarding, voice and text messaging, advanced voicemail services and conference-call facilities); video telephony; intelligent network services; leasing and sale of terminal equipment; and telephony information service.

- Internet and broadband multimedia services, principally including narrowband switched access to Internet; Internet service provider (ISP) service; portal and network services; retail and wholesale broadband access, through asymmetrical digital subscriber line (ADSL) and satellite technologies; residential-oriented value-added services (including instant messaging, concerts and video clips by streaming, e-learning, parental

control, firewall, anti-virus and content delivery); IP TV service (Imagenio) and Voice over Internet protocol (VoIP) services.

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

### Operations

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

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

(1) Includes accesses of the former Terra Networks group companies in Spain.

(2) For 2004 and 2005, this line item includes employees of Telefónica de España, S.A. (the parent company of the Telefónica de España group) and Telefónica Data España. Lines include unbundled loops.

In 2005, voice and Internet traffic decreased mainly as a result of a decrease in local calls and calls for Internet access as well as decreases in incoming traffic from other operators. The number of minutes consumed

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in 2005 decreased by 10.4% to 110,207 million minutes in 2005 from 123,026 million minutes in 2004. The decrease in minutes consumed in 2005 was mainly due to a 9.6% decrease in minutes per line per day to 17.8 minutes in 2005 from 19.7 minutes in 2004, mainly due to a decrease in minutes per day per line of traditional and incoming traffic.

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

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

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

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

## **Regulation**

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

### *Overview*

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

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

*The General Telecommunications Law*

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

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

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

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

*Conditions for the Offer of Electronic Communications Services:*

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

*Universal Service Obligations:*

- The Telecommunications Market Commission must evaluate the net cost to operators of providing universal service. Depending on the results of such evaluations, Telefónica de España, along with other operators, may be entitled to recover certain of their respective costs incurred in providing universal service; and
- The costs of intercepting communications for law enforcement purposes (whether telephone calls, e-mail or other types of communications) must be borne by operators, except that the government will continue to be responsible for its costs in connection with its direct use of communications services (e.g., telephone calls or e-mails).

*Consumer Protection:*

- Operators must meet certain minimum criteria with respect to protecting the privacy of customers' communications. For example, operators are not permitted to divulge any information regarding customers' communications to law enforcement authorities in the absence of a judicial order; and
- Customers that receive poor quality service (e.g., temporary interruptions in service and poor connection quality) may either (i) terminate service contracts with operators or (ii) be entitled to indemnification payments.

*The State Contract*

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Since 1991, we have provided telecommunications services through a contract signed with the Spanish government on December 26, 1991. The resolution of the Ministry Counsel that was enacted on August 1, 2003, prior to the approval of the General Telecommunications Law, approved the transformation of our contract with the Spanish government, adapting it to the current regulatory framework.



Under the new regulatory framework described above, all licenses and authorizations for the operation of telecommunications networks or for the provision of electronic communications services were void once the new General Telecommunications Law came into effect. However, in accordance with the first transitory disposition of the new General Telecommunications Law, the rights and obligations applicable to the individual licenses and general authorizations held by Telefónica de España will remain valid.

#### *Fixed telephony*

In February 2006, the Telecommunications Market Commission issued a final resolution liberalizing tariffs in connection with fixed telephony for retail markets, including individuals and companies. This resolution abolished the previous fixed telephony tariff regime in Spain known as "price caps". Under the new regime, operators are required to inform customers in advance of the tariffs that will be charged and the conditions of service.

Under Spanish law, the Telecommunications Market Commission considers Telefónica de España a market dominant operator in the provision of fixed line telephony services and leasing of circuits. As a market dominant operator, Telefónica de España has certain obligations regarding interconnection and access to public networks and the supply of universal service, as well as other obligations to provide public telephony service.

However, in order to comply with Article 7 of the European Union's Electronic Communications Framework Directive (2002/21/EC), the Telecommunications Market Commission conducted a study that included a public consultation period and analyzed the 18 telecommunications markets set forth in the European Commission's Recommendation on relevant product and service markets susceptible to *ex ante* regulation. The Telecommunications Market Commission conducted this study in order to be able to identify those operators with significant market power in each market and establish regulations that such operators must comply with in each market. The Telecommunications Market Commission completed its study in early 2006. The Telecommunications Market Commission's study and efforts to regulate in a manner that complies with the European Union's Electronic Communications Framework Directive is expected to produce significant changes in Spanish telecommunications regulation. See "Item 3.D. Risk Factors Risks Relating to our Industry" We operate in a highly regulated industry and could become subject to more burdensome regulation, which could adversely affect our businesses.

#### *Mobile telephony*

Mobile telephony regulation concentrates on the management and control of the use of the radio-electric public domain, which is used by operators through the allocation of frequencies in the radio-electric public domain.

For the provision of mobile telephony services, Telefónica Móviles España is considered a market dominant operator and is subject to the fulfillment of certain obligations in the interconnection services market.

#### *Internet*

Spanish law has attempted to remove legal uncertainties regarding the Internet as a transmission vehicle for diffusion and exchange of various types of information. Law 34/2002 established the concept of "information society services" which incorporates, among other things, the purchase of goods and services through electronic means and the supply of information through the Internet.

#### *Service quality*

The service quality parameters were first established through a ministerial order, dated October 14, 1999, and through the universal service quality ministerial order, dated December 21, 2001. This regulatory framework sets forth the quality standards for telecommunications services, including fixed telephony, mobile telephony and Internet access. An amendment to these service quality parameters is expected to be published in the Official

Registry (*Boletín Oficial del Estado*) in 2006. The contemplated amendments to these service quality parameters set forth more stringent requirements with respect to the level of service quality that operators must provide consumers.

### *Regulatory authorities*

In accordance with General Telecommunications Law 32/2003, the national regulatory authorities in the telecommunications sector are:

- The Spanish Government;
- The senior and directive bodies of the Ministry of Economy on issues of price regulations (Government Deputy Commission for Financial Affairs);
- The Communications State Secretary for the Information Society, a member of the Ministry of Industry, Tourism and Trade;
- The Telecommunications Market Commission; and
- The State radio-communications agency.

### **Fixed telephony regulation**

#### *Licenses and Concessions*

Under the new General Telecommunications Law, anyone involved in the operation of a telecommunications network or in the provision of electronic communication services should notify the Telecommunications Market Commission prior to the commencement of such activity. The Telecommunications Market Commission will register the telecommunications operator in the operator registry, so long as it complies with the General Telecommunications Law and all relevant regulations pursuant thereto.

All licenses and authorizations for the use of telecommunications networks or for the provision of electronic communications services expired after the new General Telecommunications Law came into force. Nevertheless, the right to occupy public and private property should continue according to the relevant regulation.

#### *Interconnection*

The General Telecommunications Law requires owners of public telecommunications networks, which includes Telefónica de España, to allow competitors to interconnect with their networks and services under non-discriminatory terms and conditions. The General Law on Telecommunications provides that the conditions for interconnection are to be freely agreed among the parties in compliance with certain minimum conditions established by law for interconnection agreements. Where the parties are unable to reach an agreement, the Telecommunications Market Commission may impose the obligation to interconnect upon the conditions it dictates.

Until the regulations governing the telecommunications markets in Spain under the General Telecommunications Law are fully developed and an analysis is completed by the Telecommunications Market Commission, the reference interconnection offer (RIO) applies. The RIO is an instrument created by Spanish law under which Telefónica de España sets forth the terms and the general, technical and financial conditions through which Telefónica de España interconnects with other operators. The applicable regulations state that interconnection prices charged by Telefónica de España in its RIO must be based on cost rather than profit. The RIO is updated periodically by regulations of the Telecommunications Market Commission.

Significant updates to the RIO have included:

- Telecommunications Market Commission resolution dated August 9, 2001, introducing interconnection pricing by digital capacity in addition to interconnection pricing per minute;

- Telecommunications Market Commission resolution dated March 31, 2004, introducing the charging of interconnection fees for toll-free calls from public-use terminals; and

- Telecommunications Market Commission resolution dated November 23, 2005, introducing interconnection prices. Telefónica de España has filed an administrative appeal against some of the sections of this resolution.

#### *Network access*

The General Telecommunications Law provides that the Telecommunications Market Commission can require an electronic communications public network operator to allow other operators to access its network. The Telecommunications Market Commission can establish the technical or operating requirements to ensure normal performance of such network. In the same manner as interconnection obligations, an operator may be declared to have significant market power, which imposes obligations regarding information transparency, non-discrimination, separation of accounts, access to specific network resources and price controls.

Under Royal Decree 7/2000 and Royal Decree 3456/2000, the "unbundling of the local loop" was established by setting forth the conditions under which the dominant operators of fixed line public networks must provide shared access to the local loop, with prices set by the Spanish government's Deputy Commission for Financial Affairs.

The Telecommunications Market Commission has amended Telefónica de España's local loop offer for 2004:

- on March 31, 2004 by lowering the monthly rental fees charged for access to the local loop;
- on July 22, 2004 by adapting the local loop offer to new ADSL velocities at the retail level; and
- on July 28, 2004 by modifying the local loop offer for massive migrations between different varieties for access to the local loop.

The Telecommunications Market Commission is expected to amend Telefónica de España's local loop offer in 2006 as a result of the development of new ADSL speeds.

Royal Decree 2296/2004 regulates matters concerning call-to-call operator selection, pre-selection of operator and safekeeping of numbers by subscribers, irrespective of the operator that provides the service.

In order to provide operators with guidance on how they can comply with their obligations pursuant to Royal Decree 2296/2004, the Telecommunications Market Commission issued Circular 1/2004. Circular 1/2004 states that operators may meet their obligations under such Royal Decree by hiring an unaffiliated third-party vendor to process customer requests regarding the selection of operators. In this manner, the third-party vendor may verify that the operator has complied with its legal obligation to allow customers to select the operator of their choice to process their telephone calls. Telefónica de España has adopted the Telecommunications Market Commission's guidance and has contracted a third-party vendor to process customer requests to use different operators to process their telephone calls.

#### *Selection of operator*

Telefónica de España, as a designated market dominant operator in the supply of connection to public telephone networks from a fixed location, must allow subscribers to place calls with any operator. Customers may pre-select any operator or choose another operator by dialing a three-digit code.

#### *Public service obligations*

*Universal service.* The General Telecommunications Law provides that operators shall be subject to rules of public service and other general public obligations in order to guarantee the existence and quality of electronic communications services.

□Universal service□ is defined as a set of communication services guaranteed to all end users, irrespective of their geographic location, of a determined quality and at an affordable price. Such services must guarantee that all citizens can receive a connection to the fixed line public network and access to the fixed line telecommunications

services available to the public, a free telephone directory, a sufficient number of public telephones, equal access to fixed line telephony services for disabled persons or those with special social needs and functional Internet access.

In addition, Law 34/2002, governing e-commerce and information services over the Internet, provides that all subscribers to the rural telephone cellular access system (TRAC) that requested an Internet connection prior to December 31, 2004 could progressively be provided with a connection that allows them functional connection to the Internet.

Pursuant to Royal Decree 424/2005, Telefónica de España's current obligation to provide universal service is imposed until 2007. Pursuant to the Telecommunications Market Commission's Regulation dated December 21, 2005, there will be a public comment period whereby members of the public may express views for the Telecommunications Market Commission's consideration regarding what operator should be selected to provide universal service after 2007. Telefónica de España has been the only operator in Spain to provide universal service since December 1998.

To finance the universal service, the General Telecommunications Law stipulates that the Telecommunications Market Commission must determine whether the net cost to provide universal services implies an unfair burden for the operators required to provide such service. The Telecommunications Market Commission has issued several resolutions relating to Telefónica de España's net costs for the provision of the universal service, indicating that Telefónica de España does not have a right to be compensated by other operators as there is no competitive disadvantage or unfair burden. On March 25, 2004, the Telecommunications Market Commission recognized the existence of a net cost of €110.0 million for Telefónica de España as a result of providing universal service, but provided no compensation since the amount was not considered an undue burden. However, Royal Decree 424/2005 provides for the possibility that Telefónica de España may recover certain costs incurred in providing universal service in 2006. See "The General Telecommunications Law" above.

### **Competition**

The following describes our current main competitors in the principal market segments in which the Telefónica de España Group operates.

Since 1997, the supply of fixed line telephone services to the public has been open to all competitors, subject to basic licensing requirements as provided for in the General Telecommunications Law, as well as the attainment of legal authorization for installment of such services.

In June 1997, Retevisión was granted a license to provide public fixed line telephone services in Spain, becoming the second operator after Telefónica de España to hold such a license. Retevisión began operations in January 1998. During 2002, as part of a reorganization process undertaken by the Auna Group, Retevisión merged with Aunacable (a cable operator belonging to the Auna Group). The new name of this fixed line telephone company is Auna Telecomunicaciones, S.A. The principal shareholders of the Auna Group are Endesa, Santander Central Hispano, Unión Fenosa and ING, together with several savings banks. In November 2005, the cable operator ONO acquired Auna Telecomunicaciones, becoming the first cable operator in Spain, named Grupo Corporativo ONO. The principal shareholders of the new group are Grupo Multitel, JP Morgan Partners, Providence Equity Partners and Thomas H. Lee Partners.

In May 1998, the Lince consortium, comprised of France Telecom and Editel, S.A. (a consortium which includes Multitel Cable, S.A. and Ferrovial Telecomunicaciones), received the third license for the provision of fixed line telephone services in Spain. Lince commenced operations in December 1998 under the trade name Uni2. In July 2001, France Telecom reached an agreement with its partners in the Lince consortium to acquire their interests in the Lince group. As a result, France Telecom now owns 100% of Uni2, which, together with Al-Pi Telecomunicaciones (a subsidiary of Uni2 that serves corporate clients and professionals in Catalonia), comprises the Uni2 group. In July 2005, France Telecom acquired 80% of Amena, the third largest Spanish mobile operator.

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Jazztel plc, a company created in July 1998, received the fourth license for the provision of fixed line telephone services in Spain. Jazztel, p.l.c. is controlled by a consortium comprised of funds managed by Espírito Santo Bank, ING and Fidelity Investments.



## Tariffs

On October 15, 1999, the Spanish government issued Royal Decree 16/1999 in order to address increasing inflation and promote a higher degree of competition among telecommunications operators. This decree established a price regulatory framework for fixed line telephony service and for lines to be leased by Telefónica de España based on maximum prices per year.

On December 22, 2005, the Spanish government's Deputy Commission for Financial Affairs (CDGAE) approved a new price regulatory framework for 2006. This new framework limits the CDGAE's regulatory jurisdiction in establishing price regulatory frameworks and guarantees the provision of universal service. For more information regarding the Telecommunications Market Commission's compliance with Article 7 of the European Union's Electronic Communications Framework Directive (2002/21/EC), see "Regulation" The General Telecommunications Law above.

Once the Telecommunications Market Commission completes its analysis of the telecommunications markets in Spain and adopts regulations pursuant thereto, as required by Article 7 of the European Union's Electronic Communications Framework Directive (2002/21/EC), this regulatory framework will no longer be valid and will be replaced by the new regulations adopted by the Telecommunications Market Commission.

On February 16, 2006, the Telecommunications Market Commission completed its analysis of the local and national fixed telephony markets in Spain and adopted regulations with respect to such markets.

The most important aspects of the newly adopted regulations are the following:

- Telefónica de España may not engage in anticompetitive pricing or price discrimination among customers, offer anticompetitive bundled service packages or enter into abusive (as defined by the regulation) contractual terms with customers.
- Telefónica de España is required to meet certain disclosure requirements, including requirements to communicate terms and prices of its service offers to the Telecommunications Market Commission at least 21 days prior to their adoption (in the case of bundled service offers, these disclosures must include itemized prices with respect to each service offered), upon request, to provide to the Telecommunications Market Commission details regarding the prices applicable to entities with which Telefónica de España has service contracts (this requires Telefónica de España to maintain records of all of the customers with which it has service contracts along with copies of such contracts).

The following table sets forth the variation in price caps from the previous price regulatory framework.

Concept	Variation
Local	□
Provincial	(36.4)%
Interprovincial	(45.6)%
International	(41.2)%
Fixed-to-mobile	(32.3)%
Information service	100.7%
Monthly rental fee	44.9%
Subscription fee	(53.4)%
<i>Tariffs for main services</i>	

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The tariffs for electronic telecommunication services for the three years ended December 31, 2005 (excluding applicable taxes) are set forth below. These are the nominal tariffs set by Telefónica de España in accordance with the applicable price regulatory framework.

	Year ended December 31,		
	2003	2004	2005
	(in euro)		
Subscription fee			
Individual lines and trunk lines	59.50	59.50	59.50
Integrated Service Digital Network			
Primary access	3,606.07	3,606.07	3,606.07
Basic access	168.28	168.28	168.28
Monthly subscription fee			
Individual telephone line	12.61	13.17	13.43
Integrated Service Digital Network			
Primary access	342.58	342.58	349.43
Basic access	23.78	24.81	25.31
Digital circuit 64 kbits/s of 4 km	236.24	236.24	236.24

*Comparison to other European Operators*

The following table sets forth the tariffs charged by Telefónica de España at December 31, 2005 compared to other European operators. Applicable rates during normal business hours have been used.

	Telefónica de España	Deutsche Telekom	France Telecom	Telecom Italia	BT (UK)
	(in euro)				
Residential monthly rental fee	13.43	13.75	11.70	12.14	13.03
Business monthly rental fee	13.43	13.75	13.10	19.20	13.72

**During Business Hours**

	Telefónica de España	Deutsche Telekom	France Telecom	Telecom Italia	BT (UK)
	(in euro)				
3-minute calls					
Local	0.0765	0.1008	0.1354	0.1013	0.1730
Long-distance national	0.2771	0.1266	0.2834	0.3329	0.1730

*Source: Eurodata, Tarifica and operators.*

**Customer Service**

One of our main priorities is to satisfy customer needs by improving the quality of our customer service. We have continued our strategy of segmenting our customers in order to tailor our services to best meet the specific needs of each customer segment. In addition, in order to increase our ability to distribute our products and services we have signed agreements with large department stores to complement our traditional channels of distribution.

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The corporate customer service model developed by Telefónica de España, which is aimed at achieving the highest degree of efficiency in customer service, features the following:

- a 24-hour personal customer service line for purchasing any type of product and service and handling customer queries;
- the Tiendas Telefónica (☐Telefónica stores☐) where customers can test and buy products marketed by Telefónica;
- Telefónica's ☐virtual☐ store, accessible by Internet, which offers the ability to order and purchase online the majority of services and products offered by Telefónica; and

- a sophisticated customer service system for corporate clients, ranging from a telephone help line for small and medium-sized businesses to the assignment of sales managers to address the needs of larger corporate clients.

In addition, we have continued to develop our product portfolio, especially in broadband services. For instance, customers now have the option to finance the acquisition of desktop or portable computers from us as part of our ADSL offerings. We also launched the Imagenio service in 2004. Imagenio is a leisure and communication service, including pay-TV with a broad range of content, from regular television channels to movies, documentary films and music concerts, and featuring Videoclub, an advanced video-on-demand service. Imagenio includes broadband Internet access, although there is a way for customers to access the service through a digital television connection. Services launched in 2005 include the "Duos" and "Trios" packages that offer broadband Internet access and/or IPTV plus unlimited local and national calls.

We have also continued to develop products previously introduced including our "combinados" plans that combine access and traffic, allowing each client to optimize its consumption according to calling destination and calling time profile. We have also initiated new access offers including "holiday line" and "young line" in order to better satisfy client needs. We have introduced packages for different customer segments, such as:

- "Tarifa mini": provides unlimited local and long distance calls for a fixed price per call;
- "Tarifa mini internacional": provides competitive prices for international calls to the Americas, Africa, Asia and Eastern Europe;
- "Tarifas planas": provides unlimited calls for different geographic areas; and
- "Bonos Fijo Móvil": provides competitive packages for calls from fixed to mobile telephones.

During 2005, the Telefonica de España Group launched a range of bundled service packages that combine IPTV, ADSL and voice services under the name "Trios" (a package comprising all three services) and "Duos" (a package allowing customers to choose two of the three services). This is in line with our strategy of focusing on an integrated offer of telecommunications solutions to satisfy customer needs and to reinforce their loyalty and the quality of the service.

### **Telefónica Móviles—Mobile Business in Spain and Latin America**

We conduct our mobile business in Spain and Latin America through Telefónica Móviles, which is a leading provider of wireless communications services in Spain and Latin America in terms of managed customers. Telefónica Móviles estimates, based on annual reports and press releases made public by its competitors and information from regulatory authorities, that it is one of the four largest global providers of wireless communications services based upon total managed customers at December 31, 2005. Telefónica Móviles offers a broad range of wireless services, including voice services, enhanced calling features, international roaming and wireless internet services.

At December 31, 2005, Telefónica Móviles provided wireless services through its operating companies and joint venture to approximately 94.4 million managed customers in territories with a population of approximately 518 million. Telefónica Móviles has operations in Spain, Mexico, Peru, El Salvador, Guatemala, Venezuela, Colombia, Panama, Nicaragua, Ecuador, Uruguay, Argentina and Chile and, through its joint venture with Portugal Telecom, it also provides wireless communication services in Brazil. Telefónica Móviles also operates in Morocco where it has a 32.18% interest in Medi Telecom and currently appoints Medi Telecom's chief executive officer.

On March 29, 2006, Telefónica Móviles' Board of Directors approved our merger proposal which is now subject to approval by shareholders at the annual general shareholders' meeting of both companies. If the merger is effected, Telefónica Móviles, S.A. will be merged into Telefónica, S.A. and will cease to exist as an independent corporate entity, with Telefónica, S.A. acquiring all of the rights and obligations of Telefónica Móviles, S.A. by

universal succession.

The following table provides a summary overview of Telefónica Móviles' principal operating companies and those companies in which it has non-controlling minority interests.

Region	Country	Company	Population (in millions)	Total customers at December 31, 2005 (in millions)
<b>Spain</b>	Spain	Telefónica Móviles España	44.6	19.9
<b>Brazil</b>	Brazil	Brasilcel, N.V.(1)	136.5	29.8
<b>Northern Region</b>			134.7	9.2
	Mexico	Telefónica Móviles México, S.A. de C.V.	106.2	6.4
	Panama	Telefónica Móviles Panamá	3.2	0.8
	Nicaragua	Telefónica Celular de Nicaragua, S.A.	5.8	0.4
	Guatemala	Telefónica Centroamérica Guatemala, and Telefónica Móviles y Compañía, S.C.A.	12.6	1.0
<b>Andean Region</b>	El Salvador	Telefónica Móviles El Salvador	6.9	0.5
			113.7	17.5
	Venezuela	Telcel, S.A.	26.5	6.2
	Colombia	Telefónica Móviles Colombia, S.A.	46.0	6.0
	Peru	Telefónica Móviles Peru	28.0	3.5
<b>Southern Cone</b>	Ecuador	Otecel, S.A.	13.2	1.9
			57.9	14.0
	Argentina	TCP Argentina and Radiocomunicaciones Móviles S.A.	39.1	8.3
	Chile	Telefónica Móvil de Chile and Telefónica Móviles Chile	15.5	5.3
	Uruguay	Abiatar, S.A.	3.3	0.4
<b>Morocco</b>	Morocco	Medi Telecom (2)	31.0	4.0

- (1) Jointly controlled and managed by Telefónica Móviles and Portugal Telecom. Through its 50% interest in Brasilcel, as of December 31, 2005, Telefónica Móviles indirectly holds 45.50% of Tele Sudeste (TDS), 33.5% of Celular CRT (CRTPart), 25.33% of Tele Leste Celular (TBE), 33.04% of Telesp Celular Participações, S.A. (TCP) and 17.34% of Tele Centro Oeste Celular Participações, S.A.(TCO). Brasilcel is proportionally consolidated in Telefónica Móviles' financial statements. As of March 26, 2006, following TCO's merger with TCP, and TSD's, TBE's and CRTPart's merger into TCP, only one company exists, which has changed its name to VIVO Participações S.A.
- (2) Jointly managed by Telefónica Móviles and Portugal Telecom. Each of Telefónica Móviles and Portugal Telecom has a 32.18% interest in Medi Telecom.

### **Services and Products**

Telefónica Móviles' operating companies offer a wide variety of wireless and related services and products to consumer and business customers. Although the services and products available vary from country to country, the following are Telefónica Móviles' principal services and products:



- *Wireless Voice Services.* Telefónica Móviles' principal service in all of its markets is wireless voice telephony, which has gained increased usage as a result of Telefónica Móviles' increased customer base and increased market penetration rates.
- *Value Added Services.* Customers in most of Telefónica Móviles' markets have access to a range of enhanced calling features including voice mail, call hold, call waiting, call forwarding and three-way calling.
- *Wireless 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 and sounds. Customers may also receive selected information, such as news, sports scores and stock quotes. Telefónica Móviles also provides wireless connectivity and internet access. Through wireless internet access, its customers are able to send and receive e-mail, browse web pages, download games, purchase goods and services in m-commerce transactions and use its other data services.
- *Corporate Services.* Telefónica Móviles provides business solutions, including wireless infrastructure in offices, private networking and portals for corporate customers that provide flexible on-line billing. Telefónica Móviles España offers corporate services through *MoviStar Corporativo*, and other advanced solutions for data, developed for specific sectors.
- *Roaming.* Telefónica Móviles has roaming agreements that allow its customers to use their handsets when they are outside of their service territories, including on an international basis.
- *Fixed Wireless.* In Argentina, Peru and Venezuela, Telefónica Móviles provides local fixed wireless service.
- *Trunking and Paging.* In Spain and Guatemala, Telefónica Móviles provides digital wireless services for closed-user groups of clients and paging services.
- *M-payment.* Through its subsidiary, Telefónica Móviles España, and together with Vodafone España, Amena and other financial institutions and processing companies, Telefónica Móviles has a 13.36% interest in Mobipay España, a company incorporated to develop micro-payments. Telefónica Móviles also has a 50% interest in Mobipay International, aimed at expediting payments through mobile phones in an international setting. Banco Bilbao Vizcaya Argentaria, S.A. is the other 50% shareholder in Mobipay International.

### **Telefónica Móviles' Operations**

Telefónica Móviles' operations currently are conducted in three distinct geographic areas:

- Spain;
- Morocco; and
- Latin America.

In order to achieve critical mass of customers and to enhance efficiency, Telefónica Móviles manages its wireless assets in Latin American in four large regions:

- the Northern Region, which is managed from Mexico and includes both our Mexican subsidiary and our operations in Guatemala, El Salvador, Panama and Nicaragua;

- the Andean Region, which includes our operations in Venezuela, Columbia, Peru and Ecuador;
- Brazil; and
- the Southern Cone, which includes our operations in Argentina, Chile and Uruguay.

The following section provides a description of the markets in which Telefónica Móviles operates. Customer information on the wireless markets in which Telefónica Móviles operates, including its market share, are estimates that Telefónica Móviles has made based on annual reports and press releases made public by its competitors or information from local regulators in the respective markets.

### *Spain*

Telefónica Móviles offers wireless services in Spain through Telefónica Móviles España, the leading wireless operator in Spain in terms of total number of customers at December 31, 2005. Telefónica Móviles España had approximately 20 million customers at December 31, 2005, representing an estimated 46% market share and 51% outgoing revenues market share.

The following table presents selected statistical data relating to the operations of Telefónica Móviles España:

	<u>At December 31,</u>	
	<u>2004</u>	<u>2005</u>
Total customers (in millions)	19.0	19.9
Pre-paid customers (in millions)	9.7	9.19
Population in service territory (in millions)	44	45

*Source: Telefónica Móviles.*

Telefónica Móviles España has offered wireless services in Spain since 1982 with the launch of analog wireless services under the brand MoviLine (services discontinued in 2004). Digital wireless services, using GSM 900 MHz technology, were launched in 1995 under the MoviStar brand name, which has since become one of the most widely recognized brands in Spain. In January 1999, Telefónica Móviles España launched the GSM 1800 MHz service. In March 2000, having achieved the highest rating in the award process, Telefónica Móviles España was awarded a third generation wireless, or UMTS, license covering the Spanish national territory for €131 million. In June 2005, Telefónica Móviles España was granted a 4 MHz block for the provision of GSM mobile telephony services in the 900 MHz band.

*Market.* With an estimated population of approximately 44 million people, Spain is the fifth largest wireless market in Western Europe with approximately 43 million wireless customers at December 31, 2005. This customer base represents a penetration rate of 98%. The penetration rate in the Spanish market grew 7.5 percentage points in 2005.

The Spanish wireless market has shown growth as a result of a decline of wireless handset prices and per minute call rates, and the introduction of pre-paid tariffs. At December 31, 2005, Telefónica Móviles España had approximately 20 million customers. The number of contract customers totaled approximately 10.7 million, representing a 15.6% increase compared to 2004.

In an increasingly competitive market, with strong competition in number portability and pressure on pricing, including termination rate reductions, along with the potential entry of new competitors, Telefónica Móviles España is focused on key initiatives to preserve its position as a leading mobile operator in the market, leading it to increase commercial efforts with measures including:

- in-depth market segmentation, with a focus on customer value;
- smart pricing to stimulate usage, launching segmented packages and innovative tariff options; and
- leveraging UMTS to develop new services, deploying the network ahead of competitors.

*Network and Technology.* Telefónica Móviles España's digital network in Spain is based upon the GSM/UMTS standard. The prevalence of the GSM standard, together with Telefónica Móviles España's international roaming agreements, enables its MoviStar customers to make and receive calls throughout Western Europe and in almost 200

countries worldwide. Telefónica Móviles España's GSM/UMTS based network provides its customers with access to many of the most advanced wireless handsets and a full panoply of services and products.

In 2004 and 2005, Telefónica Móviles España invested in the aggregate approximately €1,356 million in building out and enhancing its networks in Spain and developing its technological platforms and information systems. At December 31, 2005, Telefónica Móviles España's GSM/GPRS digital network in Spain, which consisted of 115 switching centers and approximately 18,000 base stations, provided coverage to approximately 99% of the population. At December 31, 2005, Telefónica Móviles España's UMTS network provided coverage in areas where 70% of the Spanish population resides, with 5,000 UMTS base stations installed.

*Sales and Marketing.* Since Telefónica Móviles España began providing wireless services in Spain, its sales and marketing strategy has been to generate increased brand awareness, customer growth and increased revenues. Telefónica Móviles España utilizes all types of marketing channels, including television, radio, exterior signage, telemarketing, direct mail and internet advertising. Telefónica Móviles España also sponsors several cultural and sporting events in order to increase its brand recognition.

For purposes of sales and distribution, Telefónica Móviles España divides the Spanish market into the consumer market and business market. At December 31, 2005, Telefónica Móviles España had 9,362 points of sale for the consumer market, including specialized and large retailers. In addition, Telefónica Móviles España uses approximately 118 points of sale that are owned by the Telefónica Group.

In 2005, Telefónica Móviles España continued to encourage customer migration from its pre-paid plans to its contract plans, in line with the process that started in March 2002, when the contract plans of Telefónica Móviles España shifted from a monthly fee to a minimum usage commitment. In 2005, prepaid to contract migrations were over one million, contributing to an improvement in the percentage of its contract customers to its total customers by 5 percentage points as of December 31, 2005 compared to December 31, 2004.

*Competition.* Telefónica Móviles España currently has two competitors in the Spanish market for wireless communications service: Vodafone España, a subsidiary of Vodafone PLC, and Retevisión Móvil S.A., which operates under the trade name *Amena* and was acquired by France Telecom during the second half of 2005.

*Regulation.* Licenses and concessions □ Under the new General Telecommunications Law, anyone interested in the operation of a telecommunications network or in the provision of electronic communications services should notify the Telecommunications Market Commission prior to the commencement of the activity. The Telecommunications Market Commission will register the telecommunications operator in the Operator Registry.

Under the new regulatory framework, all licenses and authorizations for the operation of telecommunications networks or for the provision of electronic communications services were extinguished once the new General Telecommunications Law came into force. However, in accordance with the first transitory disposition of the new General Telecommunications Law, the rights and obligations applicable to the individual licenses and general authorizations held by Telefónica Móviles España will remain valid. Consequently, Telefónica Móviles España must comply with the obligations established before new General Telecommunications Law came into force.

Telefónica Móviles España holds the following concessions for the use of spectrum which terms and conditions are associated with the former licenses now extinguished:

<b>Spectrum rights</b>	<b>Duration</b>	<b>Ending Date</b>	<b>Extension Period</b>
GSM 900 (2x12)	15 years	February 3, 2010	5 years
GSM 900 (2x4)	15 years	June 6, 2020	5 years
DCS-1800 (1)	25 years	July 24, 2023	5 years
UMTS	20 years	April 18, 2020	10 years
Paging	20 years	April 24, 2020	10 years

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(8) Analogic Trunking	20 years	June 2014	10 years
(4) Analogic Trunking	20 years	November 2016	10 years

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- (1) On November 29, 2002, the Ministry of Industries, Tourism and Commerce completed the allocation of the DCS-1800 band. We received 2 x 24.8 MHz of spectrum.

Interconnection ¶ Spanish law requires public telecommunications networks to provide interconnection to other public telecommunications networks established in Spain, the terms of which must be specified in an interconnection agreement between the parties. Because Telefónica Móviles España has been classified by the Telecommunications Market Commission as an operator with ¶significant market power¶ in the wireless communications and interconnection markets, it is required, among other obligations, to facilitate cost-oriented interconnection rates on a non-discriminatory and transparent basis and report to the Ministry of Economy and the Ministry of Industries, Tourism and Commerce regarding its compliance. In October 2005, the Telecommunications Market Commission established the average maximum price for Telefónica Móviles España's interconnection termination service at approximately ¶0.11 per minute.

Tariffs ¶ The mobile operators that provide mobile telephone services may generally set the tariffs they charge their customers. However, the General Telecommunications Law authorizes the Government's Deputy Commission for Financial Affairs to set transitory maximum and minimum prices, as well as fixed prices. As of the date of this Annual Report, the Deputy Commission for Financial Affairs has not regulated rates of digital wireless services.

Telefónica Móviles España can freely set rates for services provided to its customers and must only communicate the rates to the regulatory authorities and to consumer and customer organizations.

Virtual mobile operators ¶ Virtual mobile operators are mobile operators that do not own a network and that may provide mobile telephony service through voluntary non-discriminatory access agreements with mobile operators that own existing networks. On February 2, 2006, the Telecommunications Market Commission issued a regulation concerning the market for access to and call origination on public mobile telecommunications networks in Spain. In connection with this regulation, the Telecommunications Market Commission found that all mobile network operators in Spain collectively hold a dominant position in the wholesale market for mobile telephony. Consequently, the Telecommunications Market Commission has imposed an obligation on mobile operators in Spain to (i) provide network access following a reasonable request by a virtual mobile operator and (ii) offer reasonable prices for access services. The Telecommunications Market Commission in the first instance will allow mobile operators with networks and virtual mobile operators to negotiate agreements that meet the requirements set forth above. However, if mobile operators with networks and virtual mobile operators are unable to negotiate such agreements independently, the Telecommunications Market Commission will set forth the terms of such agreements for the parties.

EC regulation on roaming tariffs ¶ On March 28, 2006, Commissioner Reding announced a proposal for a new regulation on international roaming tariffs. The Commissioner intends to base such regulation on Article 95 of the EC Treaty, pursuant to the approach followed in relation to the cross-border payment regulation in 2001. To assist with the preparation of this regulation, the Commission has sought public comment. The second public comment period opened on April 3, 2006 and is to end on April 28, 2006. The European Commission could adopt the proposal in June. If such regulation were to be adopted by the European Parliament and the European Council of Ministers, it would be immediately in effect in all 25 Member States without transposition into national law and could adversely affect Telefónica Móviles and its operations.

#### *Morocco*

Telefónica Móviles provides wireless services in Morocco through Medi Telecom, S.A., in which it holds a 32.18% interest and shares management responsibilities with Portugal Telecom, which also holds a 32.18% interest in Medi Telecom. Medi Telecom is also owned by local minority shareholders. Medi Telecom is one of two wireless operators in Morocco, with over 4 million customers at December 31, 2005. Medi Telecom commenced offering wireless services in Morocco in March 2000, eight months after it was awarded a GSM license covering the Moroccan national territory.

The following table presents selected statistical data relating to Telefónica Móviles' investment in Medi Telecom:





	<u>At December 31,</u>	
	<u>2004</u>	<u>2005</u>
Total wireless customers (in millions)	2.73	4.02
Pre-paid customers (in millions)	2.62	3.87
Population in service territory (in millions)	31	31

*Source: Telefónica Móviles, except population data from Pyramid Research.*

*Shareholders' Agreement.* Telefónica Móviles España has entered into a shareholders' agreement with other shareholders of Medi Telecom under which it has the right to appoint the chief executive officer of Medi Telecom. In addition, as of April 2003, the sale or transfer of shares in Medi Telecom triggers a right of first refusal to the other non-transferring shareholder in two steps: firstly to the Technical Shareholders (Telefónica Móviles España and Portugal Telecom) and secondly to the remaining shareholders. In addition, the change of control in the direct or indirect shareholders of Medi Telecom (which specifically includes the acquisitions of such interest by a competitor of Telefónica, S.A. or Portugal Telecom) would entitle the non-affected shareholder to exercise a call option over Medi Telecom's shares owned by the party undergoing such change of control. The shareholders' agreement also requires specified majority votes to approve most corporate actions.

*Market.* With a population of approximately 31 million people, Morocco had 12.3 million wireless customers at December 31, 2005, representing a penetration rate of 40%. Medi Telecom estimates that the Moroccan market grew 34% in 2005 compared to 2004.

*Network and Technology.* Medi Telecom's network in Morocco is based upon the GSM standard. In 2004 and 2005, Medi Telecom invested a total of approximately \$156 million in building out and enhancing its digital network in Morocco. Medi Telecom has been offering wireless internet since April 2001. In 2005, Medi Telecom has been awarded a fixed license in Morocco, and the company is rolling out a fixed network based on WiMax technology.

*Sales and Marketing.* Medi Telecom's sales and marketing strategy has been to generate rapid customer growth. At December 31, 2005, approximately 96% of Medi Telecom's customers used pre-paid plans with the remainder using contract service.

*Competition.* Medi Telecom competes with Maroc Telecom, the former state monopoly provider of all telecommunications services in Morocco.

#### *Latin America* Brazil

Telefónica Móviles and Portugal Telecom are 50:50 shareholders in Brasilcel, N.V., or Brasilcel, a joint venture which combined Telefónica Móviles' and Portugal Telecom's wireless businesses in Brazil. This joint venture is the leading wireless operator in Brazil in terms of total number of customers at December 31, 2005. At December 31, 2005, Brasilcel had a total of 29.8 million customers, of which 5.7 million were contract customers. Brasilcel had an estimated average share in its markets of operations of approximately 44.2% at December 31, 2005. All of the operating companies participating in the joint venture have been operating under the brand name "Vivo" since April 2003. The licensed areas of Brasilcel include 19 states in Brazil and its federal capital, with a population of approximately 136.5 million, and covering 85.5% of Brazil's gross domestic product.

On February 22, 2006, the respective shareholders' meetings of Telesp Celular Participações S.A. ("TCP"), Tele Centro Oeste Celular Participações S.A. ("TCO"), Tele Sudeste Celular Participações S.A. ("TSD"), Tele Leste Celular Participações, S.A. ("TBE") and Celular CRT Participações S.A. ("CRTPart") approved (i) the merger of TCO in order to convert it into a wholly owned subsidiary of TCP and (ii) the merger of TSD, TBE and CRT Part into TCP. TCP was the sole surviving company of these mergers and subsequently changed its name to "VIVO Participações S.A."

The following table shows the different states where service is provided by Brasilcel's operators in 2005:

38

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<b>Company</b>	<b>State</b>
Telesp Celular	São Paulo (SP)
Tele Sudeste	Rio de Janeiro (RJ) and Espirito Santo (ES)
Global Telecom	Paraná (PA) and Santa Catarina (SC)
CRT Celular	Rio Grande do Sul (RS)
Tele Centro Oeste	Acre (AC), Goiás (GO), Mato Grosso (MT), Mato Grosso do Sul (MS), Rondônia (RO), Tocantins (TO), Distrito Federal (DF), Amazonas (AM), Pará (PA), Amapá (AP), Roraima (RR) and Maranhão (MA)
Tele Leste	Bahia (BA) and Sergipe (SE)

The following table presents statistical data relating to our operations in Brazil:

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Population in service territory (in millions)	131.5	136.5
Total customers (in millions)	26.5	29.8
Pre-paid customers (in millions)	21.4	24.1

*Source: Telefónica Móviles, except population data from Pyramid Research.*

**Market.** Brazil is one of the largest countries in the world, with a surface area of 8.5 square million kilometers and a population of approximately 185.5 million people. At December 31, 2005, with 86.2 million wireless subscribers, Brazil ranked first in Latin America in terms of number of wireless customers. At December 31, 2005, Brazil had an estimated market penetration rate of 46.5% and of 49.2% in the areas where Vivo operates.

**Network and Technology.** The licenses granted to the companies integrated in Brasilcel allow operations over the CDMA, CDMA 1XRTT, CDMA EVDO and TDMA systems. Vivo offers both analog and digital services in the band of 800 MHz. CDMA 1XRTT is a broadband transmission system for wireless networks allowing for speeds of up to 144 Kbits/s. In 2004, Vivo launched CDMA EVDO, a technology that increases data capabilities allowing speeds of up to 2.4 Mbits/s. TDMA, or time division multiple access, is a digital mobile phone technology that allows several calls to share a single channel without interfering with one another.

Of Vivo's investment in the development of the networks of its companies in Brazil in 2004 and 2005, approximately \$677 million were attributable to Telefónica Móviles as a proportion of the total investment corresponding to its interest in the Brasilcel entities.

**Sales and Marketing.** The consolidation of the different brands of the Brasilcel joint venture into the "Vivo" brand in 2003, enabled Vivo companies to develop and operate under a unified commercial strategy. Vivo is actively managing its distribution channels, which consisted of 8,282 points of sale at December 31, 2005. Additionally, Vivo prepaid customers were provided access to a wide range of "recharge" points. Credit recharges can also be made by electronic transfers through the commercial banking network. As of December 31, 2005, approximately 19% of Vivo's customers were contract clients and the remaining 81% were prepaid customers.

*Competition.* Brasilcel is the leading wireless operator in Brazil in terms of number of customers at December 31, 2005. The growth of the Brazilian market has been considerable during the past years while being accompanied by an increase in competition due to the introduction of new competitors in the regions in which Brasilcel operates. Its major competitors are subsidiaries of Telecom Italia Mobile, America Móvil, Brazil Telecom and Telemar.

*Regulation.* The wireless telecommunications companies that operate pursuant to licenses and concessions are subject to general obligations set forth by the National Agency for Telecommunications, or Anatel, and to obligations pursuant to each license concerning quality of services, network expansion and modernization.

Licenses and Concessions □ On December 4, 2002, Anatel authorized the contribution to Brasilcel of the wireless assets in Brazil of both Portugal Telecom and Telefónica Móviles and allowed the migration of Brasilcel's operators to a new licensing regime, Personal Mobile Service, or the SMP regime. Accordingly, Brasilcel's operators replaced all their old licenses with new SMP licenses. The old licenses were concessions granted under the Cellular Mobile Service, or the SMC regime. The new SMP licenses include the right to provide cellular services for an unlimited period of time but restrict the right to use the spectrum according to the schedules listed in the old licenses (Celular CRT until 2007; Telerj Celular until 2005; Telest Celular until 2008; Telebahia Celular and Telergipe Celular until 2008; TCP until 2008 or 2009 (for the cities of Ribeirao Preto and Guatapar); Global Telecom until 2013; TCO until 2006 (for Brazil's Federal District); Teleacre Celular, Teleron Celular, Telemat Celular and Telems Celular until 2009; Telegois Celular until 2008; and Norte Brasil Telecom until 2013). The Telerj Celular license was renewed in 2005 for a fifteen-year period and will expire again in 2020.

The renewal of each of these licenses must be solicited 30 months before its expiration. The companies listed above with licenses expiring within 30 months have already applied for the renewal of their licenses. For the renewal of these licenses, each operator will have to make a payment for the use of the spectrum in the amount of 2% of its annual gross revenues. This payment must be made two years after obtaining the license.

Interconnection □ Resolution 410/2005 approved the general interconnection regulations. Interconnection is mandatory for all telecommunications operators. Conflicts arising from the negotiations between operators are resolved through arbitration by Anatel. Existing regulations state that operators that offer general public services (fixed line services, personal mobile services and specialized mobile services such as trunking and cable TV) must publish the terms and conditions for interconnection with their networks.

Rates □ The rates that wireless service providers may charge their customers are also regulated by the SMP regime. The SMP regime allows operators to freely negotiate their interconnection rates with other operators. If they fail to reach an agreement, each operator may call upon ANATEL to determine the terms and conditions of interconnection. In addition, under the SMP rules, the retail rates charged to customers for fixed-to-mobile calls cannot be less than the sum of the interconnection fees charged on the fixed and mobile terminations.

Recent developments in the SMP regime □ In 2005, Anatel published proposed regulations under the SMP regime. These proposed regulations include increasing the period of time that pre-paid cards are valid, decreasing the minimum duration of service contracts that wireless service providers may offer customers and requiring wireless service providers to have more customer service stations in cities where wireless service is provided. During the public comment period that ended in January 2006, the Brasilcel operators submitted their comments against the proposed regulations. Except for Resolution 410/2005 discussed above, Anatel has yet to enact any of its other proposed regulations. If Anatel were to enact these proposed regulations, such regulations may negatively affect Telefónica Móviles' Brazilian subsidiaries' business, financial condition and results of operations.

### **Latin America □ Northern Region**

The Northern Region includes Telefónica Móviles' operations in Mexico, El Salvador, Guatemala, Panama and Nicaragua. This region is the second largest region in Latin America with a population of approximately 135 million. This area is an emerging wireless market with approximately 56 million customers at December 31, 2005, representing a penetration rate of approximately 41%. Telefónica Móviles has an estimated market share in this area of approximately 16.2% at December 31, 2005. Its major operation in the Northern Region is Mexico, which represents 79% of the region's population and 62% of the region's revenue.

The following table presents selected statistical data related to the operations of the Northern Region.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total customers (in millions)	7.7	9.2
	40	

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	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Pre-paid customers (in millions)	7.0	8.4
Fixed wireless (in millions)	0.136	0.146
Population in service territory (in millions)	132.8	134.7

*Source: Telefónica Móviles, except for population data from Pyramid Research.*

**Network and Technology.** Telefónica Móviles Mexico offers both analog and digital networks. Its digital networks are based upon the CDMA and GSM standard. The rollout of Telefónica Móviles Mexico's GSM network on a nationwide basis started in 2003 and continued during 2004 and 2005, covering approximately 50,000 villages and geographic areas representing approximately 90% of the urban population. Telefónica Móviles México has 88% of its customers in its GSM network at the end of December 2005. The rest of the operators in the region had networks based upon the CDMA or TDMA standards, and during 2004 and 2005, they have been rolling out networks based on the GSM standard. Telefónica Móviles has invested in the Northern Region a total of €737 million during 2004 and 2005, 88% of which has been invested in Mexico principally to rollout its GSM network.

**Sales and Marketing.** Telefónica Móviles' operating companies in these countries use a broad range of marketing channels, including television, radio, billboards, telemarketing, direct mail and internet advertising to market their products. At December 31, 2005, approximately 6% of Northern Region customers were contract customers, while 94% were prepaid customers.

**Competition.** Telefónica Móviles is the second largest wireless operator in Mexico, El Salvador, Nicaragua and Panama in terms of total number of customers at December 31, 2005. It is the third largest operator in Guatemala in terms of total number of customers at such date. Telefónica Móviles México competes with various operators at a national level. Telefónica Móviles Mexico's principal competitor is Telcel, a subsidiary of América Móvil. Its other significant competitors are Iusacell, Unefon and Nextel.

**Mexican Regulation.** The provision of telecommunications services in Mexico is regulated by the Telecommunications Federal Law (LFT), enacted in 1995 (D.O.F. 7/6/95), as well as specific regulations governing the different types of telecommunications services.

**Licenses and concessions** In Mexico, authorization to provide mobile telephony services is granted through a concession. Telefónica Móviles Mexico's wireless operating companies have been granted concessions to operate mobile telephony services on Band A in the following states: Baja California, Baja California Sur, Sinaloa, Chihuahua, Durango, Nuevo León, Tamaulipas and Coahuila, excluding certain select the municipalities.

Currently, only one Band A and one Band B service provider may provide mobile telephony services in each region. Each concession is granted for a period of 20 years, and may be renewed for additional 20-year periods, subject to the fulfillment by the operator of certain terms and conditions. These conditions are the fulfillment of existing obligations under the license, solicitation of renewal of the license before its expiration and acceptance of the new conditions that will be established by the SCT. The concessions to provide mobile telephony services awarded to Telefónica Móviles Mexico's operating companies each expire in 2010.

In 2002, Telefónica Móviles acquired 65% of Pegaso. In 1998, Pegaso was awarded licenses to provide personal communication services until 2018. This license may be extended for additional 20-year periods, subject to the fulfillment by the operator of certain terms and conditions.

Concessionaires of public telecommunications networks are subject to general obligations set forth by the SCT and COFETEL and to obligations pursuant to each concession concerning quality of service, network expansion and modernization.

On July 12, 2004, COFETEL called for an auction to grant concessions to provide fixed and mobile wireless access. The bidding process for certain wireless frequencies available in each of nine PCS regions began on January 11, 2005. Nextel, Telcel, Iusacell and Telefónica Móviles participated in the bidding process. However, the auction was halted on February 9, 2005 due to a court order mandating that COFETEL allow UNEFON to participate in the auction. The bidding process was reinitiated on April 1, 2005 and terminated on April 11, 2005. Telefónica Móviles



was granted concessions in four different regions in Mexico. However, as a result of a regulation enacted by the *Comisión Federal de Competencia* (COFECO) establishing a spectrum cap of 35 MHz in PCS bands, Telefónica Móviles was not able to obtain more spectrum in Mexico City through the bidding process. Telefónica Móviles is currently challenging the legality of COFECO's spectrum cap regulation.

Interconnection – Mexican legislation on telecommunications matters requires all network license holders to enter into interconnection agreements whenever another operator requests it. The terms of such agreements may be freely negotiated between parties on a non-discriminatory basis. In the event of any controversy, COFETEL must arbitrate between the parties. The interconnection agreements must be registered in the telecommunications register, and those that are signed with foreign networks require prior authorization from the SCT.

Under Mexican law, COFETEL can establish specific obligations for concessionaires of public telecommunications networks who hold significant market power regarding prices, quality of service and the provision of information.

Since May 1, 1999, the Calling Party Pays (CPP) system has applied exclusively to local service (services established between exchanges of the same local area) although the user has the option of maintaining the Receiving Party Pays system. COFETEL has stated that it is considering extending CPP to national long-distance calls, which would require regulatory approval by the Federal Commission for Regulatory Improvement. While the proposed regulation is in final stages and ready for the Federal Commission for Regulatory Improvement's approval, the approval process has been delayed as a result of the complaints of several long-distance operators.

Rates – Rates charged to customers are not regulated. They are fixed by wireless operating companies and must be registered with COFETEL. Rates are not effective until confirmed by COFETEL.

**Latin America – Andean Region**

The Andean Region includes Telefónica Móviles' operations in Venezuela, Colombia, Peru and Ecuador. At December 31, 2005, the wireless market in the region had approximately 46 million customers, and Telefónica Móviles had an estimated market share in this region of approximately 38.0%. Telefónica Móviles is the leading wireless operator in Venezuela and Peru in terms of total number of customers at December 31, 2005 and the second largest operator in Colombia and Ecuador.

The following table presents the selected statistical data related to the operations of the Andean Region.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total customers (in millions)	11.6	17.5
Pre-paid customers (in millions)	9.1	14.2
Fixed Wireless (in millions)	0.57	0.68
Population in service territory (in millions)	112	114

Source: Telefónica Móviles, except for population data from Pyramid Research.

*Network and Technology.* In Venezuela, Telefónica Móviles Venezuela operates both digital and analog networks. Its digital network is based on the CDMA standard and its analog network is based on N-AMPS. Close to 100% of its customers in Venezuela are based on CDMA. During 2005, the company launched a new technology, 1X EVDO CDMA, which improves and allows higher speed data transmission services and capacity.

Telefónica Móviles Colombia operates digital networks based upon the GSM (launched in July 2005), CDMA 1XRTT and TDMA standards. At December 31, 2005, GSM customers represented 27% of total customers.

Telefónica Móviles Perú operates both analog and digital networks. Its digital network is based upon the CDMA/CDMA 1XRTT standard. At the end of 2005, Telefónica Móviles Perú started rolling out its GSM network, and the GSM services were launched as of February 2006.

Telefónica Móviles Ecuador operates digital networks based upon the GSM standard (launched in September 2005) and CDMA 1XRTT. At December 31, 2005, GSM customers represented 9% of total customers.

Telefónica Móviles has invested a total of €616 million in the Andean Region during 2004 and 2005.

*Sales and Marketing.* Telefónica Móviles' operating companies in these countries use a broad range of marketing channels, including television, radio, billboards, telemarketing, direct mail and internet advertising to market their products. At December 31, 2005, approximately 17% of the Andean Region customers were contract customers, while approximately 78% were prepaid customers. The rest of the customers were fixed-wireless customers.

*Competition.* The major market competitors in Venezuela are Movilnet, which is a wireless services communication provider that uses CDMA and TDMA technology, and Digitel TIM, which is a wireless communications provider that uses GSM technology.

Telefónica Móviles Colombia currently has two competitors in the Colombian market for wireless communications services: Comcel, which belongs to América Móvil; and Colombia Móvil, whose brand is Ola, which obtained a PCS license in 2003 and is a joint venture of the two largest phone companies of the main Colombian cities of Bogota and Medellin.

Telefónica Móviles Peru currently has two competitors in the Peruvian market for wireless communications services: América Móvil and Nextel Peru.

Telefónica Móviles Ecuador currently has two competitors in the Ecuadorian market for wireless communications services: America Móvil and Alegro, which is owned by fixed line operators.

### ***Latin America/Southern Cone***

The Southern Region includes Telefónica Móviles' operations in Chile, Argentina and Uruguay. At December 31, 2005, the wireless market in the region had approximately 34 million customers, and Telefónica Móviles had an estimated market share of approximately 41.2% in the region. The penetration rate in the region was 58.1% at December 31, 2005. Telefónica Móviles is the leading wireless operator in Argentina and Chile in terms of total number of customers at December 31, 2005 and the second largest operator in Uruguay.

The following table presents selected statistical data related to the operations of the Northern Region.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total customers (in millions)	6.9	14.0
Pre-paid customers (in millions)	5.1	9.8
Fixed wireless (in millions)	0	0.2
Population in service territory (in millions)	54	57.9

*Source: Telefónica Móviles, except for population data from Pyramid Research.*

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*Network and Technology.* In Argentina we operate both analog and digital networks. Telefónica Móviles' digital network in Argentina is based upon the TDMA standard and the GSM standard. At December 31, 2005, GSM customers represented 51% of the total customers.

Telefónica Móvil de Chile operates both TDMA and GSM networks. GSM customers represented 51% of the total customer base as of December 31, 2005.

In Uruguay Telefónica Móviles operates both analog and digital networks. Its digital network is based upon the GSM (launched in April 2005) and CDMA standards. At December 31, 2005, GSM customers represented approximately 40% of total customers.

Telefónica Móviles has invested a total of €515 million in the Southern Region during 2004 and 2005.

*Sales and Marketing.* Telefónica Móviles' operating companies in these countries use a broad range of marketing channels, including television, radio, billboards, telemarketing, direct mail and internet advertising to market their products. At December 31, 2005, approximately 26% of Southern Region customers were contract customers, while approximately 74% were prepaid customers.

*Competition.* Telefónica Móviles' operators in Argentina currently have three competitors in the Argentine market for wireless communications service, each of which provides services on a nationwide basis: Telecom Personal, which is controlled by Telecom Italia through Telecom Argentina; CTI Móvil (controlled by América Móvil); and Nextel, owned by NII Holdings Inc.

Telefónica Móviles' operators in Chile currently have two competitors in the Chilean market for wireless communications service, each of which provides services on a nationwide basis: Entel and Smartcom.

Telefónica Móviles' operators in Uruguay currently have two competitors in the Uruguay market for wireless communications service, each of which provides services on a nationwide basis: Ancel and CTI.

### **Wireless Internet and Data Initiatives**

We believe that the convergence of data communications and voice communications represents an important opportunity to increase revenue in the mobile communications sector. An important component of our strategy is broadening uses of wireless communications, currently dominated by voice services, to include more widespread use of wireless internet and data services.

Telefónica Móviles España's revenues from services increased to €1,030 million in 2005. This increase is primarily due to the increased use of other data services (downloads, browsing, data transmission, MMS and content SMS) in addition to traditional person-to-person SMS usage. Revenues from non-traditional person-to-person SMS increased by approximately 9 percentage points in 2005 to 38% of total data revenues.

We expect that the contribution of wireless internet and data services to our revenues will increase significantly as technology and services improve and are made more accessible and user-friendly to mass-market consumers and business customers in each market in which Telefónica Móviles operates. The availability of compatible handsets at attractive prices will be key to achieving this development.

Telefónica Móviles offers its clients a wide range of data services that it seeks to continuously improve. Current data services offered include short messaging services, or SMS and Multimedia Messaging Services, or MMS, which allows customers to send messages with images, photographs and sounds. Customers may also receive selected information, such as news, sports scores and stock quotes. Telefónica Móviles also provides wireless connectivity and internet access.

### **Telefónica Latinoamérica Latin American Fixed Line Business**

Our Latin American fixed line business is conducted through Telefónica Latinoamérica. Telefónica Latinoamérica is comprised of:

- our fixed line telecommunications operators: Telesp (Brazil); Telefónica de Argentina (Argentina); CTC Chile (Chile); and Telefónica del Peru (Peru);

- our data business, Telefónica Empresas America;
- our wholesale data transmission and the international services business, Telefónica International Wholesale Services (TIWS); and
- our internet business, Terra Networks Latinoamérica.

The principal services offered by Telefónica Latinoamérica are:

- Traditional fixed line telecommunication services, principally including PSTN (public switched telephone network) lines; ISDN (integrated services digital network) access; public telephone services; local, domestic and international long distance and fixed-to-mobile communications services; supplementary value-added services (including call waiting, call forwarding, voice and text messaging, advanced voicemail services, information services and conference-call facilities); video telephony; intelligent network services; and leasing and sale of terminal equipment.
- Internet and broadband multimedia services, principally including narrowband switched access to Internet; ISP service; internet portal and network services; retail and wholesale broadband access, through ADSL and satellite technologies; residential-oriented value-added services (including instant messaging, concerts and videoclips by streaming, e-learning, parental control, firewall and anti-virus); pay TV service (Cable Magico) and VOIP services.
- Data and business-solutions services, principally including leased lines; VPN services; fiberoptics services; hosting and ASP service; outsourcing and consultancy services, including network management (CGPs) and desktop services and system integration and professional services.
- Wholesale services for telecommunication operators, principally including domestic interconnection services; international wholesale services; leased lines for other operators; network deployment and local loop leasing, under the unbundled local loop regulation framework.

All existing fixed telephony, data and internet services in the Latin American countries in which we operate are open to free competition, including PCS service in Peru for which new licenses are expected to be granted in 2006.

The following table sets forth ownership and management information as of December 31, 2005 regarding the principal fixed line telecommunications operators that are members of the Telefónica Latinoamérica group.

<b>Company</b>	<b>Year Acquired</b>	<b>Population at December 31, 2005 (millions)</b>	<b>Interest</b>	<b>Management</b>
Telecomunicações de São Paulo Telesp	1998	40.4	87.5%	Telefónica Latinoamérica manages Telesp pursuant to a management contract
Compañía de Telecomunicaciones de Chile	1990	15.5	44.9%	Telefónica Latinoamérica appoints a majority of the members of the Board of Directors
Telefónica de Argentina	1990	39.1	98.0%	Telefónica Latinoamérica controls Telefónica de Argentina through its stake in COINTEL. In addition, Telefónica Latinoamérica manages Telefónica de Argentina pursuant to a

				management contract
Telefónica del Peru	1994	28.0	97.1%	Telefónica Latinoamérica appoints a majority of the members of the Board of Directors and manages Telefónica del Peru pursuant to a management contract



In addition, Telefónica Latinoamérica group's other members include: Telefonica Empresas, following its segregation and subsequent integration into the Telefónica Latinoamérica group's fixed line activities in Latin America during 2005; Telefónica International Wholesale Services (TIWS); and Terra Networks Latinoamérica, as a result of the merger by absorption of Terra Networks into Telefónica, S.A. in July 2005.

## **Brazil**

### *Telecomunicações de São Paulo* Telesp

Telesp provides fixed line and other telecommunications services in the Brazilian state of São Paulo under concessions and licenses from Brazil's federal government. We acquired our initial interest in Telesp in 1998 as part of a consortium that acquired a majority interest in Telesp in connection with the restructuring of Telebrás, the former Brazilian state-owned telecommunications monopoly. In mid-2000, we completed an exchange offer for the Telesp shares and ADSs held by minority investors. In July 2000, we agreed to exchange our interest in Portelcom Participações S.A., the holding company which controls Telesp Celular, for Portugal Telecom's minority interest in SP Telecomunicações S.A., the holding company through which we control Telesp and paid an aggregate of approximately U.S.\$60 million to Portugal Telecom pursuant to the terms of the agreement. In December 2001, we acquired an additional 3.5% of SP Telecomunicações S.A. from Iberdrola.

Under a management contract between Telefónica Latinoamérica and Telesp, Telefónica Latinoamérica provides Telesp with management and technical support in exchange for management fees equivalent to 0.1% of Telesp's revenues, as defined in the management contract. The management contract expired in December 2005 and was renegotiated and renewed.

### *Operations*

The following table provides information with respect to Telesp's fixed line telecommunications network at the dates indicated.

	At December 31,			Increase/ (Decrease)
	2003	2004	2005	2004-2005
Fixed telephony accesses (in thousands)	12,287.0	12,455.0	12,340.0	(0.9)%
Data and Internet accesses (in thousands)	1,368.2	2,955.5	4,261.4	44.2%(1)
Broadband accesses (in thousands)	484.4	826.4	1,690.4	104.6%(1)
Penetration rate in São Paulo	31.6%	31.7%	30.9%	(0.8) p.p.
Lines in service per employee	1,792	1,865	1,744	(6.5)%

(1) Includes the former Terra Networks group companies in Brazil at December 31, 2005.

At December 31, 2005, Telesp managed approximately 16.6 million accesses, representing an increase of 7.8% from 15.4 million accesses at December 31, 2004, due to a 104.6% increase in broadband accesses due to a 46% increase in Telesp's broadband accesses as a result of its commercial efforts and the consolidation of the former Terra Networks group companies in Brazil (approximately 932 thousand accesses, of which 483.6 thousand were broadband accesses), offset in part by a 0.9% decrease in the number of fixed telephony accesses.

Telesp's network is 100% digitalized. Its productivity ratio decreased to 1,744 lines in service per employee at December 31, 2005 from 1,865 lines in service per employee at December 31, 2004, principally due to a decrease in lines in service (traditional and ADSL lines) and an increase in the number of employees as at December 31, 2005 compared to December 31, 2004, mainly due to the acquisition of Atrium (an integrated telecommunications service provider to small- and medium-size enterprises) in 2005.

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Fixed line voice traffic decreased 2.3% to 57,577 million minutes in 2005. This decrease was due to the increased use of mobile phones, which affected mainly long distance and public telephone traffic, to the decline in

traffic in the intrastate long distance market and to the increase in pre-paid lines relative to post-paid lines, which affects fixed-to-mobile and long distance traffic because of the restrictions relating to calls made from such lines. Local fixed-to-fixed traffic increased 2.6% in 2005, while internet traffic decreased 12.3% due to the migration of customers to broadband.

*Regulation.* In 1997, the Telecommunications General Law was passed in Brazil (Law 9472/97) creating a National Agency for Telecommunications, or Anatel.

*Concessions and Authorizations* ¶ Concessions and licenses to provide telecommunications services are granted under the public regime, while authorizations are granted under the private regime. Companies that provide services under the public regime, or public regime companies, are subject to certain obligations as to quality of service, continuity of service, universality of service, network expansion and modernization. Companies that provide services under the private regime, or private regime companies, are generally not subject to the same requirements regarding continuity or universality of service. However, they are subject to certain network expansion and quality of service obligations set forth in their authorizations. Public regime companies, including Telesp, can also offer certain telecommunications services in the private regime, including data transmission services.

*Fixed-line Services (Public Regime)* ¶ Our current concession agreement was extended on December 22, 2005, for an additional period of 20 years. In accordance with the Concession Agreement before the renewal, we had notified Anatel of our intention to renew such Concession Agreement on June 30, 2003.

On December 1, 2005, we sent to Anatel the necessary evidence that we had accomplished our network expansion targets established by the Serviço Telefónica Fixo Comutado, or the STFC, for 2005. The evidence of our accomplishment was submitted by Anatel to a public hearing on December 22, 2005, which was completed on February 6, 2006. Anatel is in the process of issuing a certificate.

The renewed Concession Agreement contemplates possible changes to its terms to Anatel in 2010, 2015 and 2020. This provision permits Anatel to update the renewed Concession Agreement with respect to network expansion, modernization and quality of service targets in response to changes in technology, competition in the marketplace and domestic and international economic conditions.

*Fixed-line Services (Private Regime)* ¶ The Brazilian telecommunications regulations provide for the introduction of competition in telecommunications services by requiring Anatel to authorize private regime companies to provide local and intraregional long-distance service in each of the three fixed-line regions and to provide intraregional, interregional and international long distance services throughout Brazil. Anatel has already granted authorizations to private regime operators to operate in Region III, Telesp's concession region.

*Interconnection* ¶ In July 2005, Anatel published a new regulation for interconnection among providers of telecommunications services, with material changes compared to the prior regulation. Among the key changes, it became mandatory to make an interconnection public offer for all classes and types of services, requiring operators to prepare a public document setting forth all of the conditions for the establishment of interconnection. In addition to the offers that were already contained in the current model, such as the offer between STFC carriers or between STFC and SMP/SME carriers, Telesp will have to make offers to MSC authorized companies in classes III and/or IV. Moreover, those offers are required to include criteria for treating fraudulent calls. These new regulations also contemplate the reduction of the period to fulfill the new interconnection requirements.

*Rates* ¶ For local network usage (TURL) and the interurban network (TU-RIU), rates are regulated by Anatel and an inflation index formula is included in the concession contract. Concession agreements also establish a price cap for annual rate adjustments, depending upon the type of service provided. Rates for international services are not required to follow the price cap.

In June 2003, Anatel prescribed new rates for Telesp's concession area. However, based on an injunction issued by a federal court, Telesp charged lower rates than those prescribed by Anatel. After the final decision regarding the legal injunction with the reincorporation of the IGP-DI as the index, the approved increases were applied in addition to the approved tariffs in June 2003. The increase was divided into two installments, the first one effective after September 1, 2004 and the second installment effective after November 1, 2004.

In June 2004, Anatel approved new rates for Telesp's concession areas starting in July 2004. The approved increases were applied in addition to the tariffs determined by the legal injunction. In June 2005, new rates were approved by Anatel according to the concession agreement.

In addition, in 2006 a new index will be applicable to the adjustments of telecommunication tariffs. The current index applicable to telecommunications tariffs, Índice Geral de Preços (IGP-DI) will be replaced by the Índice Sectorial de Telecomunicações or the IST, the Telecommunications Sector Index, which was created to reflect the costs incurred by the telecommunications operators.

*Competition.* In addition to evolving regulatory considerations, Telesp's business is affected by competition from other telecommunications providers. Telesp began to face competition in its region in July 1999 and anticipates that competition will contribute to declining prices for fixed line telecommunications services and increasing pressure on operating margins. Telesp's future growth and results of operations will depend significantly on a variety of factors, including:

- Brazil's economic growth and its impact on the greater demand for services;
- the costs and availability of financing; and
- the exchange rate between the *real* and other currencies.

Telesp is subject to competition for local telephone services from a "mirror" license holder, who was granted rights similar to those granted to Telesp as part of the privatization of Telebrás. It is subject to competition for interprovincial long distance services from a "mirror" license holder, Embratel and Embratel's "mirror" license holder.

*Network and Technology.* In 2003, Telesp began to offer international and interregional long distance telecommunications services known as "Super 15". Since 1999, Telesp has made significant investments to develop its broadband access business through ADSL technology under the brand "Speedy". Telesp also offers wireless broadband connectivity to its clients through Wi-Fi.

## Chile

### CTC Chile

Compañía de Telecomunicaciones de Chile, or CTC Chile, a company in which we held a 44.89% stake at December 31, 2005, is the leading telecommunications operator in Chile based on number of customers, according to information provided by its competitors and regulatory authorities. As of December 31, 2005, CTC Chile owned approximately 72.5% of all telephone lines in Chile, according to its estimates.

### Operations

The following table provides information with respect to CTC's fixed line telecommunications network at the dates indicated.

	At December 31,			Increase/ (Decrease)
	2003	2004	2005	2004-2005
Fixed telephony accesses (in thousands)	2,399.0	2,412.5	2,429.1	0.7%
Data and Internet accesses (in thousands)	487.2	473.7	483.6	2.1%

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Broadband accesses (in thousands)	125.3	200.8	314.2	56.5%
Penetration rate in Chile	21.5%	22.0%	21.0%	(1.0) p.p.
Lines in service per employee	794	869	968	11.4%

CTC Chile's accesses increased 0.9% to 2,912.7 thousand in 2005 principally due to our offering of bundled service packages and increases in broadband accesses. At December 31, 2005, the fixed telephony penetration rate

in Chile was approximately 21%. CTC Chile's productivity ratio increased to 968 lines per employee at December 31, 2005 from 869 lines per employee at December 31, 2004, principally as a result of an increase in lines in service and workforce reductions in 2005. At December 31, 2005, CTC Chile's network was 100% digitalized, and 96.5% of its network had ADSL coverage.

Broadband accesses increased 56.5% to 314,177 thousand at December 31, 2005 from 200,794 thousand at December 31, 2004, principally due to CTC Chile's commercial efforts, including the offer of bundled service packages, undertaken during 2005.

*Regulation.* The regulatory framework of Chile, defined in the General Telecommunications Law (*Ley General Telecomunicaciones*), was enacted in 1982. This law introduced competition in the telecommunications services sector in Chile (Law 18168/82 amended by Decree 1/87, Laws 19091/91 and 19302/94) and dictated provisions on licenses and permits for operating telecommunications services, rate regulation and network interconnection. Those provisions were later amended or replaced by subsequent modifications.

*Regulatory authorities* □□ The following regulatory authorities exist in Chile:

- the Under-Secretary of Telecommunications (SUBTEL);
- the Ministry of Economy, Infrastructure and Reconstruction;
- the Ministry of Transport and Telecommunications; and
- the Antitrust Commission.

*Licenses and Concessions* □□ Under Law No. 18,168, companies must obtain licenses in order to provide telecommunications services. Licenses granted for public and intermediate services generally have 30-year terms and may be renewed indefinitely for 30-year periods at the request of the operator (although certain licenses held by CTC Chile have longer terms).

A license may be terminated, after notice of noncompliance with the applicable technical regulations, by executive decree of the Ministry of Transport and Telecommunications, if the operator is in violation of the law or does not comply with the terms and conditions to which the license is subject. If a license is terminated, the holder is barred from applying for any license for a period of five years.

CTC Chile holds the following licenses:

- *Local Telephony Public Service.* CTC Chile holds licenses for local telephone service in all regions of Chile for a 50-year period beginning as of December 1982.
- *Multicarrier Long Distance Licenses.* CTC Chile, through Telefónica Mundo and Globus, respectively, holds 30-year licenses granted in April 1993 and licenses for an indefinite term to provide domestic and international long distance services through central switches and cable and fiber-optic networks nationwide.
- *Data Transmission.* CTC Chile, through Telefónica Empresas, holds, since March 1987, nationwide public service data transmission licenses for an indefinite term.
- *Pay TV.* In 2005, CTC Chile obtained a nationwide 10-year renewable license to provide limited satellite television service. In 2006, CTC Chile obtained a limited television service permit to provide satellite television service through CTC Chile's broadband network. The permit does not have an expiration date.

Telecommunications services in Chile are provided on a competitive basis, although access rates (for network use) must be set by the Ministry of Transport and Telecommunications and the Ministry of Economy, according to article 25 of the General Telecommunications Law.



*Interconnection* [ ] Interconnection is obligatory for all license holders of public telecommunications services and intermediate services that provide long distance services. The Exempt Resolution No. 1007/95 sets the procedures and deadlines to establish and accept interconnections between networks of public telephone service and intermediate services.

*Rates* [ ] Under the General Telecommunications Law, maximum tariffs for telephony services are set every five years by the Ministry of Transport and Telecommunications and the Ministry of Economy. The Antitrust Commission may subject any telephony service to price regulation, except for mobile telephone services to the public that are expressly exempted under the General Telecommunications Law.

Each maximum tariff takes into account the relevant cost components associated with providing the regulated service and is adjusted monthly in accordance with a tariff index. A distinct tariff index exists for each individual regulated service that reflects the different theoretical cost components associated with each such service.

On October 13, 2003, the Antitrust Commission issued Resolution No. 709, approving CTC Chile's request for local telephony services tariff flexibility and the ability to offer alternative plans within a framework of conditions specified by the regulator. On February 26, 2004, a framework regarding how CTC Chile may offer the above-mentioned alternative tariff plans was published. One relevant aspect is that no previous authorization is required to offer such plans. Plans are not subject to maximum levels or predetermined structures and may include joint offers with other telecommunications and non-telecommunications services.

On May 4, 2004, a new tariff decree was proposed by the Ministry of Transport and Telecommunications. CTC Chile and other operators filed appeals to the tariff decree and subsequently the Ministry resubmitted the decree to the Chilean General Controller in September 2004, and again in December 2004 with slight modifications to the document submitted in May 2004. On February 11, 2005, Tariff Decree No. 169 was published in the Official Gazette. CTC Chile has applied the new tariffs to its customers retroactively since May 6, 2004.

## **Argentina**

### *Telefónica de Argentina*

Telefónica de Argentina is a leading provider of fixed line public telecommunications services and basic telephone services in Argentina based on number of customers, according to information provided by its competitors and regulatory authorities. Telefónica de Argentina is licensed to provide local and domestic long distance and international services and domestic and international telex services throughout Argentina. Telefónica de Argentina's licenses do not expire but may be cancelled as a result of a failure to comply with the terms of the license. During 2000, we increased our stake in Telefónica de Argentina through a public exchange offer for Telefónica de Argentina shares and ADSs held by minority investors and our acquisition of a 50% interest in Compañía de Inversiones en Telecomunicaciones (COINTEL), which held a 52.9% stake in Telefónica de Argentina. At December 31, 2005, we held a 98.0% interest in Telefónica de Argentina.

As of December 31, 2005, approximately 57% of Telefónica de Argentina's lines in service were in the Greater Buenos Aires metropolitan area, including 20% of Telefónica de Argentina's lines in service that were located within the City of Buenos Aires. Approximately 56% of Telefónica de Argentina's lines in service as of December 31, 2005 were residential, with the remainder being professional, commercial and governmental customers.

Telefónica Latinoamérica has a management contract with Telefónica de Argentina under which it has agreed to manage Telefónica de Argentina's business and provide services and expertise regarding Telefónica de Argentina's entire range of activities in return for a percentage of Telefónica de Argentina's operating revenues equivalent to 4% of its gross revenue prior to amortization and interest expense. This contract was renegotiated during 2003 and was extended through 2008 with a five percentage point reduction of our management fee. Under the management contract, Telefónica Latinoamérica manages Telefónica de Argentina's day-to-day operations.



### Operations

The following table provides information with respect to Telefónica de Argentina's fixed line telecommunications network at the dates indicated.

	At December 31,			Increase/ (Decrease)
	2003	2004	2005	2004-2005
Fixed telephony accesses (in thousands)(1)	4,166.0	4,325.4	4,532.2	4.8%
Data and Internet accesses (in thousands)	768.0	890.1	902.1	1.4%
Broadband accesses (in thousands)	69.3	190.2	303.5	59.6%
Penetration rate in Argentina	22.1%	25.1%	26.0%	0.9 p.p.
Lines in service per employee	529.0	559.0	585.0	4.7%

Telefónica de Argentina's accesses increased 29.4% to 5,434.3 thousand at December 31, 2005 from 5,215.5 thousand in 2004. The fixed telephony penetration rate in Argentina was 26% at December 31, 2005. At December 31, 2005 Telefónica de Argentina's estimated market share for local telephony was 51.4%, its estimated market share for domestic long distance was 40.7% and its estimated market share for international long distance was 49.8%. Broadband accesses increased 177.9% to 303.5 thousand at December 31, 2005 from 190.2 thousand at December 31, 2004, principally due to Telefónica de Argentina's commercial efforts, including the expansion of broadband service in the southern part of the country.

Voice traffic per line increased 3.1% in 2005 from 2004, principally due to the 18.7% increase in total incoming traffic and the 28% increase in fixed-to-mobile traffic. Narrowband internet traffic decreased by 29.4%, mainly due to customers' migration to broadband services.

*Regulation.* The basic legal framework is set forth in the National Telecommunications Law (No. 19.798) from 1972 and in the specific regulations governing each service. Through Decree 264/98, the telecommunications market in Argentina was deregulated.

On September 3, 2000, the Argentine government issued Decree No. 764/00, which approved rules for licenses for telecommunications services, interconnection, universal service and for the administration, management and control of the radio electric spectrum.

In January 2002, the Public Emergency Law introduced significant changes to the agreements executed by the Argentine government, including those regarding utilities, such as Telefónica de Argentina's tariff agreements. This law mandated the conversion of prices and tariffs in such agreements into pesos at a rate of one peso per one U.S. dollar without the possibility of adjusting such conversion rate or indexation of any kind. It also authorizes the Argentine government to renegotiate the above-mentioned contracts.

On October 21, 2003, Law No. 25.790 became effective, extending the term for the renegotiation of the concession or licensing agreements with public utilities until December 31, 2004. This law also established that the decisions made by the Argentine government during the renegotiation process shall not be limited by, or subject to, the stipulations contained in the regulatory frameworks currently governing the concession or licensing agreements for the respective public utilities. Renegotiated agreements may cover some aspects of concession or licensing agreements and may contain formulas to adjust such agreements or temporarily amend them. The law includes the possibility of agreeing upon periodic reviews, as well as the establishment of conditions regarding the quality parameters applied to services. Law No. 25.972 extended the emergency renegotiation period until December 31, 2005. On January 10, 2006, Law No. 26.077 extended the emergency renegotiation period until December 31, 2006.

As an investor in Argentina through Telefónica de Argentina, we commenced arbitration proceedings against the Republic of Argentina before the CIADI (*Centro Internacional de Arreglo de Diferencias Relativas a*

*Inversiones*) based on the Reciprocal Protection of Investments Treaty between Spain and Argentina for damages suffered by us because of the measures adopted by the Argentine government. We have temporarily suspended our participation in these proceedings in light of an agreement we reached on February 15, 2006 with the Argentine

government with respect to the renegotiation of Telefónica de Argentina's concession agreement. This agreement is currently subject to the Argentine Congress's approval. Once approved by the Congress it will have to be approved by a Presidential Decree. If our agreement with the Argentine government is approved by the Argentine Congress we plan to withdraw our claims against the Republic of Argentina.

*Regulatory authorities* □ The provision of telecommunications services is regulated by the Secretary of Communications and supervised by the National Communications Commission, subject to the participation in certain cases of the Under Secretary of Competition, Deregulation and Consumer's Defense (*Sub Secretaría de la Competencia, la Desregulación y la Defensa del Consumidor*).

*Licenses* □ The licenses, all granted for an unlimited period of time and held by Telefónica de Argentina S.A., and the regulations that govern them are:

- Decree 2344/90: License to provide fixed line telecommunications services.
- Decree 2346/90: License to provide international telecommunications services, including telex and data transmission.
- Decree 90/99: License to provide local, long distance, international and data transmission telecommunications services in the northern region.
- Resolution 1995/95: License to provide international telex services.
- Resolution SC 16/01: License to provide Internet access and international data transmission services.
- Resolution SC 59/01: License to provide data transmission.
- Resolution SC 225/03: License to provide transmission of television signals.

*Interconnection* □ Decree No. 764/00 approved new rules for national interconnection and established interconnection standards and conditions with which telephone service providers must comply without affecting pre-existing agreements.

The rules for national interconnection set forth the basic principles to be taken into account regarding interconnection among operators such as who will be able to agree on tariffs and service terms and conditions on a non-discriminatory basis, provided that they comply with certain minimum obligations.

The regulations also establish the obligation for dominant and significant market operators to unbundle their local loops (physical link and its capacity between the carrier's capacity and the clients' facilities) and to allow competitors to use them on a technically reasonable basis. However, these regulations remain in the early stages of their development.

*Rates* □ Decree No. 764/00 established that providers of telephone services may freely set rates and/or prices for their services, which shall be applied on a non-discriminatory basis. However, until the Secretary of Communications determines that there is effective competition for telecommunications services, the "dominant" providers in such areas, which include Telefónica de Argentina, must respect the maximum tariffs established in the general rate structure. Below the amounts established in such tariff structure, such providers may freely set their rates by areas, routes, long distance legs and/or customer groups.

The guidelines set forth in article 26 of Decree 1185/90 are still applicable for operators with significant market power. These established the information obligations that operators have with regard to the tariffs, both to clients as well as to the regulatory authority. This decree also establishes the powers that such authority has to

revise and oppose such tariffs.

The Public Emergency Law converted these tariffs into pesos at a rate of one peso per one U.S. dollar and provided that the Argentine government would renegotiate the tariff regime.

*Competition.* Telecom Argentina, Compañía de Teléfonos del Interior S.A., an affiliate of Telmex, and Compañía de Teléfonos del Plata S.A., an affiliate of Bell South, were awarded licenses to provide the same basic telephone services throughout Argentina as of October 10, 1999. Since November 2000, other principal competitors, including Impsat Corp. and AT&T, have also entered the market, as well as smaller regional competitors.

## **Peru**

### *Telefónica del Peru*

At December 31, 2005, Telefónica del Peru was the leading fixed line telecommunications operator in Peru based on number of customers, according to information provided by its competitors and regulatory authorities. At December 31, 2005, we held a 98.2% interest in Telefónica del Peru.

Under a management contract between Telefónica Latinoamérica and Telefónica del Peru, Telefónica Latinoamérica provides Telefónica del Peru with management and technical support in exchange for management fees equivalent of 1% of Telefónica del Peru's total revenues. This contract expires in 2014.

On April 15, 2003, OSIPTEL introduced the multicarrier dial-up service for the long distance market. This system allows callers to freely select the operator they want to use for each call. Each operator has a predetermined number that the caller dials as a prefix to the call. This service favored the entrance of new operators with lower long distance tariffs. In the domestic and international long distance markets, at December 31, 2005 Telefónica del Peru had 75% and 63% estimated market shares, respectively, compared with 72% and 63%, respectively, at December 31, 2004. TELMEX and Americatel are its main competitors. Telefónica del Peru is the leading provider of public telephone service, with TELMEX as its main competitor. In addition, Telefónica del Peru provides cable television in the Lima metropolitan area and seven other cities through its wholly owned subsidiary, Telefónica Multimedia S.A.C.

### *Operations*

The following table provides information with respect to Telefonica del Peru's fixed line telecommunications network at the dates indicated.

	At December 31,			Increase/ (Decrease)
	2003	2004	2005	2004-2005
Fixed telephony accesses (in thousands)	1,964.0	2,138.9	2,347.6	9.8%
Data and Internet accesses (in thousands)	234.2	298.2	403.2	35.2%
Broadband accesses (in thousands)(1)	90.7	205.4	340.4	65.7%
Pay TV accesses (in thousands)	363.1	389.2	462.2	18.8%
Penetration rate in Peru (lines over population)	7.2%	7.3%	7.9%	0.6 p.p.
Lines in service per employee	649.0	781.0	804.0	2.9%

(1) Includes ADSL and broadband cable accesses.

The number of Telefónica del Peru's accesses increased 14.3% to 3,213.0 thousand at December 31, 2005 from 2,826.3 thousand at December 31, 2004 due to the 65.7% increase in broadband accesses, 18.8% increase in Pay TV accesses and 9.8% increase in fixed telephony accesses.

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Total traffic decreased by 2.8% in 2005 from 2004. Voice traffic increased 2.2% in 2005 as a result of a 32.1% increase in international long distance traffic, a 14.4% increase in incoming interconnection traffic and a 1.7% increase in local fixed-to-fixed traffic, while internet traffic decreased 39.9% due to customers' migration to broadband services.

At December 31, 2005, Telefónica del Perú's network was 97% digitalized.



*Regulation.* The Telecommunications Act (*Texto Único Ordenado de la Ley de Telecomunicaciones*) approved in 1993 (DS 13-93-TCC) and the General Regulations implementing the statute approved in 1994 (DS 6-94-TCC 1994), as amended (D.S. 027-2004-MTC), make up the legal framework for the telecommunications sector in Peru.

*Licenses and Concessions.* Telefónica del Peru provides telecommunications services based on concessions granted by the Ministry of Transport and Telecommunications. The concession term is for 20 years, which may be renewed totally or partially at Telefónica del Peru's request. Total renewal is for a further 20-year period. Partial renewal is for periods of up to five additional years. Once a regulated operator chooses either a partial or total renewal modality, they cannot switch. Telefónica del Peru selected a partial renewal modality, which will allow Telefónica del Peru to renew its term every five years from the effective date, up to a maximum of 20 years. Under the terms of Telefónica del Peru's concession contracts, the Ministry of Transport and Telecommunications may choose not to renew or extend Telefónica del Peru's contracts if it has repeatedly not complied with the terms of its concessions contracts as determined by the Peruvian government. A partial renewal of five years was approved by Ministry Resolution No 272-92 dated June 21, 1999, extending the concession term until 2019.

In December 2003, Telefónica del Peru petitioned the government for a five-year extension of its concession contracts from 2019 to 2024. In June 2004, the Ministry of Transport and Telecommunications notified Telefónica del Peru of its recommendation not to renew the concession contracts for an additional five-year period. As of the date of this Annual Report, a final decision has not been issued. If the request for extension is denied, then Telefónica del Peru may again petition for the additional five-year extension period from 2019 to 2024 in December 2008. The maximum period of the contract is through 2034.

*Rates* □ The tariffs for the services regulated following the period of limited concurrence must be approved by OSIPTEL in accordance with a price cap formula based on a productivity factor.

On July 19, 2004, OSIPTEL set the value of the productivity factor for the 2004 to 2007 period at an annual rate of 10.1% and 7.8% for local and long distance calls, respectively. The productivity factor set is applicable until August 31, 2007. A review process shall be put in place every three years.

*Interconnection prices* □ Interconnection charges have exhibited a downward trend. Except for charges for call termination in the local fixed network, which are set on the basis of costs, charges were established using the international comparison method. However, OSIPTEL has initiated several administrative procedures to set new interconnection charges for several services.

### ***Telefónica Empresas América***

During 2005, we continued implementing certain measures to simplify our business lines by integrating the former Telefónica Empresas business line's operations into the Spanish and Latin American fixed line businesses. Pursuant to this reorganization, the operations of Telefónica Empresas América, or TEA, and Telefónica International Wholesale Services, or TIWS, are now conducted by Telefónica Latinoamérica.

TEA is a holding company for operations in Latin America focused on corporate communication services, including voice services, private virtual networks, Internet connectivity, International data services, hosting and other company solutions.

After the spin-off in 2001 of the data transmission operations of the integrated telecommunications operators in Brazil, Argentina and Peru into TEA and together with its other operations in Colombia, Mexico and the United States, TEA offers a unique network platform for the provision of corporate data transmission services to multinational clients in Latin America.

TEA's strategy in each country depends on the status of development of its network and its market share. In those countries in which our Group holds a leading position, TEA concentrates on offering □one-stop shopping□ services and customized communications solutions to corporate customers, with particular emphasis on value

added services, such as hosting, content delivery and e-solutions. We refer to these markets as TEA's "incumbent markets". In those countries where TEA is a new entrant, TEA offers a complete portfolio of IP services and

packaged solutions to the most attractive market segments, such as small and medium-sized enterprises, Internet service providers and other Telefónica Group companies. We refer to these markets as TEA's "expansion markets".

#### *Incumbent Markets*

TEA's incumbent markets include Brazil, Argentina, Chile and Peru. TEA manages operations focused on significant clients of the Telefónica Group. At December 31, 2005, TEA had 48,483 end user connections in Brazil, 9,979 in Argentina, 5,676 in Peru and 17,503 in Chile.

#### *Expansion Markets*

TEA's expansion markets include Colombia, Mexico, Puerto Rico and the United States. At December 31, 2005, TEA had an aggregate of 3,686 end user connections in these expansion markets.

#### ***Telefónica International Wholesale Services***

In 2002, Telefónica Data's international network included the international data transmission services and the international services integrated in Telefónica DataCorp. During 2003, Telefónica DataCorp transferred its international network to Telefónica International Wholesale Services (TIWS), a new business line of the Telefónica Group. TIWS was created to become a global wholesale operator of data, voice and broadband capacity.

Since 2003, TIWS is the business unit responsible for other telecommunications operators and for managing the Group's international services and the network which supports these services.

#### ***Terra Networks Latinoamérica***

Pursuant to its merger by absorption into Telefónica, as of July 2005, Terra Network's operations in the United States and Latin America ("Terra Networks Latinoamérica") are now conducted through Telefónica Latinoamérica. Terra Networks Latinoamérica's results have been included in our Telefónica Latinoamérica business line since July 2005.

Terra Networks Latinoamérica is a leading interactive services provider in Latin America, offering Internet access and local language interactive content and services to more than 4.7 million pay customers in Brazil (including 0.48 million broadband customers in Brazil, which we have reflected under our discussion of Telesp above), Mexico, Peru, Chile, Argentina, Venezuela, Colombia, the United States and Central America at December 31, 2005.

#### **Cesky Group**

On April 12, 2005, we signed an agreement with the Czech government to purchase its 51.1% stake in Cesky Telecom a.s. As a result of our acquisition of the Czech government's 51.1% stake in Cesky Telecom a.s. for €2.7 billion, we were required to conduct a public tender offer for all of the remaining outstanding shares of Cesky Telecom a.s. Pursuant to the tender offer, we acquired an additional 18.3% interest in Cesky Telecom a.s. for approximately €911 million. As of December 31, 2005, we held a 69.4% interest in Cesky Telecom a.s.

The Cesky Group is comprised of Cesky Telecom a.s. ("Cesky"), Eurotel Praha, spol.s.r.o. ("Eurotel") and several other companies specializing in the provision of telecommunications or related services. The Cesky Group offers a broad range of voice and data services using fixed line and mobile technologies, including access to network infrastructure for other telecommunications operators and providers of both public and private networks and services. On March 1, 2006, Cesky Group announced the approval of its board of directors' intention to integrate its fixed line and mobile operations into a new integrated telecommunications operator.

Most of services of the Cesky Group are provided in the Czech Republic. The Cesky Group provides services to four main customer segments: residential, small- and medium-size enterprises, corporate clients and the government. Additionally, the Cesky Group provides wholesale services to other public telecommunications network operators and provides of public telecommunications services in the Czech Republic, Austria, Slovakia and Germany.

**Cesky**

The principal services offered by Cesky, our fixed line business in the Czech Republic, are:

- Traditional fixed line telecommunication services, principally including PSTN lines; ISDN access; public telephone services; local, domestic and international long distance and fixed-to-mobile communications services; supplementary value-added services (such as call waiting, call forwarding, three-party service, voice and text messaging, advanced voicemail services and conference-call facilities); intelligent network services; leasing and sale of terminal equipment; and telephony information services.
- Internet and broadband multimedia services, principally including narrowband switched access to Internet; retail and wholesale broadband access, through ADSL; and residential-oriented value-added services (such as instant messaging, concerts and videoclips by streaming, e-learning, parental control, firewall and anti-virus).
- Data and business-solutions services, principally including leased lines; VPN services; and hosting and ASP service.
- Wholesale services for telecommunication operators, principally including domestic interconnection services; international wholesale services; leased lines for other operators' network deployment; and local loop leasing under the unbundled local loop regulation framework.

**Operations**

The following table presents, at the dates indicated, selected statistical data relating to Cesky.

	<b>At December 31,</b>			<b>Increase/ (Decrease)</b>
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2004-2005</b>
Fixed telephony accesses (in thousands)	3,585	3,368	3,126	(7.2)%
Broadband accesses (in thousands)	15	101	274	171.3%
Penetration rate in Czech Republic	36%	34%	32%	(2.0) p.p.
Lines in service per employee	329	383	415	8.4%

As at December 31, 2005, Cesky had 3,126,016 fixed telephony accesses (mainly telephone lines, including ISDN lines), of which 2,127,957 were residential lines, 972,057 were business lines and 25,486 were pay telephones. The total number of fixed telephony accesses at December 31, 2005 decreased by 242,310 from December 31, 2004. This decrease was mainly due to the rapid increase in mobile penetration in the Czech Republic, as customers have substituted their use of fixed lines for mobile phones to a greater extent than in other countries. This decrease was offset in part by the rate rebalancing of monthly access fees, which the company was able to agree with the regulator on favorable terms.

The minutes of traffic generated in 2005 decreased by 29.2% compared to 2004 as a result of both migration of Internet dial up traffic to broadband connections and the substitution effect of mobile for fixed line traffic.

**Regulation**

The regulatory environment for the electronic communications market in the Czech Republic experienced a number of changes in the course of 2005. The most significant development was the substitution of the Act No. 151/2000 Coll., on telecommunications, as amended (Telecommunications Act) by a new law, the Act No.

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127/2005 Coll., on electronic communications, as amended (Act on Electronic Communications), effective from May 1, 2005, and the subsequent adoption of related laws (government regulations, decrees and general provisions).

The telecommunications industry in the Czech Republic is regulated by the Ministry of Informatics of the Czech Republic (MoI) and the Czech Telecommunications Office (CTO). The authority of the MoI relates mostly to policy making and international relations, whereas regulatory authority resides mainly in the CTO. Market competition is regulated by the Office for Protection of Economic Competition (OPEC).

Under the Act on Electronic Communications, Cesky provides electronic communications services on the basis of its notification to the CTO dated October 7, 2005 No.: 31618/2005-631. The telecommunications license previously granted to Cesky by CTO decision ref. no.: 38155/2001/I-603 dated March 4, 2005 ceased to be effective due to the changes in the legislation which eliminated the license regime as a result of which electronic communication services are currently provided only on the basis of notification to the CTO. Cesky Telecom has received the relevant certificates from the CTO. These certificates are not restricted for a certain period of time. In addition to these basic certificates relating to its core businesses, Cesky Telecom holds various other licenses, authorizations and permissions for specific services, some of which have expiry dates.

### *Universal Service*

The CTO requires Cesky to provide universal service in the public interest on a public fixed telecommunications network. Cesky was determined by the CTO pursuant to the Act on Electronic Communications as a universal service provider in the following areas:

- regular publication of telephone directories in the area of the public telephone service and provision of access to users of these directories under Section 38(2c) of the Act on Electronic Communications;
- directory information service in the area of the public telephone service and provision of access to users of the information service under Section 39(2d) of the Act on Electronic Communications; and
- public telephone booth services under Section 38(2e) of the Act on Electronic Communications.

Cesky is still awaiting the decision of the CTO with respect to other services that shall form a part of the universal service, especially the service of access in the fixed point to the publicly available telephone service and connection in the fixed point to the public telephone network. The CTO was required to issue a decision regarding these services by the end of January 2006, but the decision has not yet been issued.

Pending the introduction of the other universal service elements under the Act on Electronic Communications, Cesky remains the only universal service provider under the conditions of the Regulatory Framework set forth in the Act on Electronic Communications, related laws and telecommunications licenses.

### *Competition*

The liberalization of the Czech telecommunications market has attracted many alternative telecommunications operators. In the past, most of these alternative telecommunications operators concentrated on providing services to corporate customers. Via carrier selection and pre-selection, these alternative telecommunications providers began to focus on providing voice services to residential customers and recently on providing Internet access to the retail market. 2005 was characterized by the consolidation of several small telecommunications operators by GTS Novera and its sole shareholder, GTS Central Europe (GTS CE). GTS Novera became the largest alternative telecommunications operator in the Czech fixed line market after the merger of two biggest alternative telecommunications operators – GTS CZECH and Aliatel in February 2005. On November 29, 2005, GTS CE signed a purchase agreement for 100% of the shares of Contactel. On December 6, 2005, GTS CE reached an agreement with Telenor of Norway to acquire 100% of the shares of Telenor Networks and Nextra. According to publicly available information, the market share of alternative telecommunications operators as at the end of 2005 in terms of revenues was approximately 33%.

### *Tariffs*

Retail tariffs for Cesky's voice services are currently regulated. The main feature of the regulation of retail tariffs is the establishment of maximum prices for monthly access charges and voice services. Beginning May 1, 2006, it is expected that retail tariffs will no longer be regulated and that prices will be based on market competition.

***Eurotel***

Eurotel is the largest provider of wireless voice and data services in the Czech Republic in terms of customers. Customers can choose from an extensive portfolio of mobile voice and data services. Eurotel provides these services



via its 450 MHz Nordic mobile telephone network (["NMT"]) network and 900/1800 MHz GSM network. Eurotel offers voice and SMS services, as well as mobile Internet access, WAP and a wide range of multimedia services and content, including video and MMS.

On December 1, 2005, Eurotel started the commercial operation of its UMTS network. Eurotel was the first Czech mobile operator to launch UMTS services, comprising data as well as voice, video and multimedia transmission in real time. These services are available to both contract and pre-paid customers.

Eurotel also offers a wide range of value added services:

- Eurotel Asistent 1188 telephone directory services;
- Voice mail, call waiting, conference calls and caller identification;
- SIM card-embedded services: two telephone numbers on one card SIM or one number on two SIM cards;
- SMS to fixed line; and
- Access to corporate mail applications, integrating corporate e-mail with an SMS gateway, for corporate customers.

### **Operations**

The following table presents, at the dates indicated, selected statistical data relating to Eurotel.

	<b>At December 31,</b>		
	<b>2003</b>	<b>2004</b>	<b>2005</b>
	<b>(in thousands)</b>		
Total customers	4,215	4,394	4,676
Contract customers	885	1,058	1,546
Population in service territory	10,211	10,210	10,210

With approximately 4.7 million customers at December 31, 2005, Eurotel is the largest provider of wireless voice and data services in the Czech Republic. Eurotel is also the leading mobile Internet provider in the Czech Republic. At December 31, 2005, the wireless penetration rate in the Czech Republic was 112%.

#### *Network and technology*

Eurotel was the first operator to offer wireless services in the Czech Republic. In 1991, Eurotel obtained a license to operate a 450 MHz network and started operating in the same year. In 1996, it obtained a license to operate a 900 MHz network, and in 1999, it obtained a license to operate an 1800 MHz network, in each case using GSM technology. Each of Eurotel's licenses was issued for a period of 20 years.

Eurotel uses mainly GSM technology for its voice services. In 2004, however, it began to use a 450 MHz NMT network for wireless data services, thus becoming the first European operator to use the latest CDMA2000 1xEV-DO technology for high-speed Internet access.

Eurotel uses GPRS, high-speed circuit-switched data (["HSCSD"]), code division multiple access 1x evolution-data optimized technology (a technology that offers near-broadband packet data speeds for wireless access to the

internet) (CDMA2000 1xEV-DO) and wireless fidelity (Wi-Fi) technologies to offer a broad range of Internet access services.

Currently, Eurotel's 900/1800 MHz networks cover 99% of the population in the Czech Republic.

### *Regulation*

Eurotel conducts its operations on the basis of general authorizations. Eurotel has notified its operations to the CTO and has received the relevant certificates from the CTO. These certificates are not restricted for a certain period of time. In addition to these basic certificates relating to its core businesses, Eurotel holds various other licenses, authorizations and permissions for specific services, some of which have expiry dates.

Unlike the fixed line telephone market, where the CTO regulates primarily the revenues from telecommunications services, universal service prices and interconnection prices, the main area of regulation in the mobile telephone market is the determination of the prices for interconnection to public mobile networks. In its pricing decision no. 02/PROP/2005, effective as of April 1, 2005, the CTO reduced the maximum price for interconnection to public telecommunications networks for the service of call termination in public mobile telecommunications networks by 2.5%, from CZK 3.19 per minute to CZK 3.11 per minute.

The Act on Electronic Communications requires mobile operators to provide mobile number portability. A mobile number portability solution was developed, tested and put in operation jointly by mobile operators in the Czech Republic and such service has been available since January 15, 2006.

### **Competition**

The three principal mobile operators in the Czech Republic are Eurotel, Oskar Mobil and T-Mobile. In June 2005, the Vodafone Group acquired the newest mobile operator in the Czech Republic, Oskar Mobil. At December 31, 2005, Eurotel had an estimated 41% market share, followed by T-Mobile with an estimated 40% market share and Oskar/Vodafone with an estimated 19% market share.

### **Tariffs**

Tariffs are freely established by telecommunications providers, subject to regulation by the CTO. Interconnection prices are set by the CTO.

### **Telefónica Contenidos – Audio-visual Media and Content Business in Europe and Latin America**

Telefónica Contenidos conducts our worldwide audio-visual content and media business. Telefónica Contenidos develops and distributes audiovisual content through traditional media and new technology platforms.

During the last three years, Telefónica Contenidos has divested its non-strategic assets, including sales of its interests in: Antena 3 and the Onda Cero radio network; Lolafilms, a Spanish motion picture production company; Rodven, a Venezuelan record company; Mediapark, a Spanish television channel production company; Radio Continental and Radio Estereo, two Argentine radio companies owned by Atlantida de Comunicaciones; and Torneos y Competencias, the company that holds the broadcasting rights for the Argentine national soccer league. In September 2004, Telefónica Contenidos sold its 5% stake in Pearson, plc for €345 million.

### **Endemol Entertainment**

In July 2000, we acquired 99.2% of Endemol Entertainment Holding N.V., or Endemol, one of Europe's leading television producers. Endemol develops and produces audiovisual programming for free-to-air television, pay television and the Internet. Endemol has produced reality television shows such as Big Brother, Fear Factor and Operación Triunfo.

In November 2005, we sold a 25% interest in Endemol N.V. through a public offering outside of the United States for an aggregate amount of approximately €281.25 million. Endemol N.V. shares are currently listed on Euronext Amsterdam.

Endemol has a very strong international network built by a combination of start-ups, acquisitions and joint ventures, with operations in 23 countries around the world.

With the further development of the Internet and increased capabilities of mobile telephony to provide new platforms suitable for delivering entertainment content that attracts younger audiences (which are more appealing to advertisers) away from traditional television production, Endemol has refined its interactive strategy by focusing on brand development, bringing content to other channels by using Endemol TV brands and developing new content for other channels and platforms.

Endemol continues to develop its strategy of geographic diversification. In 2005, Endemol started operations in Thailand and India. In 2004, Endemol started operations in Russia, Chile and Colombia.

### **ATCO**

Telefónica Contenidos controls ATCO, a holding company that owns of Telefé, a television company in Argentina. Telefé owns a leading free-to-air television channel in Argentina in terms of audience and a broadcasting producer.

### **Pay Television**

We hold a minority stake in Sogecable, a satellite pay TV company with operations in analog pay TV (until November 2005), thematic channels, film production and distribution. Sogecable was created in 2003 as a result of the integration of the two then existing satellite digital television platforms in Spain. The other shareholders in Sogecable are Grupo Prisa and Vivendi Universal, with whom Telefónica Contenidos signed an agreement providing for equal corporate governance rights among the three parties.

Following the integration of the two platforms in July 2003, Sogecable, launched commercial advertisements under the brand "Digital+". At December 31, 2005, Sogecable had 1.96 million subscribers. In November 2005, Sogecable launched "Cuatro", a new free-to-air television station, after the Spanish government's approval of the modification of the "Canal+" license, removing the restrictions on the number of hours of open broadcasting. Since that time, "Canal+", the premium pay-tv channel, is only available on "Digital+".

In March 2006, we sold shares representing a 6.57% stake in Sogecable to Prisa in connection with their tender offer for shares of Sogecable. Following such sale and the consummation of Prisa's tender offer, we held a 17.3% stake in Sogecable, while Prisa held a 44.5% stake.

In March 2006, Sogecable's shareholders approved a capital increase in exchange for shares of its affiliate, Canal Satellite Digital, S.L. not owned by Sogecable. As a result of such capital increase, our stake in Sogecable was diluted to 16.84% .

### **Telefónica Servicios Audiovisuales and Hispasat**

Through Telefónica Servicios Audiovisuales, we offer audiovisual transmission services, production services and systems integration services to the audiovisual industry. Telefónica Contenidos also holds a 13.2% interest in Hispasat, a Spanish satellite communications system.

### **Directories Business Telephone Directory Business in Europe and Latin America**

Telefónica Publicidad e Información publishes, develops and sells advertising in telephone directories. In addition to printed directories, it offers directories online and in telephone-based format. Telefónica Publicidad e Información has operations in Spain, Brazil, Chile and Peru. In addition, Telinver is the Group's telephone directory subsidiary in Argentina. In 2005, we commenced offering telephone directory assistance in Italy.

At December 31, 2005, we held a 59.90% interest in TPI. On February 28, 2006, the Board of Directors of Telefónica resolved to explore strategic alternatives in relation to Telefónica's holding in the share capital of

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Telefónica Publicidad e Información, S.A. (TPI), which operates our directories business, including a possible total or partial divestiture of its holdings in that company. Telefónica intends to explore such a sale with potential buyers.

**Atento Call Center Business**

Atento offers integrated telephone assistance services as well as sophisticated customer relationship management services such as the development and implementation of customer loyalty programs, telemarketing services and market research. In addition, Atento rents call centers and provides staff for such centers to third parties. Atento has sought to diversify its client base and serves companies in the financial, consumer and energy sectors, as well as public institutions. At December 31, 2005, Atento operated more than 61 call centers and had 96,003 call center personnel in 12 countries on three continents, including Europe (Spain), Latin America and Northern Africa (Morocco).

**O2**

In order to integrate O2 into the Telefónica Group, in 2006 we expect to add a new business line that will be principally comprised of O2 and will also include Cesky Telecom and Telefónica Deutschland.

O2 is a leading provider of mobile communications services in Europe, with operations in the United Kingdom, Germany, Ireland and the Isle of Man. At December 31, 2005, O2 had approximately 27,419 thousand mobile customers, of which 39.8% were contract customers and 60.2% were prepaid customers. At that date, O2 had approximately 16,045 employees.

**Operations**

*United Kingdom.* O2 is the a leading mobile operator in the United Kingdom with approximately 15,981 thousand customers at December 31, 2005. O2 has a strong presence in business and mobile data services.

O2 provided analog mobile telephone services from January 1985 until October 2000 and has provided GSM services since July 1994. In June 2000, O2 launched GPRS services to the U.K. market. O2 was awarded one of the five UMTS licenses in the United Kingdom in April 2000 for £4.03 billion and completed the roll out of the first phase of its UMTS network in the United Kingdom in 2004. O2 commenced offering initial UMTS services to corporate customers in October 2004 and to retail customers in February 2005. In addition, following a five-year network roll-out that was also completed in 2004, O2 also provides nationwide mobile radio services designed to service the needs of police and emergency services personnel in England, Wales and Scotland.

O2 also has a 50% interest in a joint venture, Tesco Mobile, to sell exclusively Tesco branded mobile services in Tesco stores across the United Kingdom, using O2's technology and network.

The following table presents, at the dates indicated, selected statistical data relating to O2's operations in the United Kingdom.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total mobile customers (in thousands)	14,216	15,981
Pre-paid customers (in thousands)	9,341	10,479

*Germany.* O2 is a mobile operator in Germany with approximately 9,769 thousand customers at December 31, 2005.

In May 1997, O2 was awarded the fourth German GSM license and launched GSM mobile services in October 1998. In January 2001, O2 launched its GPRS service. O2 was awarded a UMTS license in Germany in August 2000 for an equivalent of £5.16 billion. O2 provides services through roaming agreements with other operators, including its agreement with T-Mobile, in the areas where it has not developed its own network. O2 is in the process of deploying its own UMTS network in Germany to offer high quality mobile services and to reduce its reliance on roaming agreements with other operators to provide its services.

The following table presents, at the dates indicated, selected statistical data relating to O2's operations in Germany.



	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total mobile customers (in thousands)	7,399	9,769
Pre-paid customers (in thousands)	3,254	4,799

*Ireland.* O2 is a mobile operator in Ireland with approximately 1,602 thousand customers at December 31, 2005.

O2 launched its commercial GSM services in Ireland in March 1997 and its GPRS service in Ireland in January 2002. In October 2002, O2 was awarded one of four UMTS licenses offered by the Irish government.

The following table presents, at the dates indicated, selected statistical data relating to O2's operations in Ireland.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total mobile customers (in thousands)	1,516	1,602
Pre-paid customers (in thousands)	1,118	1,173

*Isle of Man.* O2 provides mobile and fixed line and Internet services on the Isle of Man. At December 31, 2005, O2 had 67,000 customers on the Isle of Man.

O2's business in the Isle of Man, Manx Telecom, was awarded in 1987 a 20-year license to operate the Isle of Man's telecommunications network. The license originally covered fixed line telephony, but was expanded in 1994 to include GSM mobile services and in 1999 to include UMTS services. Manx Telecom launched Europe's first UMTS network in December 2001. On January 1, 2004, Manx Telecom was awarded a license extension for 15 years. Manx Telecom is the only provider of mobile and fixed telephony on the Isle of Man. Furthermore, Manx Telecom has continued with its major investment program to make broadband available to as many customers on the Isle of Man as possible.

The following table presents, at the dates indicated, selected statistical data relating to O2's operations on the Isle of Man.

	<b>At December 31,</b>	
	<b>2004</b>	<b>2005</b>
Total customers (in thousands)	63.0	67.0
Pre-paid customers (in thousands)	41.0	45.0

#### *Selected Financial Information*

The following table presents selected consolidated financial data of O2. The consolidated income statement data for the fiscal year ended March 31, 2005 and the consolidated balance sheet data as of March 31, 2005 set forth below are derived from O2's consolidated financial statements. O2's consolidated financial statements as of and for the fiscal year ended March 31, 2005 are not included in this Annual Report. O2's consolidated financial statements as of and for the fiscal year ended March 31, 2005 have been prepared in accordance with accounting principles generally accepted in the United Kingdom (UK GAAP). IFRS differs in certain significant respects from

UK GAAP.

**As of or for the year ended  
March 31, 2005**

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**(£ in millions)**

**UK GAAP**

**Consolidated Income Statement Data**

Group turnover	6,890
Net operating expenses (including exceptional items)	(6,342)
Group operating profit	341

	<b>As of or for the year ended March 31, 2005</b>
	<b>(£ in millions)</b>
Profit on ordinary activities before taxation	309
Profit for the financial year	301
<b>Consolidated Balance Sheet Data</b>	
Fixed assets	11,496
Net current assets	442
Net assets	10,281
Shareholders' funds	10,281

*Regulation of O2*

O2 is subject to national regulation in each of the countries in which it operates, as well as EU-wide regulation.

*Regulation in the European Union.* Regulation in the European Union is governed by the EU regulatory framework for the electronic communications sector (the EU Framework). The EU Framework comprises four principal Directives. Among other things, the Directives set out policy objectives and regulatory principles that National Regulatory Authorities ("NRAs") must follow. The Directives provide for a new authorization system for companies which provide electronic communications networks and services, contain measures to ensure the universal provision of basic services to consumers and set out the terms on which providers may access each other's networks and services. Importantly, the EU Framework also harmonizes the rules for deciding when regulation may be imposed on electronic communications providers. In particular, it provides that electronic communications providers can usually only be subject to specific regulation in markets in which they have "SMP" (equivalent to market dominance).

Currently, the European Commission is in its second and final phase of consultations on a proposed EU regulation with respect to international roaming charges. See "Telefónica Móviles" Mobile Business in Spain and Latin America"Spain"Regulation". If such regulation were to be adopted, it could adversely affect O2 and its operations.

*Regulation in the United Kingdom.*

*Implementation of the New EU Regulatory Framework* The EU Framework was implemented in the United Kingdom by the Communications Act 2003 (the "Communications Act") on July 25, 2003. Under the Communications Act, responsibility for the regulation of electronic communications networks and services rests with the Office of Communications ("Ofcom").

*Market reviews* In June 2004, Ofcom completed its review of voice call termination on individual mobile networks. As a result of that review, Ofcom concluded that the charges O2 made to other operators for terminating calls on the O2 network had to be cut. From September 1, 2004, Ofcom required O2 to lower its call termination charges from an average of 8.03 pence per minute to an average of 5.63 pence per minute.

*National roaming* O2 in the UK and Vodafone are subject to an obligation to negotiate a national roaming agreement with the new entrant mobile network operator, "3" (the "National Roaming Condition"). In accordance with this obligation, O2 entered into an agreement with 3 to permit it to use O2's second generation network to originate and terminate calls to and from its subscribers while it builds its own UMTS network. On December 22, 2004, 3 invited mobile operators to tender for the supply of second generation roaming services to 3 when the exclusivity period in their agreement with O2 expires. Although Ofcom proposed discontinuing the National Roaming Condition in July 2004, its decision on this issue has been postponed pending the outcome of 3's tendering exercise.



*Future Mobile Spectrum* □ In January 2005, Ofcom began consultations on the release of future mobile spectrum over the next five years. Of particular importance will be the UMTS expansion band (2500MHz-2690MHz).

*Regulation in Germany.* The EU Framework was implemented in Germany at the end of June 2004 by the Telecommunication Act. Responsibility for regulation of electronic communications networks and services rests with the telecommunications regulator, RegTP.

*Regulation in Ireland.* The EU Framework was implemented into Irish law on 25 July 2003. Responsibility for regulation of the communications industry in Ireland lies with a three-person regulatory body, known as the Commission for Communications Regulation (□ComReg□).

*Regulation in the Isle of Man.* The Isle of Man is a self-governing Crown Dependency with its own parliament and is not part of the United Kingdom or the EU. Accordingly, Manx legislation and regulations predominantly govern operations in the Isle of Man.

## **International Strategic Partnerships**

### **China Netcom**

In June 2005, Telefónica Internacional acquired through open market purchases 2.99% of the outstanding shares of China Netcom Group Corporation (Hong Kong) Limited, a Chinese telecommunications company, for an equivalent of approximately €240 million. In September 2005, Telefónica Internacional increased its stake in China Netcom Group Corporation (Hong Kong) Limited to 5.0% of its outstanding shares through open market purchases for an equivalent of approximately €427.9 million. As a result of our shareholdings in China Netcom Group Corporation (Hong Kong) Limited, we have the right to appoint one of the company's directors. On September 12, 2005, José María Álvarez-Pallete López was appointed as a member of China Netcom Group Corporation (Hong Kong) Limited's Board of Directors and is also a member of China Netcom Group Corporation (Hong Kong) Limited's Strategic Planning Committee.

### **Portugal Telecom**

At December 31, 2005, we held a 9.84% effective interest in Portugal Telecom, our joint venture partner in Brazil. See □□Telefónica Móviles□Mobile Business in Spain and Latin America.□

### **Mobipay**

Telefónica Móviles is jointly developing with other telecommunications companies a new, simple, fast, low cost and secure mobile payment system, under the Mobipay brand, to process automated transactions including vending machines, personal money transfers, micropayments and electronic invoicing. For a description of Mobipay and other □m-pay□ initiatives see □□Telefónica Móviles□Mobile Business in Spain and Latin America□Services and Products□.

### **Our Strategic Alliance with Banco Bilbao Vizcaya Argentaria**

#### *Uno-e Bank*

In February 2000, we and Banco Bilbao Vizcaya Argentaria, S.A. entered into a strategic alliance agreement, which provided that the online bank, Uno-e, would be 49%-owned by Terra Lycos and 51%-owned by Banco Bilbao Vizcaya Argentaria, S.A. On May 15, 2002, Terra Networks, S.A. and Banco Bilbao Vizcaya Argentaria, S.A. agreed to merge Uno-e Bank, S.A. with Finanzia Banco de Crédito, S.A., a wholly owned subsidiary of Banco Bilbao Vizcaya Argentaria, S.A. On January 10, 2003, Terra Networks, S.A. signed a liquidity contract that replaced a previous agreement. The liquidity contract grants Terra Networks a put option to sell its interest in

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the merged entity to Banco Bilbao Vizcaya Argentaria, S.A. between April 1, 2005 and September 30, 2007. The sale price will be the greater of (i) the value determined by an investment bank or (ii) the value calculated by multiplying Uno-e's earnings for the most recent fiscal year by BBVA's price-to-earnings ratio. Additionally, the contract provides that if Uno-e does not obtain certain ordinary revenue and earnings before taxes, the aggregate market value of the shares

Terra Networks, S.A. owns cannot be valued at less than €148.5 million. In June 2003, Finanzia Banco de Crédito, S.A. contributed its consumer finance business to Uno-e Bank in exchange for ordinary shares of Uno-e Bank S.A. At December 31, 2005, Terra Networks, S.A. (now Telefónica, S.A.) and the BBVA Group held a 33% and 67% stake in Uno-e Bank, S.A., respectively.

### Seasonality

Our main 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.

### C. ORGANIZATIONAL STRUCTURE

Please see [History and Development of the Company](#) [Overview](#).

### D. PROPERTY, PLANT AND EQUIPMENT

#### Spain

#### *Fixed lines*

In order to provide residential and other telecommunications services in Spain, we operate a full telecommunications services network. We benefit from an intensive capital investment plan carried out over the last decade, which focused on network expansion as well as network upgrading. As a result, we now have:

- A network consisting of fiber optical cable to the curb in every Spanish city with a population of more than 50,000 inhabitants;
- Switching including synchronous digital hierarchy;
- An asynchronous transfer mode rollout (ATM); and
- System 7 signaling throughout (used for commutation circuits networks).

Our infrastructure development objective is to achieve a fully digital system which allows simultaneous voice, data, text, and image transmission, and which permits cost-efficient network management and maintenance. Consistent with this aim, we are moving towards a simplified two-level hierarchical network through the use of remote units, and we are presently increasing operational efficiencies through centralization of our network supervision and management functions. The local digitalization rate in our network has increased from 56.7% in 1995 to 95.62% as of December 31, 2005, and our long distance lines are now 100% digitalized.

In carrying out our infrastructure development program, we have increased the use of fiber optical cable in our network.

The following table shows the total length of the four basic types of cable used in our network:

<b>At December 31,</b>				
2001	2002	2003	2004	2005

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Coaxial cable (Km.)	4,756	2,468	2,457	2,444	2,441
Optical fiber cable (Km.)	58,156	60,932	64,934	75,888	80,093
Copper cable in interurban links (Km. aerial cable)	57,095	56,753	56,492	59,324	59,326

65

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The deployment of broadband infrastructure at December 31, 2005 is as follows:

	<b>At December 31, 2005</b>
ADSL connections (in thousands)	3,533
ADSL lines over Basic Telephony Network (BTN)	3,409
ADSL lines over ISDN	144
Switchboards with ADSL over BTN	4,659
Switchboards with ADSL over ISDN	1,235
Degree of DSLAM equipment occupation (%)	92.3%
Average time of retail ADSL service provision in PSTN and ISDN (in days)	12.48
ADSL lines subscribed per 100 inhabitants	10.5

Our number of ADSL lines subscribed per 100 BTN and/or ISDN access lines at December 31, 2005 were as follows:

	<b>Lines</b>	<b>ADSL</b>	<b>Coverage</b>
BTN (in thousands)	148.38	236.01	15.9%
ISDN	931.90	129.94	13.9%
Total	157.70	249.01	15.8%

The Spanish demography and topography presents significant challenges regarding the provision of basic telephony services throughout the country, especially to rural areas. Our continuous plan of rural expansion has been partly fostered by the Spanish local authorities. We are capable of using alternative technologies in order to extend the provision of services to remote and underpopulated areas according to our universal service obligations. Wireless access services have been established in areas in which wireless service could be provided at a lower cost per customer than fixed line telephony services.

### **Wireless Networks**

Telefónica Móviles España's digital network in Spain is based on the GSM standard, which has been adopted by more than 130 countries worldwide, including all member countries of the European Union. The wide acceptance of the GSM standard, together with its international roaming agreements, enables Telefónica Móviles España's customers to make and receive calls throughout Western Europe and in more than 200 countries worldwide. Telefónica Móviles España's GSM-based network provides its customers with access to many of the most advanced wireless services and a full portfolio of services and products. In addition, in 2001 Telefónica Móviles España launched a general packet radio service, or GPRS, which permits faster-based technology for the transmission of data and improved networks utilization.

To continue increasing the GSM network's capacity and in order to improve network coverage quality in highly populated areas and to allow for a more intensive use of its network inside offices in urban areas, Telefónica Móviles España has continued rolling out its UMTS network in compliance with its obligations under its UMTS license. In June 2002, we fulfilled the Spanish government's requirements regarding the initial roll-out for our UMTS network. In October 2003, Telefónica Móviles was the first mobile operator in Spain to launch a pre-commercial service based on UMTS technology and in 2004, Telefónica Móviles launched its commercial UMTS service in Spain.

### **Argentina**

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Telefónica de Argentina's properties consist of transmission plants and exchange equipment. Most of Telefónica de Argentina's properties are located in and around the Buenos Aires region.

As of December 31, 2005, the telephony service has approximately 4.4 million lines in service with approximately 26 lines in service per each 100 inhabitants in the southern region.

Telefónica de Argentina's long distance service is provided mainly through a microwave network using analog lines and switchboards. As of December 2005, Telefónica de Argentina had built approximately 19,000 kilometers

of optical fiber network, of which 5,300 kilometers were located in the northern region and are dedicated to the provision of national long-distance services between Argentina's main cities.

## Brazil

### *Network and Facilities*

Telesp's network includes installed lines and switches, an access lines network connecting customers to switches and trunk lines connecting switches and long-distance transmission equipment. As of December 31, 2005, our regional telephone network in Brazil included approximately 14.3 million installed access lines, including public telephone lines, of which 12.3 million access lines were in service. At that time, of the access lines in service, approximately 74.7% were residential, 19.9% were commercial, 2.7% were public telephone lines and 2.7% were for our own use and for testing. Intraregional long-distance transmission is provided by a microwave network and by fiber optic cable. Telesp's network strategy is to develop a broadband integrated network that is compatible with several types of telecommunications services and multimedia applications.

The following table sets forth selected information about our network in Brazil at the dates indicated.

	<b>At December 31,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Installed access lines (in millions)	14.3	14.4	14.2	14.2	14.3
Access lines in service (in millions)(1)	12.6	12.5	12.3	12.5	12.3
Average access lines in service (in millions)	11.9	12.6	12.4	12.3	12.4
Access lines in service per 100 inhabitants	33.8	32.9	31.6	31.7	30.9
Percentage of installed access lines connected to digital switches	95.7	96.1	96.9	98.7	100.0
Number of public telephones (in thousands)	342.8	330.9	331.1	331.2	331.5

(1) Data includes public telephone lines.

### *Technology*

We are currently implementing the necessary infrastructure for the offering of [Wi-Fi], which is a wireless Internet access connection that offers mobility to our Internet clients.

As of December 31, 2005, Telesp's network was 100% digital.

## Peru

In order to provide telecommunications services in Peru, Telefónica del Peru operates a telecommunications multiservice network. Over the last decade, a number of significant capital investments were made in order to enlarge the telecommunications infrastructure and to provide the telecommunications network with the latest generation technologies. As a result, we currently have:

- a solid optical fiber and coaxial cable network;
- a communications network interconnected through signaling protocol number 7;

- an ATM network; and
- a transmission network including synchronous digital hierarchy (SDH) technology.

The objective while developing Telefónica del Perú's infrastructure is to achieve a completely digital system that allows for simultaneous voice, video, data and text transmission, and therefore achieves network management and maintenance efficiencies. Accordingly, our network is simplified to a two-level hierarchy network through the use of remote units. We are also increasing our operating efficiencies through effective management of network centralization.

The following table sets forth selected information about our network in Peru at the date and for the period indicated.

	<b>At or for the year ended December 31, 2005</b>
Digitalization %(1)	96.81%
Number of fixed lines in service (in thousands)(2)	2,352,555
Number of fixed lines installed	2,509,789

(1) Local switching equipment only.

(2) Includes fixed line public telephones. Does not include cellular public telephones.

Telefónica del Peru has increased the number of ISDN lines. As of December 31, 2005, Telefónica del Peru had approximately 39,370 ISDN lines.

Telefónica del Peru's infrastructure development plan has increased the use of optical fiber into its network.

<b>Description</b>	<b>At December 31,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Coaxial cable (Km.)	5,697	5,738	5,797	5,870	7,959
Optical fiber cable (Km.)	6,728	6,761	6,993	7,090	7,563
Subscriber network (thousand Km.-pair)	5,270	5,316	5,517	5,757	6,237

## Chile

The principal plant and equipment of CTC Chile consists of outside plant and switching equipment and operating units that are located throughout the country. The company's land and buildings principally consist of its telephone exchanges and other technical, administrative and commercial properties. As of December 31, 2005, the company's telephone network in Chile included approximately 3 million of lines installed, of which 2.4 million lines were in service. Additionally, CTC Chile's long distance subsidiary currently operates the most extensive fiber optic network in the country, including connections to Peru and Argentina. It also operates digital satellite and microwave links in areas not covered by the fiber optic network and participates actively in the development and use of submarine fiber optic networks.

The following table sets forth selected information about CTC Chile's fixed telephony network at the indicated dates.

	<b>At December 31,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Lines installed	3,019,416	3,023,541	3,037,267	3,043,379	3,007,432
Fixed lines in service	2,723,310	2,686,695	2,416,779	2,427,364	2,440,827
Average fixed lines in service	2,736,633	2,732,208	2,558,291	2,406,266	2,451,536
Lines per 100 inhabitants (1)	17.6	17.4	16.1	15.0	15.1

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Number of new lines connected	330,619	340,419	308,266	343,318	358,088
Number of public telephones (in thousands)	12,880	11,834	11,060	10,288	10,272
ADSL connections in service	14,808	54,163	125,262	200,794	314,177

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(1) Based on CTC Chile's average fixed lines in service per 100 inhabitants and 2002 Census.

**Technology**

Since 1993, CTC Chile's nationwide local telephony network is fully digitalized.

### **Wireless Networks**

Telefónica Móviles Chile owns, or controls through long-term leases or licenses, property consisting of plant and equipment used to provide wireless communication services.

Plant and equipment used to provide wireless communication consist of:

- switching, transmission and receiving equipment;
- connecting line (cables, wires, poles and other support structures, conduits and similar items);
- land and buildings;
- easements; and
- other miscellaneous properties (work equipment, furniture and plants under construction).

### **Satellite Communications**

As at December 31, 2005, we had an interest in one international satellite communications organization or company: a 13.2% interest in Hispasat, the communications satellite company which carries the Digital+ direct-to-home (DTH) satellite television service and operates a new satellite system in Brazil and Latin America (Amazonas).

In March 2005, we sold our 0.7% interest in Intelsat, the international satellite company to a consortium of private equity funds for approximately \$23 million.

In January 2005, we sold our 0.7% interest in New Skies Satellites, the communications satellite company that was formerly part of Intelsat, in January 2005 to Zeus Holdings Limited for approximately \$8 million.

We have implemented a satellite IP-access platform, which has been in operation since February 2003. We currently provide broadband Internet and Intranet access with similar speed and performance as with the ADSL technology. This satellite platform also provides VoIP services, which have been in operation since the second half of 2004.

### *Submarine Cable*

We are also one of the world's largest submarine cable operators. We currently participate in 44 international underwater cable systems (13 of which are moored in Spain) and own 11 domestic fiber optic cables.

## **ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not applicable.

## **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

### **A. OPERATING RESULTS**

#### **Overview**

The Telefónica Group has structured its management according to its different business lines which are separately managed and organized by reference to the products and services provided. The Telefónica Group's

principal lines of business in 2005 were:

- Telefónica de España: fixed line telephony in Spain;
- Telefónica Móviles: mobile telephony in Spain and Latin America;
- Telefónica Latinoamérica: fixed line telephony in Latin America;



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

## 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, which differ in certain respects from U.S. GAAP. Please refer to note 23 to our Consolidated Financial Statements for a discussion of these differences.

### **Non-GAAP Financial Information**

#### *Operating Income Before Depreciation and Amortization*

Operating income before depreciation and amortization is calculated by excluding depreciation and amortization expenses from our operating income in order to eliminate the impact of generally long-term capital investments that cannot be significantly influenced by our management in the short-term. Our management believes that operating income before depreciation and amortization is meaningful for investors because it provides an analysis of our operating results and our segment profitability using the same measure used by our management. Operating income before depreciation and amortization also allows us to compare our results with those of other companies in the telecommunications sector without considering their asset structure. We use operating income before depreciation and amortization to track our business evolution and establish operational and strategic targets. Operating income before depreciation and amortization is also a measure commonly reported and widely used by analysts, investors and other interested parties in the telecommunications industry. Operating income before depreciation and amortization is not an explicit measure of financial performance under IFRS or U.S. GAAP and may not be comparable to other similarly titled measures for other companies. Operating income before depreciation and amortization should not be considered an alternative to operating income as an indicator of our operating performance, or an alternative to cash flows from operating activities as a measure of our liquidity.

The following table provides a reconciliation of operating income before depreciation and amortization to operating income for the Telefónica Group for the periods indicated.

	<b>Year ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
Operating income before depreciation and amortization	12,222.03	15,276.43
Depreciation and amortization expense	(5,666.03)	(6,717.68)
Operating income	6,556.00	8,558.75

The following tables provide a reconciliation of operating income before depreciation and amortization to operating income for the Telefónica Group and each of our business lines for the periods indicated.

#### **Year ended December 31, 2005**

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	<b>Telefónica de España</b>	<b>Telefónica Móviles</b>	<b>Telefónica Latinoamérica</b>	<b>Cesky Group</b>	<b>Telefónica Contenidos</b>	<b>Directories Business</b>	<b>Atento</b>	<b>Others and Eliminations</b>	<b>Total</b>
Operating income before depreciation and amortization	4,766.79	5,817.01	3,758.32	456.68	269.20	219.28	116.36	(127.21)	15,276.4
Depreciation and amortization expense	(2,139.15)	(2,374.01)	(1,792.47)	(291.85)	(28.88)	(23.58)	(27.87)	(39.47)	(6,717.6
Consolidated Operating income	2,627.66	3,443.00	1,965.85	164.83	240.32	195.70	88.49	(167.08)	8,558.7

70

Year ended December 31, 2004

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<b>Telefónica de España</b>	<b>Telefónica Móviles</b>	<b>Telefónica Latinoamérica</b>	<b>Cesky Group</b>	<b>Telefónica Contenidos</b>	<b>Directories Business</b>	<b>Atento</b>	<b>Others and Eliminations</b>	<b>Total</b>
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