

Telefónica Finance USA, L.L.C.
Management Report and Financial Statements
For the Years Ended December 31, 2010 and 2009

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C N M V
Registro de Auditorías
Empleadas
Nº **13197**

Management Report

Management Report

Telefonica Finance USA, L.L.C. (Delaware)

Management herewith submits the Financial Statements of Telefonica Finance USA, L.L.C. (the Company) for the financial year ended December 31, 2010.

Net Income

For 2010, the Company's net income totaled €83.705.247, which represents an increase over 2009 net income of €16.848, which is set out in detail in the accompanying Financial Statements.

As in previous years, during 2010 the sole income source of the Company is generated from the 2002 €2 billion Promissory Note dated December 30, 2002 signed with Telefonica Europe B.V. During 2010, the Company generated interest income of €95.820.000, as compared to €95.740.444 for 2009.

While market interest rates were generally lower during 2010 versus 2009, this did not have an impact on interest income as the interest rate on the loan itself was unchanged. The Company obtained €79.556 more in interest income during 2010 when compared to 2009 due to the change in the loan margin from 0,603% to 0,607% on December 30, 2009.

There are no significant changes to report in comparison to the 2010 Statement of Operations. The Company's expenses come mainly from the paid fees of a liquidity agreement signed together with the underwriters of our preferred capital securities. The Company's administrative expenses have increased by €62.818. This is almost entirely the result of the amount paid for rating agency fees (€56.664).

Dividends Payment

€83.680.000 preferred dividends were paid during 2010. This is the same amount that was paid during 2009.

Assets

No relevant changes have been registered. At December 31, 2010, the €2 billion Loan remains the same outstanding amount as compared to 2009. No capital repayment has been done.

Liabilities

There have been no notable changes in our current liabilities. The Company has not incurred any long-term liabilities.

Management Report

Telefonica Finance USA, L.L.C. (Delaware) (continued)

No significant variations have occurred in the Company's equity. A minor increase €25.248 in equity has occurred as a result of a retained earnings increase.

Risk Management

Company operations have always been structured taking into account potential risk variables.

Foreign Currency Risk

Since the Company's functional currency is the Euro (EUR), and there aren't any significant foreign currency denominated financial assets or liabilities in the Balance Sheets, fluctuations in foreign exchange rates will not have a significant impact on our accounts.

Interest Rate Risk

The Company's preferred capital securities pay preferred dividends quarterly. These dividends are index to the three-month-Euribor (European Interbank Offered Rate). Preferred capital securities were issued including a cap of 6.823% for the calculation of the dividend, as well as a floor on 4.184%. The Company also incorporated the same cap and floor on its Promissory Note dated December 30, 2002, thus avoiding potential cash-flow mismatches with respect to interest rates fluctuations. The Promissory Note dated December 30, 2002 earns interest based on the three-month Euribor plus a margin (0.607%) and is subject to a cap and floor as previously mentioned. The margin on the Promissory Note dated December 30, 2002 was changed from 0.603% to 0.607% on December 30, 2009.

Future Developments

No significant variation of granted loans or outstanding liabilities is expected.

There are no plans for any new intercompany loans, but it could change during 2011 fiscal year attending to the Telefonica's group financing needs. Telefonica Finance USA, L.L.C. is a wholly owned subsidiary of Telefonica Europe B.V., which, in turn, is a wholly owned subsidiary of Telefonica, S.A.

Delaware, March 2, 2011

Financial Statements With Report of
Independent Certified Public Accountants

Report of Independent Certified Public Accountants

The Board of Trustees and Securityholders
Telefónica Finance USA, L.L.C.

We have audited the accompanying balance sheets of Telefónica Finance USA, L.L.C. (the Company), as of December 31, 2010 and 2009, and the related statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Telefónica Finance USA, L.L.C. at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 2, 2011

Telefónica Finance USA, L.L.C.

Balance Sheets

	December 31	
	2010	2009
Assets		
Current assets:		
Cash	€ 46.271	€ 26.475
Prepaid expenses	20.048	
Accrued interest receivable	547.969	532.333
Total current assets	<u>614.288</u>	<u>558.808</u>
Loan to Telefónica Europe B.V. (Note 3)	2.000.000.000	2.000.000.000
Total assets	<u>€ 2.000.614.289</u>	<u>€ 2.000.558.808</u>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	€ 34.572	€ 4.336
Notes payable	12.000	12.000
Preferred dividends payable	464.889	464.889
Liquidity fee payable	66.658	66.661
Total current liabilities	<u>566.119</u>	<u>535.886</u>
Stockholders' equity:		
Common capital (Note 4)	95	95
Preferred capital securities (Note 5)	2.000.000.000	2.000.000.000
Retained earnings	36.074	10.827
Total stockholders' equity	<u>2.000.036.170</u>	<u>2.000.010.922</u>
Total liabilities and stockholders' equity	<u>€ 2.000.614.289</u>	<u>€ 2.000.558.808</u>

See accompanying notes.

Telefónica Finance USA, L.L.C.

Statements of Operations and Retained Earnings

	Year Ended December 31	
	2010	2009
Revenues:		
Interest income	€ 95.820.000	€ 95.740.444
Operating expenses:		
Liquidity fee	12.000.000	12.000.000
Administrative expenses	114.515	51.897
Total operating expenses	<u>12.114.515</u>	<u>12.051.897</u>
Other expense:		
Loss on currency exchange	<u>(238)</u>	<u>(148)</u>
Net income	83.705.247	83.688.399
Preferred dividends	<u>(83.680.000)</u>	<u>(83.680.000)</u>
Net income attributable to common securityholder	25.247	8.399
Retained earnings – beginning of year	10.827	2.428
Retained earnings – end of year	<u>€ 36.074</u>	<u>€ 10.827</u>

See accompanying notes.

Telefónica Finance USA, L.L.C.

Statements of Cash Flows

	Year Ended December 31	
	2010	2009
Operating activities		
Net income	€ 83.705.247	€ 83.688.399
Adjustments to reconcile net income to cash provided by operations:		
Changes in operating assets and liabilities:		
Increase in prepaid expenses	(20.048)	—
Increase in accrued interest receivable	(15.363)	(444)
(Decrease) increase in payables	30.233	(151)
Cash provided by operating activities	<u>83.699.796</u>	<u>83.687.804</u>
Financing activities		
Payment of preferred dividends	(83.680.000)	(83.680.000)
Cash used in financing activities	<u>(83.680.000)</u>	<u>(83.680.000)</u>
Increase in cash	19.796	7.804
Cash – beginning of year	26.475	18.671
Cash – end of year	<u>€ 46.271</u>	<u>€ 26.475</u>
Supplemental disclosure of noncash financing activities		
Accrued dividends on preferred capital securities	<u>€ —</u>	<u>€ —</u>

See accompanying notes.

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements

December 31, 2010

1. General

Telefónica Finance USA, L.L.C. (the Company) was formed under the laws of the State of Delaware on June 27, 2002. The Company commenced operations on December 30, 2002. The Company is a wholly owned subsidiary of Telefónica Europe B.V. (Telefónica Europe), which, in turn, is a wholly owned subsidiary of Telefónica, S.A. (Telefónica). Telefónica is a Spanish corporation that operates in the telecommunications, internet, and media businesses. The Company was established for the purpose of issuing preferred capital securities and common capital securities and to use substantially all of the proceeds thereof to enter into loan agreements with Telefónica Europe or other non-U.S. affiliates of Telefónica.

2. Summary of Significant Accounting Policies

The Company's functional currency is the Euro. The following summarizes the significant accounting policies:

Cash – Cash represents cash with original maturities of three months or less.

Revenue Recognition – Interest income is recognized as earned, based upon the principal amount outstanding on an accrual basis.

Fair Value of Financial Instruments – Presented below is a brief summary of the significant management estimates relating to the fair value of financial instruments:

Cash – The recorded amounts of cash approximate fair value due to the short-term nature of these instruments.

Loan to Telefónica Europe B. V. – The estimated fair value for the loan receivable, which is separately disclosed elsewhere, is based on directly or indirectly observable market based inputs used in models or other valuation methodologies.

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Estimates and Assumptions – Preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported in the financial statements and related notes. Actual results may differ from those estimates.

Income Taxes – The Company is a domestic limited liability company and is considered a pass through entity for U.S. federal income tax purposes. As such, the income tax effects of the results of operations of the Company accrue directly to the owners. Accordingly, the accompanying financial statements do not include any effects for income taxes.

Subsequent Events – In preparing the accompanying financial statements, management has evaluated subsequent events through March 2, 2011.

Adopted New Accounting Pronouncements – In June 2009, the Financial Accounting Standards Boards (FASB) issued its final statement of financial accounting standards No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principle – a replacement of FASB Statement No. 162*. ASC 105 establishes the FASB Accounting Standards Codification (ASC) as the source of Authoritative Accounting Principles recognized by the FASB to be applied by nongovernmental entity, in the preparation of financial statements in conformity with GAAP in the United States. The ASC only changes the referencing of financial accounting standards and does not change or alter existing U.S. GAAP. We have adopted this standard as of the annual reporting period ending December 31, 2009.

In May 2009, the FASB issued new guidance as part of ASC Topic 855, *Subsequent Events* (ASC 855), which establishes general standards of accounting for disclosing events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. We have adopted this standard as of December 31, 2009.

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Effective January 1, 2008, the Company adopted ASC Topic 820, *Fair Value Measurements and Disclosures* (ASC 820), to measure the fair value of our financial assets and financial liabilities. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

ASC 820 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy under ASC 820 are described below:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities. The Company used Level 1 assumptions for our cash. The valuations are based on quoted prices that are readily and regularly available in an active market, and accordingly, a significant degree of judgment is not required.

Level 2: Directly or indirectly observable market based inputs used in models or other valuation methodologies. The Company used Level 2 assumptions for the valuation of our loan receivable, using directly or indirectly observable market based inputs used in models or other valuation methodologies. These inputs include interest rates, yield curves, credit risk, and liquidity risk.

Level 3: Unobservable inputs that are supported by little or no market data and require the use of significant management judgment. As of December 31, 2010, we did not have any Level 3 financial assets or liabilities.

The fair value of the loan to Telefonica Europe B.V. in accordance with ASC 820 as of December 31, 2010, was €2,094,630,521 compared to a carrying value of €2,000,000,000. This compares with a fair value as of December 31, 2009, was €2,124,125,782 compared to a carrying value of €2,000,000,000.

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements (continued)

3. Loan to Telefónica Europe B.V.

On December 30, 2002, the Company made a loan of €2 billion to Telefónica Europe in exchange for a promissory note. The note, which matures on December 30, 2012, bears interest at a rate equal to the three-month Euro Interbank Offered Rate (Euribor) plus a margin (0,603%), provided, however, that the three-month Euribor effective rate shall in no event be less than 4,184% or more than 6,823%. The margin on the note was changed from 0,603% to 0,607% on December 30, 2009. Interest shall be due and payable quarterly in arrears on March 30, June 30, September 30, and December 30. The effective interest rate of the loan was 4,791% as of December 30, 2010, and 4,791% as of December 30, 2009.

4. Common Capital

The Company has issued 10 common capital securities to Telefónica Europe. Common capital securities are allocated 100% of all net losses of the Company (in the event such should occur) and all gains and losses resulting from the disposition of assets from the Company. The net profits of the Company are allocated to the preferred capital securities until the amount so allocated equals the amount of dividends declared for the year on the preferred capital securities. Any net profits in excess of the amount allocated to the preferred capital securities are allocated to the common capital securities. There have been no allocations of Common Capital in 2010 or 2009.

5. Preferred Capital Securities

The Company is authorized to issue and sell preferred capital securities having an aggregate initial liquidation preference of €2 billion. This amount may be amended or restated by resolution of the Board of Directors. Holders of preferred capital securities are entitled to receive, when and if declared by the Board of Directors out of the Company's net profits, cash dividends that will be paid at such rates as will be determined by the Board of Directors prior to the first issuance of these securities. Dividends on the preferred capital securities are noncumulative.

Preferred capital securities possess no voting rights. However, in the event that the Company fails to pay dividends in full on the preferred capital securities (and the guarantor fails to make a corresponding payment under the guarantee) for five consecutive dividend periods, then the holders of the preferred capital securities have the right to alter the composition of the Board of Directors as prescribed in the Amended and Restated Limited Liability Company Agreement of the Company (the Agreement).

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements (continued)

5. Preferred Capital Securities (continued)

Preferred capital securities may not be sold or otherwise transferred to persons in the United States of America except pursuant to sales or other transfers that satisfy the requirements of Regulation S under the Securities Act of 1933 (the Securities Act) or that are otherwise exempt from the registration requirements of the Securities Act.

In the event of any voluntary or involuntary liquidation of the Company, the holders of the preferred capital securities will be entitled to receive out of the assets of the Company available for distribution to security holders, an amount equal to the liquidation preference per preferred capital security, plus accrued and unpaid dividends thereon for the then-current dividend period, if any, to the date of liquidation. This distribution will occur before any distribution of assets is made to holders of common capital securities or any other class of securities ranking junior to the preferred capital securities.

On December 30, 2002, the Company completed the issuance of two million preferred capital securities and received proceeds of €2 billion from the issuance. Preferred capital security holders are entitled to receive dividends at a rate equal to the three-month Euribor effective rate, provided, however, that the three-month Euribor effective rate shall in no event be less than 4.184% or more than 6.823%. The effective rate for the dividends was 4.184% as of December 30, 2010 and 2009. Dividends are payable quarterly in arrears on March 30, June 30, September 30, and December 30. The preferred capital securities shall not be redeemed by the Company prior to December 30, 2012, with the exception of certain tax-related events, as defined in the Agreement. In the event the preferred capital securities are not redeemed on December 30, 2012, preferred capital securityholders are entitled to receive dividends at a rate equal to the three-month Euribor rate plus an effective annual rate of 4%. All costs related to this transaction were incurred by Telefónica and will not be charged to the Company. Telefónica is the guarantor of these securities.

6. Liquidity Fee

In December 2002, the Company entered into a Contrato de Liquidez (the Liquidity Fee Agreement) with the underwriters of its preferred capital securities offering. Pursuant to the Liquidity Fee Agreement, the Company is committed to pay a quarterly liquidity fee of 0.15% of the outstanding principal amount of the preferred capital securities to certain financial institutions. Liquidity fees paid in 2010 and 2009 were €12,000,000, respectively.

Telefónica Finance USA, L.L.C.

Notes to the Financial Statements (continued)

7. Related-Party Transactions

Pursuant to the Agreement, Telefónica Europe is responsible for, and will pay substantially all expenses of the Company to the extent such expenses are not paid by the Company. The expenses covered by the Agreement include administrative and organization costs as well as any costs resulting from any litigation against the Company. Minimal expenses were paid on behalf of the Company in 2010 and 2009.

As discussed in Note 3, the Company's loan to Telefónica Europe B.V. is with a related party.

Puglisi & Associates, under the terms of a Vendor Agreement dated October 24, 2002, provides accounting, accounts payable, treasury functions, and related administrative functions for the Company. The related vendor fee amounts to \$28,500 per year. Under the terms of a Lease Agreement dated October 24, 2002, Puglisi & Associates also provides office space to the Company. The office lease expense amounts to \$1,500 per year. Puglisi & Associates is a sole proprietorship owned by Donald J. Puglisi, who is a director of Telefónica Finance USA, LLC. The related director fee amounts to \$6,000 per year.

Had the Company operated autonomously, the financial position, results of operations, and cash flows may have differed from what is presented here in these financial statements.

**RESPONSABILITY STATEMENT TO THE FINANCIAL STATEMENTS FOR THE
YEAR ENDED DECEMBER 31, 2010.**

(Article 8.1.b. of Royal Decree 1.362/2007)

The members of the Board of Directors of Telefónica Finance USA, L.L.C. hereby declare that, to the best of their knowledge:

- (i) the Annual Financial Statements for the year ended December 31, 2010, approved at the meeting held on March 3, 2011, and prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of Telefónica Finance USA, L.L.C.
- (ii) the management report includes a fair review of the development and performance of the business and the position of Telefónica Finance USA, L.L.C. and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that Telefónica Finance USA, L.L.C. faces.

On April 27, 2011

Mr. Fernando Rodríguez Álvarez-Cantón
Director of Telefónica Finance USA, L.L.C.

Mr. Donald J. Puglisi
Director of Telefónica Finance USA, L.L.C.