

TELESP PARTICIPACOES SA  
Form 20-F  
April 15, 2005  
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As filed with the Securities and Exchange Commission on April 15, 2005

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## SECURITIES AND EXCHANGE COMMISSION

### FORM 20-F

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004

OR

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

Commission file number 001-14475

## TELECOMUNICAÇÕES DE SÃO PAULO S.A. TELESP

(Exact name of registrant as specified in its charter)

## Telecommunications of São Paulo Telesp

(Translation of registrant's name into English)

Federative Republic of Brazil

(Jurisdiction of incorporation or organization)

Rua Martiniano de Carvalho, 851 21º andar

01321-001 São Paulo, SP, Brasil

(Address of principal executive offices)

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

**Title of each class:**

**Name of each exchange on which registered:**

Preferred Shares, without par value  
American Depositary Shares (as evidenced by American Depositary  
Receipts), each representing 1,000 shares of Preferred Stock

New York Stock Exchange\*  
New York Stock Exchange

\* Not for trading purposes, but only in connection with the registration on the New York Stock Exchange of American Depositary Shares representing those Preferred Shares.

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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 stock of Telecomunicações de São Paulo S.A. Telesp as of December 31, 2004.

165,320,206,602  
328,272,072,739

**Shares of Common Stock**  
**Shares of Preferred Stock**

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.

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Yes  No

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

Item 17  Item 18

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**INTRODUCTION**

References in this annual report to Telesp, we, our, us and the company are to Telecomunicações de São Paulo S.A. TELESP and its consolidated subsidiaries (unless the context otherwise requires). In addition, all references in this annual report to:

ADSs are to our American Depositary Shares, each representing 1,000 shares of our non-voting preferred shares;

Anatel are to *Agência Nacional de Telecomunicações* ANATEL, the National Telecommunications Agency of Brazil;

BOVESPA are to the *Bolsa de Valores de São Paulo*, or the São Paulo Stock Exchange;

Brazilian Central Bank or Central Bank are to the *Banco Central do Brasil*, the Central Bank of Brazil;

Brazilian Corporate Law are to the *Lei das Sociedades por Ações*, Law No. 6,404 of December 1976, as amended;

Brazilian government are to the federal government of the Federative Republic of Brazil;

CMN are to the *Conselho Monetário Nacional*, the Monetary Council of Brazil;

Commission or SEC are to the U.S. Securities and Exchange Commission;

Corporate Law Method is the accounting practice to be followed in the preparation of our financial statements for regulatory and statutory purposes prescribed by the Brazilian Corporate Law and accounting standards issued by the CVM and the Independent Auditors Institute of Brazil (*Instituto dos Auditores Independentes do Brasil* IBRACON);

CVM are to the *Comissão de Valores Mobiliários*, the Securities Commission of Brazil;

General Telecommunications Law are to *Lei Geral de Telecomunicações*, as amended, which regulates the telecommunications industry in Brazil;

real, reais or R\$ are to Brazilian reais, the official currency of Brazil; and

US\$, dollars or U.S. dollars are to United States dollars;

Unless otherwise specified, data relating to the Brazilian telecommunications industry included in this annual report were obtained from Anatel.

The Glossary of Telecommunications Terms that begins on page 90 provides the definition of certain technical terms used in this annual report.

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**FORWARD-LOOKING STATEMENTS**

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Certain statements included in this annual report, principally in Item 3.D Risk Factors, Item 4 Information on the Company and Item 5 Operating and Financial Review and Prospects, contain information that is forward looking, including, but not limited to:

statements concerning our operations and prospects;

the size of the Brazilian telecommunications market;

estimated demand forecasts;

our ability to secure and maintain telecommunications infrastructure licenses, rights-of-way and other regulatory approvals;

our strategic initiatives and plans for business growth;

industry conditions;

our funding needs and financing sources;

network completion and product development schedules;

expected characteristics of competing networks, products and services; and

other statements of management's expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts.

Forward-looking statements may also be identified by words such as believe, expect, anticipate, project, intend, should, seek, estimate, similar expressions. Forward-looking information involves risks and uncertainties that could significantly affect expected results. The risks and uncertainties include, but are not limited to:

the short history of our operations as an independent, private-sector entity and the ongoing introduction of greater competition to the Brazilian telecommunications sector;

the cost and availability of financing;

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uncertainties relating to political and economic conditions in Brazil as well as those of other emerging markets;

inflation and exchange rate risks;

the Brazilian government's telecommunications policy; and

the adverse determination of disputes under litigation.

We undertake no obligation to update publicly or revise any forward-looking statements because of new information, future events or otherwise. In light of these risks and uncertainties, the forward-looking information, events and circumstances discussed in this annual report might not occur. Our actual results and performance could differ substantially from those anticipated in our forward-looking statements.

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**PRESENTATION OF FINANCIAL INFORMATION**

Our consolidated financial statements as of December 31, 2004 and 2003 and for the years ended December 31, 2004, 2003 and 2002, have been prepared in accordance with the Corporate Law Method, which differs in certain significant respects from generally accepted accounting principles in the United States, or U.S. GAAP. Note 32 to our financial statements appearing elsewhere in this annual report describes the principal differences between the Corporate Law Method and U.S. GAAP as they relate to us, and provides a reconciliation to U.S. GAAP of net income and shareholders' equity. These consolidated financial statements have been audited by Deloitte Touche Tohmatsu Auditores Independentes.

We have made rounding adjustments to reach some of the figures included in this annual report. Accordingly, numerical figures shown as totals in some tables may not be an arithmetic aggregation of the figures that preceded them.

**Table of Contents****PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

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

Not applicable.

**ITEM 3. KEY INFORMATION****A. Selected Financial Data**

Our consolidated financial statements included in this annual report on Form 20-F and the selected financial data presented for the periods described below have been prepared in accordance with the Corporate Law Method, which is the same basis of accounting used in our annual and interim financial statements published in Brazil, audited by Deloitte Touche Tohmatsu Auditores Independentes. For consistent presentation, we have used the Corporate Law Method for all periods described in this annual report on Form 20-F. See Note 2 to the consolidated financial statements.

The following tables present a summary of our selected financial data at the dates and for each of the periods indicated. You should read the following information together with our audited consolidated financial statements and the notes thereto included elsewhere in this annual report and with Item 5 Operating and Financial Review and Prospects.

	Year ended December 31,				
	2004	2003	2002	2001	2000
	(in millions of reais, except per share data)				
<b>Income Statement Data:</b>					
Corporate Law Method					
Net operating revenue	13,309	11,805	10,088	9,049	7,310
Cost of services (1)	(7,496)	(6,715)	(5,770)	(4,896)	(4,185)
Gross profit	5,813	5,090	4,318	4,153	3,125
Operating expenses, net (1)	(2,544)	(2,643)	(2,207)	(1,955)	(1,238)
Operating income before financial income (expense)	3,269	2,447	2,111	2,198	1,887
Financial expense, net	(404)	(630)	(755)	(336)	(153)

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Operating income	2,865	1,817	1,356	1,862	1,734
Net non-operating income (expense)	40	50	(33)	(17)	68
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income before taxes and minority interests	2,905	1,867	1,323	1,845	1,802
Income and social contribution taxes	(724)	(279)	(247)	(269)	(331)
Minority interests					(1)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net income	2,181	1,588	1,076	1,576	1,470
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Earnings per thousand shares in <i>reais</i>	4.42	3.22	2.18	3.19	2.97
Cash Dividends per thousand shares in <i>reais</i> , net of income tax					
Common Shares	5.63	6.90	1.78	1.83	1.53
Preferred Shares	6.20	7.60	1.96	1.83	1.53
<i>U.S. GAAP</i>					
Net income (loss)	2,184	2,011	675	1,652	1,755
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net income (loss) per thousand shares:					
Common shares Basic (2)	4.05	3.62	1.25	3.35	3.58

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	Year ended December 31,				
	2004	2003	2002	2001	2000
(in millions of reais, except per share data)					
Weighted average number of common shares outstanding - basic (thousands)	165,320,207	165,320,207	165,321,904	165,322,470	165,376,730
Common shares Diluted (2)	4.05	3.62	1.25	3.35	3.58
Weighted average number of common shares outstanding diluted (thousands)	165,320,207	165,320,207	165,321,904	165,322,470	165,376,730
Preferred shares Basic (3)	4.61	4.31	1.43	3.35	3.58
Weighted average number of preferred shares outstanding - basic (thousands)	328,272,073	328,272,073	328,325,175	328,342,876	325,037,442
Preferred shares Diluted (3)	4.61	4.31	1.43	3.35	3.58
Weighted average number of preferred shares outstanding (thousands)	328,272,073	328,272,073	328,325,175	328,342,876	325,037,442

(1) Reflects the reclassification of our employees profit sharing expense in 2001 and 2000.

(2) <b>Net income per thousand shares in accordance with U.S. GAAP</b>	<b>2001</b>
Common shares Basic and diluted	
Before cumulative effect of a change in accounting principle	3.29
Cumulative effect of a change in accounting principle	0.06
U.S. GAAP net income	3.35
(3) <b>Net income per thousand shares in accordance with U.S. GAAP</b>	<b>2001</b>
Preferred shares Basic and diluted	
Before cumulative effect of a change in accounting principle	3.29
Cumulative effect of a change in accounting principle	0.06
U.S. GAAP net income	3.35

	December 31,				
	2004	2003	2002	2001	2000
(in millions of reais, except per share data)					
<b>Balance Sheet Data:</b>					
Corporate Law Method					
Property, plant and equipment, net	13,369	14,735	16,223	17,515	15,715
Total assets	18,752	20,123	22,361	22,828	19,979
Loans and financing - current portion	530	1,982	2,471	2,636	1,194
Loans and financing - non-current portion	2,226	995	2,115	1,368	705
Shareholders equity	11,399	12,269	14,483	14,699	14,464
Capital stock	5,978	5,978	5,978	5,640	5,848
Number of shares outstanding (in thousands)	493,592,279	493,592,279	493,592,279	493,665,346	493,665,346
<i>U.S. GAAP</i>					
Property, plant and equipment, net	13,700	15,063	16,749	18,191	16,427
Total assets	19,159	20,470	23,036	23,517	20,745
Loans and financing current portion	478	1,878	2,305	2,543	1,174
Loans and financing non-current portion	2,231	942	2,055	1,349	705
Shareholders equity	11,422	12,280	14,174	14,638	14,233

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	December 31,				
	2004	2003	2002	2001	2000
	(million of <i>reais</i> except when indicated)				
<b>Cash Flow Data:</b>					
<b>Operating activities:</b>					
Net cash provided by (used in) operating activities	5,606	4,977	4,574	3,775	3,425
<b>Investing activities</b>					
Net cash used in investing activities	(1,415)	(1,278)	(1,614)	(4,526)	(4,186)
<b>Financing activities:</b>					
Net cash provided by (used in) financing activities	(4,167)	(3,974)	(2,675)	860	789
Increase (decrease) in cash and cash equivalents	24	(276)	285	109	28
Cash and cash equivalents at beginning of year	215	491	206	97	69
Cash and cash equivalents at end of year	239	215	491	206	97

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Prior to March 14, 2005, there were two principal foreign exchange markets in Brazil, in which rates were freely negotiated but could be strongly influenced by Central Bank intervention:

the commercial rate exchange market dedicated principally to trade and financial foreign exchange transactions such as the buying and selling of registered investments by foreign entities, the purchase or sale of shares or ADSs, or the payment of dividends or interest with respect to shares or ADSs; and

the floating rate exchange market that was generally used for transactions not conducted through the commercial foreign exchange market.

In March 2005, the National Monetary Council enacted Resolution No. 3265, pursuant to which the commercial rate exchange market and the floating rate exchange market were unified in a sole exchange market, effective as of March 14, 2005. The new regulation allows, subject to certain procedures and specific regulatory provisions, the purchase and sale of foreign currency and the international transfer of reais by a person or legal entity, without limitation as to amount, provided, however, the transaction has a legal objective. Foreign currencies may only be purchased through financial institutions domiciled in Brazil authorized to operate in the exchange market.

Between March 1995 and January 1999, the Brazilian Central Bank permitted the gradual devaluation of the *real* against the U.S. dollar pursuant to an exchange rate policy that established a band within which the *real*/U.S. dollar exchange rate could float. Responding to pressure on the *real*, on January 13, 1999, the Brazilian Central Bank widened the foreign exchange band and, on January 15, 1999, allowed the *real* to float.

As of December 31, 2004, the commercial market rate for purchasing U.S. dollars was R\$2.6544 to US\$1.00. See Item 5.A Operating and Financial Review and Prospects Operating Results Overview Brazilian Economic Environment.

The following tables show, for the periods and date indicated, certain information regarding the *real*/U.S. dollar commercial or unified exchange rate, as applicable.

Year ended December 31,	Exchange Rate of R\$ per US\$			
	Low	High	Average	Year-End
1999	1.2078	2.1647	1.8158	1.7890
2000	1.7234	1.9847	1.8295	1.9554
2001	1.9357	2.8007	2.3522	2.3204
2002	2.2709	3.9552	2.9309	3.5333
2003	2.8219	3.6623	3.0711	2.8892
2004	2.6544	3.2051	2.9257	2.6544

Source: Central Bank.

**Exchange Rate of R\$ per US\$**

	<b>High</b>	<b>Low</b>
Month		
December 2004	2.7867	2.6544
January 2005	2.7222	2.6248
February 2005	2.6320	2.5621
March 2005	2.7621	2.6011
April 2005 (through April 14, 2005)	2.6598	2.5598

Source: Central Bank.

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**C. Capitalization and Indebtedness**

Not applicable.

**D. Reasons for the Offer and Use of Proceeds**

Not applicable.

**E. Risk Factors**

*This section is intended to be a summary of more detailed discussions contained elsewhere in this annual report. The risks described below are not the only ones we face. Additional risks which we do not presently consider material, or of which we are not currently aware, may also affect us. Our business, results of operations or financial condition could be impacted if any of these risks materializes and, as a result, the market price of our preferred shares and our ADSs could be affected.*

**Risks Relating to Developments in Brazil and Their Impact on Our Business**

*The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. Brazilian political and economic conditions have a direct impact on our business, operations and the market price of our preferred shares and our ADSs.*

In the past, the Brazilian government has intervened in the Brazilian economy and occasionally made drastic changes in policy. The Brazilian government's actions to control inflation and affect other policies have often involved wage and price controls, currency devaluations, capital controls, and limits on imports, among other measures. Our business, financial condition and results of operations may be adversely affected by changes in government policies, as well as general economic factors, including:

currency fluctuations;

inflation;

price instability;

energy policy;

interest rates;



tax policy; and

other political, diplomatic, social and economic developments in or affecting Brazil.

***Inflation and certain government measures to curb inflation may have adverse effects on the Brazilian economy, the Brazilian securities market and/or our business and operations.***

Brazil has experienced extremely high rates of inflation in the past. Inflation and certain of the government's measures taken in the attempt to curb inflation have had significant negative effects on the Brazilian economy. Since 1994, Brazil's inflation rate has been substantially lower than in previous periods. Consumer prices rose 7.6% in 2004, the lowest rate of inflation in four years. The amplified consumer price index, or IPCA, was 9.3% in 2003, as compared to 12.5% in 2002 and 7.7% in 2001. Brazil's general price index, or the IGP-DI, reflected inflation rates of 12.1% in 2004, 7.7% in 2003, 26.4% in 2002 and 10.4% in 2001. However, inflationary pressures persist, and actions taken in an effort to curb inflation, coupled with public speculation about possible future governmental actions, have contributed to economic uncertainty in Brazil and heightened volatility in the Brazilian securities market. If Brazil experiences significant inflation rates, we may be unable to increase service tariffs and prices charged to our customers in amounts that are sufficient to cover our increasing operating costs, and our business may be adversely affected as a consequence.

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*Fluctuations in the value of the Brazilian real against the value of the U.S. dollar may adversely affect our ability to pay U.S. dollar-denominated or U.S. dollar-linked obligations and could lower the market value of our preferred shares and ADSs.*

The Brazilian currencies have experienced devaluations in the past. The *real* devalued against the U.S. dollar by 18.7% in 2001 and 52.3% in 2002. In contrast, the *real* appreciated in 2003 and 2004 against the U.S. dollar by 18.2% and 8.1%, respectively. See Item 3.A Selected Financial Data Exchange Rates for more information on exchange rates.

As of December 31, 2004, 44.6 percent of our R\$2.76 billion total indebtedness was denominated in foreign currencies, and primarily in U.S. dollars and Japanese yen. As of December 31, 2004, we had currency hedges in place to cover virtually all of our foreign currency denominated debt. See Item 11a-Quantitative and Qualitative Disclosure about Market Risk Exchange Rate Risk. Significant costs relating to our network infrastructure are payable or linked to payment by us in U.S. dollars. However, other than income derived from hedging transactions and international long distance interconnection, all of our revenues are generated in *reais*. To the extent that the value of the *real* decreases relative to the U.S. dollar, our debt becomes more expensive to service and it becomes more costly for us to import technology and goods necessary to operate our business. Certain additional costs, however, are offset by revenues from corresponding hedging transactions. Nevertheless, currency fluctuations are expected to continue to affect our financial income and expense.

*Deterioration in economic and market conditions in other countries, especially emerging market countries, may adversely affect the Brazilian economy and our business.*

The market for securities issued by Brazilian companies is influenced by economic and market conditions in Brazil and, to varying degrees, market conditions in other Latin American and emerging market countries. Although economic conditions are different in each country, the reaction of investors to developments in one country may cause the capital markets in other countries to float. Developments or conditions in other emerging market countries have at times significantly affected the availability of credit in the Brazilian economy and resulted in considerable outflows of funds and declines in the amount of foreign currency invested in Brazil.

For example, in 2001, after prolonged periods of recession followed by political instability, Argentina announced that it would no longer continue to service its public debt. In order to address the deteriorating economic and social crisis, the Argentine government abandoned its decade-old fixed dollar-*peso* exchange rate, allowing the *peso* to float to market rate levels. In 2002, the Argentine *peso* experienced a 236% devaluation against the U.S. dollar. The situation in Argentina may have negatively affected investors' perceptions towards Brazilian securities. In 2003, the Argentine economy began to stabilize and the Argentine *peso* experienced a 12.6% appreciation against the U.S. dollar; in 2004, the Argentine *peso* devalued by 1.2% against the U.S. dollar.

Although market concerns that similar crises would ensue in Brazil have not become a reality, the volatility in market prices for Brazilian securities increased in 2001 and 2002. If market conditions in other countries, especially emerging market countries continue to deteriorate, they may adversely affect our ability to borrow funds at an acceptable interest rate or to raise equity capital, when and if there is a need. Accordingly, adverse developments in other countries, especially other emerging market countries, could lead to a reduction in both demand for, and the market price for the preferred shares and ADSs.

## **Risks Relating to the Brazilian Telecommunications Industry and Us**

*Extensive government regulation of the telecommunications industry and our concession may limit our flexibility in responding to market conditions, competition and changes in our cost structure or impact our tariffs.*

Our business is subject to extensive government regulation. Anatel, which is the primary telecommunications industry regulator in Brazil, is responsible for, among other things:

regulations;

licensing;

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tariffs;

competition;

telecommunications resource allocation;

service standards;

technical standards;

quality standards;

interconnection and settlement arrangements; and

supervision of universal service obligations.

The initial monthly fees and usage fee tariffs for our services (local and long-distance) were initially determined in our concession agreement, which also sets the annual price adjustment. We derive a substantial portion of our revenues from services subject to this price adjustment. The method of price adjustment is basically a price cap. Anatel applies annually a price index correction that reflects the inflation index of the period (in accordance with the concession contract) and a productivity factor (in accordance with the concession contract) to our local and long-distance tariffs. Anatel has complied with the tariff range set by the concession agreement. We are currently involved in litigation relating to the inflation index used to calculate the price adjustment of our fees. See Item 4B Local Rates and Item 8A Regulatory and Antitrust Litigation for additional information on these claims. In addition, Anatel enacted the Local Areas Regulation (Regulation 373) in June 2004 which reconfigured the fees for calls between certain municipalities and localities. The Local Areas Regulation reduces revenues received from both intraregional and local calls. See Item 5A Operating Results Overview Regulatory and Competitive Factors. We expect that Anatel's regulatory policies with respect to fees and other aspects of the telecommunications market will continue to affect our business.

***Our concession may be terminated by the Brazilian government under certain circumstances.***

We operate our business under a concession granted by the Brazilian government. According to the terms of the concession, we are obligated to meet certain network expansion requirements and to maintain minimum quality and service standards. For example, Anatel requires that we satisfy through December 2005 certain conditions with respect to, among other things, expansion of our network to provide public telephone service for all areas with populations in excess of 100, expansion of our network to provide private individual telephone service for all areas with populations in excess of 300 and, with respect to quality of service, targets for call completion rates. Our ability to satisfy these terms and conditions, as well as others, may be affected by factors beyond our control. We cannot assure you that, going forward, we will be able to comply with all of the requirements imposed on us by Anatel or the Brazilian government. Our failure to comply with the requirements of our concession may result in the imposition of fines or other government actions, including the termination of our concession. Any partial or total revocation of our concession would have a material adverse effect on our financial condition and results of operations.

Our current Concession Agreement expires December 31, 2005, and, subject to satisfactory completion of certain network expansion, modernization and service quality obligations, contemplates a full renewal for an additional 20 years or revocation. In accordance with the notice

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provisions of the current Concession Agreement, we formally notified Anatel of our intention to renew such Concession Agreement on June 30, 2003. While the basic form of the renewed Concession Agreement has been finalized by Anatel and subject to extensive public comment, certain regulatory terms and conditions that will, or may be incorporated, into the renewed Concession Agreement remain pending. Such regulatory additions to the renewed Concession Agreement pertain to, among other things, price index, general competitive practices, corporate and consumer accounting and productivity measures. See Item 4B Business Overview Regulation of the Brazilian Telecommunications Industry Concessions and Authorizations. Subject to our satisfaction of the network expansion, modernization and service quality obligations set forth in the current Concession Agreement through December 2005, the renewed Concession Agreement will become effective on January 1, 2006.

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### ***We face substantial competition from other fixed-line providers that may reduce our market share.***

The satisfaction of Anatel's universal service targets by several fixed telecommunications services providers opened our region to the provision of local and long-distance telecommunications services by other providers. We have experienced, and expect to continue to experience, market adjustments in which providers take actions in order to compete for clients, especially corporate clients. Such actions tend to result in lower prices and impacts market share. The providers that have met the universal service targets are allowed to change their shareholding structures, thereby driving an increase in business combinations, consolidations and capital infusions. As a result of such activity, the Brazilian telecommunications market continues to reorganize and the profile of our competitors remains subject to change. This move towards reorganization and consolidation is evidenced by Telemar's acquisition of Pegasus and the building of its own network in Region III (as Telemar is now authorized to offer services outside its region), the acquisition of MetroRED and Vant by Brasil Telecom and the acquisition of AT&T Latin America, Embratel and Vésper by Teléfonos de México, S.A. de C.V., or Telmex. Similarly, we continue to expand our business, and currently operate in the concession areas of Telemar and Brasil Telecom when we identify desirable opportunities that comport with our strategic business objectives.

### ***We face increasing competition from cellular service providers.***

Rapid growth of the cellular telecommunications industry and intense competition among cellular services providers have resulted in lower prices for cellular services. Cellular services are increasingly becoming an alternative to fixed-line services for residential customers and we expect that this trend may negatively impact the use of fixed telecommunications services for some relative period of time. See Item 4 Information on the Company Competition. Indeed, in the second quarter of 2003, the number of cellular phones surpassed the number of fixed phones in Brazil, and, in the first quarter of 2004, the same phenomenon transpired in the State of São Paulo. While some of the negative impact from the migration to cellular services is mitigated by the interconnection fees we receive from cellular to fixed-line calls, we cannot assure you that this will continue or that the continued growth of cellular services, and possible combination packages of services between fixed-line and mobile services, will not ultimately have an adverse impact on our business. Subsidiaries of America Móvil, S.A. de C.V. operating under the brand name Claro and Embratel, each controlled by Carso Telecom Group (Carso Global Telecom, S.A. de C.V. is a closely-held company in Mexico among Carlos Slim Helú and family), may accelerate this trend of combination offerings involving fixed-line and mobile services.

### ***The industry in which we conduct our business is subject to rapid technological changes and these changes could have a material adverse effect on our ability to provide competitive services.***

The telecommunications industry is subject to rapid and significant technological changes. 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 be further developed.

The advent of new products and technologies could have a variety of consequences for us. New products and technologies may reduce the price of our services by providing lower-cost alternatives, or they may also be superior to, and render obsolete, the products and services we offer and the technologies we use, thus requiring investment in new technology. If such changes do transpire, our most significant competitors in the future may be new participants in the market without the burden of any installed base of older equipment. The cost of upgrading our products and technology in order to continue to compete effectively could be significant.

### **Risks Relating to the Preferred Shares and the ADSs**

*The Preferred Shares and ADSs generally do not have voting rights.*

In accordance with Brazilian Corporate Law and our bylaws, holders of preferred shares, and therefore of the ADSs, are not entitled to vote at meetings of our shareholders, except in limited circumstances set forth in Item 10.B Memorandum and Articles of Association.

*You might be unable to exercise preemptive rights with respect to the preferred shares unless there is a current registration statement in effect which covers those rights or unless an exemption from registration applies.*

You will not be able to exercise the preemptive rights relating to the preferred shares underlying your ADSs unless a registration statement under the U.S. Securities Act of 1933, as amended, or the Securities Act, is effective with

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respect to those rights, or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement. Unless we file a registration statement or an exemption from registration applies, you may receive only the net proceeds from the sale of your preemptive rights by the depositary, or if the preemptive rights cannot be sold, they will lapse and you will not receive any value for them. For more information on the exercise of your rights, see Item 10 Additional Information Memorandum and Articles of Association Preemptive Rights on Increase in Preferred Share Capital.

### **Certain Factors Relating to Our Controlling Shareholder**

*Our controlling shareholder has a great deal of influence over our business.*

Telefónica Internacional S.A., or Telefónica Internacional, our principal shareholder, currently owns directly and indirectly approximately 84.71% of our voting shares and 87.49% of our total capital. See Item 7.A Major Shareholders and Related Party Transactions Major Shareholders. As a result of its share ownership, Telefónica Internacional has the power to control us and our subsidiaries, including the power to elect our directors and officers and to determine the outcome of any action requiring shareholder approval, including transactions with related parties, corporate reorganizations and the timing and payment of our dividends. Given this degree of control over our company, circumstances could arise under which the interests of Telefónica Internacional could be deemed to be in conflict with the interests of our other shareholders.

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

### **A. History and Development of the Company**

#### **General**

We are a corporation (*sociedade anônima*) organized under the laws of the Federative Republic of Brazil and registered with the CVM, as a publicly held company. Our stock is traded on BOVESPA. We are also registered with the Commission in the United States and our ADSs are traded on the New York Stock Exchange, or NYSE. Our headquarters are located at Rua Martiniano de Carvalho, 851, 21º andar, 01321-001, São Paulo, SP, Brazil. Our telephone number is 55-11-3549-7922.

At December 31, 2004, we had 165,320,206,602 outstanding common shares, with no par value per share, and 328,272,072,739 preferred shares, with no par value per share, and our shareholders' equity was in the amount of R\$11,398,632,000 as presented under the Corporate Law Method.

We provide fixed-line telecommunications services in the State of São Paulo under a concession agreement granted in 1998 by the Brazilian government arising out of the restructuring and privatization of the Telebrás System, as described below. This concession authorizes us to provide fixed-line telecommunications services in a specific region, which includes all of the State of São Paulo with the exception of a small area where a previously existing fixed-line service provider that was not part of the Telebrás System continues to operate independently.



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As of December 31, 2004, our regional telephone network included approximately 14.2 million installed lines, including public telephone lines, of which 12.5 million lines were in service. Of the access lines in service, approximately 74.8% were residential, 20.1% were commercial, 2.6% were public telephone lines and 2.4% were for our own use and for testing.

### **Historical Background**

#### *The Restructuring and Privatization*

Before the incorporation of Telecomunicações Brasileiras S.A. - Telebrás in 1972, there were more than 900 telecommunications companies operating throughout Brazil. Between 1972 and 1975, Telebrás and its operating subsidiaries, collectively the Telebrás System, acquired almost all of the telephone companies in Brazil and monopolized the provision of public telecommunications services in virtually all areas of the country.

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On April 12, 1973, our predecessor company, which carried the same name as we do, Telecomunicações de São Paulo S.A. Telesp, began providing telecommunications public services as a Telebrás System operating company in the State of São Paulo. In 1973, our predecessor company acquired Companhia Telefônica da Borda do Campo, or CTBC, which had long been active in the São Paulo metropolitan area as a telecommunications public services concessionaire. With this acquisition, our predecessor company became the main supplier of fixed-line telecommunications services in the State of São Paulo and would remain so until a wave of deregulation in the 1990s.

In 1995, the Brazilian government began a comprehensive reform of Brazil's telecommunications regulatory system. In July 1997, Brazil's national congress adopted the General Telecommunications Law, which provided for the establishment of a new regulatory framework, the introduction of competition and the privatization of the Telebrás System.

In May 1998, the Telebrás System was restructured to form, in addition to Telebrás, twelve new holding companies. Virtually all assets and liabilities of Telebrás were allocated to the new holding companies. The resulting new holding companies, together with their respective subsidiaries, consisted of: (i) eight cellular holding companies, each in one of eight cellular regions, holding one or more operating companies providing cellular services; (ii) three fixed-line holding companies, each in one of three fixed-line regions, holding one or more operating companies providing local and intraregional long-distance services; and (iii) Embratel Participações S.A., a holding company of Empresa Brasileira de Telecomunicações S.A. Embratel, which provides international long-distance services throughout Brazil.

Telesp Participações S.A., or TelespPar, was one of the resulting holding companies formed in connection with the Telebrás restructuring. In connection with the breakup of Telebrás, TelespPar was allocated all the share capital held by Telebrás in the operating subsidiaries of the Telebrás System in the State of São Paulo, including our predecessor company, that provided fixed-line telecommunications service in the State of São Paulo. In July 1998, the federal government sold substantially all its shares of the resulting holding companies, including TelespPar, to private sector buyers.

On December 31, 1998, TelespPar held 67.77% of our predecessor's company capital and 29.01% of the capital of CTBC. The federal government's shares of TelespPar were purchased by SP Telecomunicações Holding S.A., or SP Telecomunicações, formerly known as Tele Brasil Sul Participações S.A., a consortium comprised of Telefónica Internacional, Portelcom Fixa S.A., Banco Bilbao Vizcaya S.A., Iberdrola Investimentos S.U.L., CTC Internacional S.A. and Telefónica de Argentina S.A. As a result of a subsequent reorganization of SP Telecomunicações, one of its subsidiaries, SPT Participações S.A., or SPT, became the controlling shareholder of TelespPar.

### ***The Reorganization***

On November 30, 1999, the shareholders of our predecessor company, together with the shareholders of TelespPar, CTBC and SPT, approved a reorganization which involved successive mergers. Our predecessor company's operations and the operations of CTBC and SPT were incorporated into TelespPar, which remained as the surviving entity and became the telecommunications services company operating under our current name, Telecomunicações de São Paulo S.A. Telesp.

### ***Accomplishment of Targets***

On September 30, 2001, we achieved our December 31, 2003 network expansion and universal service targets, as further described below, which was acknowledged by Anatel through Act 23.395 of March 1, 2002. Since we had accomplished the universal service targets, on April 29,

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2002, Anatel granted us a concession allowing us to offer international and interregional long-distance services outside our concession region, thereby enabling us to have a presence throughout Brazil. Accordingly, on May 7, 2002, we began providing international long-distance service and on July 29, 2002 we began providing interregional long-distance service. See Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies Network Expansion General Plan on Universal Service Targets for information relating to Anatel's network expansion and universal service targets.

### *The Spin-off of Certain Data Transmission Operations*

On January 30, 2001, our shareholders approved the spin-off of certain operations of our data transmission business into an independent Brazilian corporation, Telefônica Data Brasil Holding S.A., or Data Brasil. This spin-off

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was part of Telefónica's global business reorganization to allow managerial and operational consolidation of business lines through separate, but affiliated, global business units and to enhance the strategic and competitive position of the group.

As a result of the spin-off, we hold no interest in the equity share capital of Data Brasil and Data Brasil holds no interest in our equity share capital. The relationship between Data Brasil and us is limited. We only enter into certain arrangements in the ordinary course of business that normally exists between a fixed-line network operator and a data transmission services provider. Still, we and Data Brasil remain indirectly under the common control of Telefónica, S.A. and certain of its affiliates.

### ***Ceterp's Acquisition***

On December 22, 1999, we acquired through a public auction from the municipal government of the City of Ribeirão Preto, in the State of São Paulo, 51.0% of the voting shares and 36.0% of the total shares outstanding of Centrais Telefônicas de Ribeirão Preto S.A., or Ceterp. Ceterp provided fixed-line and cellular services in the State of São Paulo outside the Telebrás System and had been one of our minor competitors. According to the terms of the acquisition, on December 30, 1999, we acquired an additional 45% of the voting shares and 36% of the total shares outstanding of Ceterp from certain pension funds.

Under the terms of the acquisition, we were required to launch a tender offer for the remaining minority shares of Ceterp at a price equal to that paid to the selling pension funds, with adjustments for inflation and interest. This tender offer was completed on October 4, 2000 and, as a result, we increased our holdings to 99.85% of the voting shares and 96.97% of the preferred shares of Ceterp.

In order to comply with regulatory requirements, on October 27, 2000, Ceterp sold for cash Ceterp Celular S.A., its wholly owned cellular subsidiary, to Telesp Celular.

On November 30, 2000, Ceterp was merged into us.

### **Corporate Structure and Ownership**

Our general corporate and shareholder structure is as follows:

### **Capital Expenditures**

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Prior to privatization, our capital expenditures were planned and allocated on a system-wide basis and subject to approval by the Brazilian government. These constraints on capital expenditures prevented us from making certain investments that otherwise would have been made to improve telecommunications services in our concession region.

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These restrictions have been lifted and we are now permitted to determine our own capital expenditure budget, subject to compliance with certain obligations to expand service under the concession.

The following table sets forth our capital expenditures for each year in the three-year period ended December 31, 2004.

	Year ended December 31,		
	2004	2003	2002
	(in millions of reais)		
Switching equipment	67.9	58.0	158.0
Transmission equipment	215.2	97.4	349.6
Infrastructure	17.9	41.7	88.0
External network	82.8	265.9	264.0
Data transmission	234.6	199.0	221.3
Line support equipment	296.4	205.9	296.7
Administration (general)	322.1	358.0	124.3
Long-distance	12.0	16.0	3.3
Other	90.0	103.0	160.8
<b>Total capital expenditures</b>	<b>1,338.9</b>	<b>1,344.9</b>	<b>1,666.0</b>

The primary focus of our capital expenditure program has been, and continues to be, the expansion, modernization and digitalization of the network in order to comply with Anatel's targets and to provide quality service for our clients. See Item 4.B Information on the Company Business Overview Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies.

We anticipate that our capital expenditures for 2005 will be approximately R\$1.7 billion. We expect to fund these expenditures with funds internally generated from our operations and through external sources of credit.

**B. Business Overview****Our Region**

The State of São Paulo covers an area of 248,809 square kilometers, representing approximately 2.9% of Brazil's territory. The population of the State of São Paulo is approximately 39.0 million, representing 22% of Brazil's total population. The gross domestic product, or GDP, of the State of São Paulo in 2004 was an estimated R\$575.2 billion, or approximately US\$197.0 billion, representing approximately 33% of Brazil's GDP for the year. The State of São Paulo's annual per capita income during 2004 was an estimated R\$14,365, or approximately US\$4,919.

The concessions granted by the Brazilian government in 1998 allowed us to provide fixed-line telecommunications services to a region that includes most approximately 95% of the State of São Paulo. The portion of the State of São Paulo that is excluded from our concession region

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represents approximately 1.5% of total lines in service and 1.9% of the population in the state. This concession is operated by CTBC Telecom.

Our concession region is Region III, which is comprised of 622 municipalities, including the City of São Paulo, with an aggregate population of approximately 39 million. Of the municipalities in Region III, 59 have populations in excess of 100,000. The City of São Paulo has a population of approximately 11 million. According to the plan established by the federal government, whereby the government granted licenses to four providers of fixed-line telecommunications services, the State of São Paulo was divided into four sectors including sectors 31 (our predecessor company's area prior to the reorganization), 32 (the area corresponding to Ceterp prior to our acquisition), 33 (corresponding to the portion of the State of São Paulo that we do not service) and 34 (CTBC's area prior to the reorganization). Through transactions that took place in November 1999 and December 2000, CTBC Borda do Campo and Ceterp merged into our company, which now holds Sectors 31, 32 and 34. Sector 33 is held by CTBC Telecom.

On September 30, 2001, we attained our December 31, 2003 network expansion and universal service targets, as further described below in Services Interregional and International Long-Distance Services. As a result, on April 29, 2002, Anatel granted us an operating concession to provide international and interregional long-distance services outside

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our concession region, thereby enabling us to have a presence throughout Brazil. On May 7, 2002, we began offering international long-distance service and, on July 29, 2002, we started offering interregional long-distance service.

The conditions for the provision of intraregional, interregional and international long-distance services outside the concession area contemplate that providers already operating services under a selection code (a two-digit code to be input by the caller as a prefix to the number dialed) shall keep such code under the new licenses authorizing operation outside the applicable concession area. Accordingly, we continue using the provider selection code 15 which permits our callers to originate calls using our services even though such caller is outside our concession area. All interregional and international cellular calls, whether in our concession area or that of another provider, dialed using Personal Mobile Service SMP, through which mobile services users choose the provider for interregional and international long-distance calls, require dialing our code 15 in order to use our services. See Services Network Services.

## **Services**

### ***Overview***

Our services consist of:

local services, including installation, monthly subscription, measured service and public telephones;

intraregional, interregional and international long-distance services;

network services, including interconnection and the leasing of facilities, and other services.

In March 2002, Anatel certified our compliance with the 2003 universal service targets and authorized us in April 2002 to start exploiting local and intraregional services in certain regions in which we were not operational and interregional and international long-distance services throughout Brazil. See Competition and Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies Public Regime Service Restrictions.

We provide interconnection services to cellular service providers and other fixed telecommunications companies through the use of our network. In April 1999, we also began to sell handsets and other telephone equipment through Assist Telefônica S.A., our wholly owned subsidiary. Until January 2001, we provided data transmission services, but spun off our data transmission operations into Data Brasil. See Certain Developments The Spin-off of certain Data Transmission Operations.

The following table sets forth our operating revenue for the years indicated. Our tariffs for each category of service are discussed below under Rates and Taxes. For a discussion of trends and events affecting our operating revenue, see Item 5 Operating and Financial Review and Prospects.



	Year ended December 31,		
	2004	2003	2002
	(in millions of reais)		
Local service	8,477	7,824	6,951
Intraregional service	2,334	1,821	1,347
Interregional long-distance service	732	639	255
International long-distance service	113	101	40
Data transmission	997	592	438
Network services	5,129	4,654	4,176
Goods sold	21	23	19
Other	623	568	451
<b>Total</b>	<b>18,426</b>	<b>16,222</b>	<b>13,677</b>
Taxes and discounts	(5,117)	(4,417)	(3,589)
<b>Net operating revenue</b>	<b>13,309</b>	<b>11,805</b>	<b>10,088</b>

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### ***Local Service***

Local service includes installation, monthly subscription, measured service and public telephones. Measured service includes all calls that originate and terminate within the same local area or municipality of our concession region, which we refer to as local calls, and the leasing of our network for paging and trunking services. Excluding the portion of our region that was serviced by Ceterp before our acquisition in December 1999, we were the only supplier of local fixed-line and intraregional long-distance telecommunications services in our region until July 1999. At that time, licenses were auctioned to permit a competitor to provide local fixed-line and intraregional long-distance telecommunications services in our region, including the area formerly served by Ceterp. Vésper São Paulo S.A. received authorization and began operations in December 1999. Embratel also began to provide local services in our concession region in January 2003. See Competition.

Telesp became the first telephone service concessionaire in Brazil to offer local services outside its concession region (the State of São Paulo). In May 2003, we achieved the network expansion and universal service targets established by Anatel, and began providing local services to six other states in Brazil, including Sergipe, Espírito Santo, Rio Grande do Sul, Paraná, Santa Catarina and certain areas in Rio de Janeiro.

### ***Intraregional Long-Distance Service***

Intraregional long-distance service consists of all calls that originate in one local area or municipality and terminate in another local area or municipality of our concession region. We were the sole provider of intraregional long-distance service in our region until July 3, 1999, when the federal government also authorized Embratel and Intelig to provide intraregional long-distance services. Vésper also began to provide intraregional long-distance services in our concession region in December 1999. See Competition.

### ***Interregional and International Long-Distance Service***

On March 1, 2002, Anatel acknowledged that we had satisfied its network expansion and universal service targets two years prior to the scheduled date. As a result, on April 25, 2002, Anatel published an order that allowed us to be the first fixed-line telephone company to provide the full range of STFC services and expanded our concession to develop services in the local, intraregional, interregional and international markets throughout Brazil.

On April 29, 2002, certain provisions of the Anatel's order were partially suspended as a result of injunctions sought by Embratel. The injunctions prevented us from commencing our interregional services that originated in our concession region, Region III, and terminated in other concession areas, namely Region I (Telemar's concession region) and Region II (Brasil Telecom's concession region). However, our concession to provide local and interregional services in Region I, Region II, Sector 33 of Region III and international services in all three regions was not affected. These injunctions were lifted in June 2002, however, the lawsuits brought by Embratel have not yet been dismissed and therefore the possibility that we may be barred from providing interregional services still exists, although our risk of loss in this legal proceeding is deemed remote.

We began operating international long-distance service in May 2002 and interregional long-distance services in July 2002. Interregional long-distance service consists of state-to-state calls within Brazil. International long-distance service consists of calls between a point within our concession region and a point outside Brazil.

*Network Services*

In 2003, the most important development in network services was the migration of the mobile cellular service to the Personal Mobile Service - SMP, through which mobile services users began to choose the provider for interregional and international long-distance calls, as they had already been choosing for fixed telephone service. The introduction of the Carrier Selection Code - CSP required us to negotiate and enter into new interconnection agreements in order to implement the new rules and regulations specifically applicable to the rendering of this new service.

In 2004, four new mobile service providers entered the SMP market:

Telemig Cellular and Amazonia Cellular (formerly Mobile Cellular Service), each controlled by Algar S.A. Empreendimentos e Participações, a multi-industry holding company, referred to as the Algar Group;

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Brasil Telecom Cellular, a new provider controlled by fixed-line provider Brasil Telecom; and

CTBC Celular, a subsidiary of CTBC Telecom (which is controlled by Telepart Participações, or Telpart Group, comprised of investment funds managed by Opportunity Bank and various Brazilian pension funds).

Several new agreements were required in 2004 by and among all SMP providers in order to guarantee correct billing for the long distance services provided by Telesp (CSP 15) which was billed to customers by their selected mobile service provider.

Our network is used for calls by our customers and by other service providers either to complement their own networks or to carry their long-distance traffic being charged on a per minute basis.

We also provide dedicated services to companies authorized to operate in the Multimedia Communication Service – SCM. The demand for those services is significant due to the good technical quality and reach of our network, particularly in the State of São Paulo.

The telecommunications services market is growing through the presence of several local, regional and mobile service providers in the State of São Paulo. We have been successful in offering network use services and network facilities to such telecommunications services providers.

***Other Services***

Currently, we also provide a variety of other telecommunications services that extend beyond basic telephone service, including interactive banking services, electronic mail and other similar services.

***Interconnection***

We have entered into interconnection agreements, which allow our customers to communicate with customers of other local and long-distance telephone operators and vice-versa. In 2004, we entered into twelve new interconnection agreements, further evidencing the burgeoning market for both local and long-distance services and corresponding expansion of services by market participants. The interconnection services we render to other mobile and fixed telecommunications providers generate revenues from the use of our local network when a call is either originated or terminated.

In 2003, the most important development in revenues obtained from interconnection fees was the migration of mobile cellular service to Personal Mobile Service - SMP, through which mobile services users began to choose the provider for interregional and international long-distance calls, as they had already been choosing for fixed telephone service.

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In 2004, Anatel published releases proposing modifications to the interconnection rules in general and, specifically, to the interconnection charging rules. We believe these modifications would be favorable to our business and are hopeful that such proposals are adopted as regulations in 2005.

### *I-Telefônica*

I-Telefônica is a free Internet access service provider launched in September 2002 by our subsidiary Assist Telefônica. The product initially covered 10 cities as test markets, but has expanded and currently covers 620 cities in the State of São Paulo and over 1,000 cities in all of Brazil. The service delivers high quality, stable Internet access that is structured to ensure that our clients do not encounter a busy signal when connecting to the Internet. I-Telefônica permits us to increase the range of our services and better supplies our customers by offering an entry-level option to the Internet market. I-Telefônica also represents a strategic tool to protect us against the possible traffic imbalance that may be generated by Internet access service providers that do not use our network.

### *IP Network Asset Acquisition*

On December 10, 2002, after receiving the approval from Anatel, our board of directors approved a proposal to acquire certain assets from Telefônica Empresas S.A., one of the companies of the Telefônica group, including the

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following services: (a) an Internet service which allows our customers to access our network through remote dial-up connection, and (b) services that allow customers of Internet Service Providers, or ISPs, to have access to broadband Internet. The purpose of this asset acquisition was to capitalize on synergies that would assist in developing our network and provide a quick response to market competitors.

### ***Authorization to provide Multimedia Services***

On January 29, 2003, Anatel granted our Multimedia Communications Service (SCM) license nationwide, allowing ASSIST, our wholly-owned subsidiary, to provide voice and data services through points-of-presence (POPs), which are comprised of private telecommunications networks and circuits.

On November 11, 2004, Anatel granted us an experimental and scientific license to test Wi-Max technology, a multimedia service. The term of this license is 12 months and may be renewed for an additional one year.

### ***Acquisition of Atrium***

On December 30, 2004, we entered into a transaction to acquire indirect control of Atrium Telecomunicações Ltda. from Launceston Partners CV (a company incorporated in the Netherlands and controlled by the investment funds Advent Latin American, Advent PGGM Global, J.P. Morgan Partners Latin America, J.P. Morgan Capital and Sixty Wall Street Fund). Atrium provides various types of telecommunications services in Brazil, including internet and intranet services, telecommunications management services and the sale and rental of telecommunications representatives and related equipment. The transaction was approved by at a special meeting of our shareholders (*Assembléia Geral Extraordinária*) on January 19, 2005. The acquisition was carried out through the purchase of the total share capital of Santo Genovese Participações Ltda., which held 99.99% of the representative share capital of Atrium. The purchase price was approximately R\$113.4 million and, while one of three necessary regulatory approvals has been granted by an agency of the Brazilian government (the Secretariat for Economic Policy of the Ministry of Finance), certain regulatory approvals remain pending. We believe that this acquisition will improve our ability to offer quality telecommunications services to a broader national market.

### **Corporate Customer Services**

We provide our corporate clients telecommunications solutions that meet the needs of a number of different industries, including commerce, manufacturing, services, financial institutions and government.

Our clients are assisted by highly qualified professionals who offer the support required for the best technical solutions. We provide voice and data services tailored to meet the needs of each specific client. We work closely with our customers to identify their requirements and usage patterns, and strive to continuously improve and streamline our services to meet their needs and sustain our competitive position within the marketplace.

### **Rates and Taxes**

**Rates**

*Overview*

We generate revenues from (i) activation and monthly subscription charges; (ii) usage charges, which include measured service charges; and (iii) network usage charges.

Rates for telecommunications services are subject to comprehensive regulation by Anatel. See Regulation of the Brazilian Telecommunications Industry Rate Regulation. Since the relative stabilization of the Brazilian economy in mid-1994, there have been two major changes in rates for local and long-distance services. First, in January 1996, rates for all services were increased, primarily to compensate for accumulated effects of inflation. Then, in May 1997, the rate structure was modified through a tariff rebalancing that resulted in higher charges for measured service and monthly subscription and lower charges for intraregional, interregional and international long-distance services. The purpose of the change was to eliminate the cross-subsidy between local and long-distance services.

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Concession agreements, which are valid from 1998 until December 31, 2005, establish a price cap for annual rate adjustments, generally effected at June of each year. The annual rate adjustment is applied to the following categories of service rates:

- (1) local services, where rates are established pursuant to a basket of tariffs. This basket includes rates for the installation of residential and commercial lines, measured services, activation and subscription fees. In case of a price adjustment, each one of the items within the local tariff basket has a different weight, and as long as the total local tariff price adjustment would not exceed the rate of increase in the General Price Index, or IGP-DI, minus a productivity factor established in the concession agreements, each individual tariff within the basket can exceed the IGP-DI variation by up to 9%.
- (2) local network services, which may be adjusted taking into account the weighted average of traffic per hour, with adjustments limited to the rate of increase in the IGP-DI minus a productivity factor established in the concession agreements;
- (3) public telephone services, with adjustments limited to the rate of increase in the IGP-DI; and
- (4) domestic long-distance services, with rate adjustments divided into intraregional and interregional long-distance services, which are calculated, based on the weighted average of the traffic, taking into account time and distance. For these categories, each tariff may individually exceed the rate of increase in the IGP-DI by up to 5%, however, the total adjustments on the basket of tariffs cannot exceed the rate of increase in the IGP-DI minus a productivity factor established in the concession agreements. See Regulation of the Brazilian Telecommunications Industry Rate Regulation.

Rates for international services are not required to follow the price cap established for other services and, therefore, we are free to negotiate our tariffs based on the international telecommunications market, where our main competitor is Embratel.

### ***Local Rates***

Our revenue from local service consists principally of activation charges, monthly subscription charges, measured service charges and public telephone charges. Users of measured service, both residential and non-residential, pay for local calls depending on usage, which is measured in pulses. The first pulse is recorded at the moment a call is in fact connected to its destination. Afterwards, pulses occur system-wide every four minutes, regardless of the moment when a particular call was initiated. As a result, the time between the first pulse and the second (system-wide) pulse may vary between one second and four minutes. Thus, based upon when during a cycle a call is initiated, the charge for the call may vary significantly.

Local charges for weekday calls are determined by multiplying the number of pulses by the charge per pulse. For calls made at night and during selected weekend hours, callers are charged for only one pulse regardless of the duration of a call. Under current Anatel regulations, residential customers receive 100 free pulses per month and commercial customers receive 90 free pulses per month.

In June 2004, Anatel prescribed new rates for our concession area. These rates were above the rates previously put in place by a federal court injunction in June 2003. The injunction suspended rates prescribed by Anatel in June 2003 which increased fees for fixed-line telecommunications services based on variation of the General Price Index (IGP-DI measured by *Fundação Getúlio Vargas*) as required by the concession agreement. The injunction required use of the Consumer Price Index (IPCA, published by the *Instituto Brasileiro de Geografia e Estatística*) instead of the General Price Index. The federal court reasoned that the variation of the Consumer Price Index reflected inflation more accurately than the variation of the General Price Index. See Item 8 Regulatory and Antitrust Litigation. On July 1, 2004, the injunction was



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invalidated by the Superior Court of Justice (*Superior Tribunal de Justiça - STJ*), one of Brazil's intermediate federal appellate courts, thereby restoring the terms of the concession agreements and reestablishing the General Price Index as the proper measure for fees in connection with fixed-line telecommunications.

As a result of this judicial determination, we recouped the right to pass the cost of the tariffs prescribed by Anatel in June 2003 through to our consumers. Accordingly, the new rates prescribed by Anatel in June 2004 were compared to the rates prescribed in June 2003 and the difference would be passed on to customers. Payment of the difference, in accordance with the STJ's determination, did not have a retroactive effect, but, rather, as agreed with Anatel, was divided

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into two forward-looking parcels, with the first charged in September 2004 and the second in November 2004, thereby implementing the cost of the adjustment for 2004.

The tariffs were applied to consumers as follows:

In July and August 2004, we charged a monthly subscription rate of R\$33.45 for residential clients. Commercial clients and PBX were charged a monthly subscription rate of R\$50.41 in Sector 31, R\$49.08 in Sector 34 and R\$46.83 in Sector 32. Rates for measured service were R\$0.12918 per pulse in Sector 31, R\$0.12374 per pulse in Sector 34 and R\$0.13522 per pulse in Sector 32. Activation fees, including taxes, were R\$64.16 for Sector 31, R\$51.21 for Sector 32 and R\$24.91 for Sector 34.

In September and October 2004, we charged a monthly subscription rate of R\$34.50 for residential clients. Commercial clients and PBX were charged with a monthly subscription rate of R\$54.35 in Sector 31, R\$52.51 in Sector 34 and R\$50.37 in Sector 32. Rates for measured service were R\$0.13324 per pulse in Sector 31, R\$0.13324 per pulse in Sector 34 and R\$0.13964 per pulse in Sector 32. Activation fees, including taxes, were R\$73.10 for Sector 31, R\$58.97 for Sector 32 and R\$32.03 for Sector 34.

Beginning in November 2004, we charged a monthly subscription rate of R\$35.55 for residential clients. Commercial clients and PBX were charged with a monthly subscription rate of R\$58.29 in Sector 31, R\$55.96 in Sector 34 and R\$53.91 in Sector 32. Rates for measured service were R\$0.13730 per pulse in Sectors 31 and 34, and R\$0.14407 per pulse in Sector 32. Activation fees, including taxes, were R\$82.06 for Sector 31, R\$66.74 for Sector 32 and R\$39.15 for Sector 34.

### ***Intraregional and Interregional Long-Distance Rates***

Intraregional long-distance service consists of all calls that originate in one local area or municipality of our concession region and terminate in another local area or municipality of our concession region. All other calls are denominated interregional long-distance calls. Rates for intraregional and interregional long-distance calls are computed on the basis of the time of day, day of the week, duration and distance of the call, and also may vary depending on whether special services, including operator assistance, are used.

On March 1, 2002, Anatel acknowledged that we had reached its network expansion and universal service targets two years prior to the scheduled date. As a result, on April 25, 2002, Anatel published an order that allowed us to be the first concessionaire to provide the full range of STFC services and expanded our concession to develop services in the local, intraregional, interregional and international markets throughout Brazil.

On April 29, 2002, certain provisions of Anatel's order were partially suspended as a result of certain legal proceedings brought by Embratel. The proceedings prevented us from commencing our interregional services that originated in our concession region, Region III, and terminated in other concession areas, namely Region I (Telemar's concession region), and Region II (Brasil Telecom's concession region). However, our concession to provide local and interregional services in Regions I and II, Sector 33 of Region III and international services in all three regions was not affected. On June 28, 2002, Anatel dismissed the proceedings and allowed us to begin offering interregional services originating in our concession region.

On July 29, 2002 after we received the concession from Anatel to provide interregional long-distance services throughout Brazil, we launched several new options of interregional calling plans relating to consumer Code 15, which is the selection code dialed by customers who may

choose a long-distance provider with each call, and may result in different prices based upon frequency of use and customer calling patterns.

***International Long-Distance Rates***

On May 7, 2002, we began operating international long-distance services. International long-distance calls are computed on the basis of the time of day, day of the week, duration and destination of the call, and also may vary depending on whether special services are used or not, including operator assistance.

We developed alternate rate plans for our residential and corporate customers.

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### *Network Usage Charges*

We earn revenues from any fixed-line or mobile service provider that either originates or terminates a call within our network. We also pay interconnection fees to other service providers when we use their network to place or receive a call. Under the General Telecommunications Law, all fixed-line telecommunications service providers must provide interconnection upon the request of any other fixed-line or mobile telecommunications service provider. We have interconnection agreements with other telephone service providers, including Embratel, Intelig and Telesp Celular. The interconnection agreements are freely negotiated among the service providers, subject to a price cap and in compliance with the regulations established by Anatel, which includes not only the interconnection basic principles covering commercial, technical and legal aspects, but also the traffic capacity and interconnection infrastructure that must be made available to requesting parties. If a service provider offers to any party an interconnection tariff below the price cap, it must offer the same tariff to any other requesting party on a nondiscriminatory basis. If the parties cannot reach an agreement on the terms of interconnection, including the interconnection tariff, Anatel can establish the terms of the interconnection. See Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies.

In accordance with Anatel regulations, we must charge interconnection fees to the other telephone service providers based on the following tariffs:

Tariff for the use of our local network we charge long-distance service providers a network usage charge for every minute used in connection with a call that either originates or terminates within our local network. We charge local service providers a fee for traffic that exceeds 55% of the total local traffic between the two service providers.

Tariff for the use of our long-distance network we charge the service provider a network usage charge on a per minute basis only when the interconnection access of our long-distance network is in use.

Tariff for the lease of certain transmission facilities used by another service provider in order to place a call.

Cellular telecommunications service in Brazil, unlike in the United States, is offered on a calling party pays basis, under which the subscriber pays only for calls that he or she originates. Additionally, a subscriber pays roaming charges on calls originated and terminated outside his or her home registration area. Calls received by a subscriber are paid for by the party that places the call in accordance with a rate based on per minute charges. For example, a fixed-line service customer pays a rate based on per minute charges for calls made to a cellular service subscriber. The lowest base rate per minute, or VC1, applies to calls made by a subscriber in a registration area to persons in the same registration area. Calls to persons outside the registration area, but within our concession region, are charged at a higher rate, VC2. Calls to persons outside our concession region are billed at the highest rate, VC3. When a fixed-line service customer calls a mobile subscriber, we charge fixed-line service customers per minute charges based on VC1, VC2, or VC3 rates. In turn, we pay the cellular service provider the cellular network usage charge.

Our revenue from network services also includes payments by other telecommunications service providers for the use of part of our network arranged on a contractual basis. Other telecommunications service providers, including providers of trunking and paging services, may use our network to connect a central switching office to our network. Some cellular service providers use our network to connect cellular central switching offices to the cellular radio-based stations. We also lease transmission lines, certain infrastructure and other equipment to other providers of telecommunications services.

We expect that the increase of our market share in long-distance, interregional and international services will reduce our revenues from interconnection services. We will invoice the client directly and therefore will not receive the interconnection charges from our competitors that otherwise would have to use our network to originate and terminate such client call. We have entered into several co-billing agreements in order

to enable us to charge calls using the Code 15 in invoices from other providers.

***Data Transmission Rates***

Although we spun off most of our data transmission services to Data Brasil, we still receive revenues from the rental of dedicated analog and digital lines for privately leased circuits to corporations.

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### **Taxes**

The cost of telecommunications services to each customer includes a variety of taxes. The principal tax is a state value-added tax, the *Imposto sobre Circulação de Mercadorias e Serviços*, or ICMS, which the Brazilian states impose at varying rates on revenues from the provision of telecommunications services. The rate in the State of São Paulo is 25% for domestic telecommunications services.

Other taxes on gross operating revenues include two federal taxes, the *Contribuição para o Programa de Integração Social* or PIS, and *Contribuição para o Financiamento da Seguridade Social* or COFINS, imposed on gross operating revenues at a combined rate of 3.65% for telecommunications services and 9.25% for other services. PIS is a tax designed to share business profits with employees through a mandatory national savings program, and is financed by monthly deposits collected as a percentage of gross operating revenues. COFINS is a tax designed to finance special social programs created and administered by the Brazilian government. On February 2, 2004, the combined rate of PIS and COFINS imposed on gross operating revenues generated by services other than telecommunications services increased from 4.65% to 9.25%. However, revenues related to, among other things, equity, dividends and fixed asset sales are not subject to PIS and COFINS, except for hedging transactions and interest on shareholders' equity (*juros sobre o capital próprio*).

In addition, the following contributions are imposed on certain telecommunications services revenues:

*Contribution for the Fund for Universal Access to Telecommunications Services – FUST.* FUST was established in 2000, to provide resources to cover the cost exclusively attributed to fulfilling obligations (including free access to telecommunications services by governmental institutions) of universal access to telecommunications services that cannot be recovered with efficient service exploration or that is not the responsibility of the concessionaire. Contribution to FUST by all telecommunications services companies began in January 2001, at the rate of 1% of net operating telecommunications services revenue, and it may not be passed on to customers.

*Contribution for the Fund of Telecommunications Technological Development – FUNTTEL.* FUNTTEL was established in 2000, in order to stimulate technological innovation, enhance human resources development, create employment opportunities and promote access by small and medium-sized companies to capital resources, so as to increase the competitiveness of the Brazilian telecommunications industry. Contribution to FUNTTEL by all telecommunications services companies began in March 2001, at the rate of 0.5% net operating telecommunications services revenue (excepting interconnection revenues), and it may not be passed on to customers.

We must also pay the Contribution for the Fund of Telecommunications Fiscalization – FISTEL. FISTEL is a fund supported by a tax applicable to telecommunications operators (the FISTEL Tax), and was established in 1966 to provide financial resources to the Brazilian government for the regulation and inspection of the telecommunications sector. The FISTEL Tax consists of two types of fees: (i) an installation inspection fee assessed on telecommunications central offices upon the issuance of their authorization certificates; and (ii) an annual operations inspection fee that is based on the number of authorized central offices in operation at the end of the previous calendar year. The amount of the installation inspection fee is a fixed value, depending upon the kind of equipment installed in the authorized telecommunications station. The operations inspection fee equals 50% of the total amount of the installation inspection fee that would have been paid with respect to existing equipment.

### **Billing and Collection**

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We send each customer a monthly bill covering all of the services provided during the prior period. Telephone service providers are required under Brazilian law to offer their customers the choice of at least six different payment dates within the monthly billing cycle. In our case, customers are divided into thirteen different groups, and each group receives a bill according to a specific billing date within the monthly billing cycle.

We have a billing and collection system with respect to fixed-line-to-fixed-line and fixed-line-to-mobile for local, long-distance, subscription and receivables services. Payments of the bills are effected under agreements with various banks either by debiting the customer's checking account, by direct payment to a bank or through the Internet.

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Brazilian telecommunications regulations require that we offer a new billing system known as co-billing. The co-billing system results in a third-party telephone service company's invoice being included within our own invoice. Our customers can receive and subsequently pay all of their bills (including the tariffs for the use of services of another telephone service provider) by using one invoice. In order to develop this co-billing system, we share our billing and collection infrastructure with the other telephone service companies and have developed a special system to facilitate this co-billing. We have co-billing agreements (*i.e.*, co-billing in ) with Intelig, Embratel, Vésper, Telemar/TNL, GVT, CTBC Telecom and Brasil Telecom, each of which provides fixed-line services, and with TIM and Claro, each of which provides mobile services. Similarly, we employ the same co-billing system to bill for the use of our services by customers of other service providers. We have co-billing agreements of this nature (*i.e.*, co-billing out ) with Vésper, Telemar, CTBC, Brasil Telecom, Sercomtel and GVT, each of which provides fixed-line services, and with Claro, Oi, Tim, Telemig Celular, Amazônia Celular, Sercomtel Celular, CTBC Celular and VIVO, each of which provides mobile services.

Anatel regulations allow us to restrict a customer from making outgoing calls after a receivable has been outstanding for 30 days a partial block or restrict a customer from making outgoing or receiving incoming calls a total block after 60 days and to disconnect a customer upon failure to pay after 90 days. In 2004, we partially blocked 441,270 telephone lines and totally blocked 467,500 telephone lines. We charge fines at a rate of 2% per month plus an interest at the rate of 1% per month on the overdue amounts. On December 31, 2004, 5.48% of all receivables had been outstanding between 30 and 90 days, and 15.59% of all receivables had been outstanding for more than 90 days. For a discussion of provisions for past due accounts, see Item 5 Operating and Financial Review and Prospects.

In 2004, we further developed our end-to-end revenue assurance tool automating our billing controls for telecommunications services. This revenue assurance tool (which we refer to as Call Detail Record or CDR Tracking ) provides daily alerts in order to detect billing issues, and we prioritize our response to CDR Tracking alerts based on the amounts and time of the outstanding receivable. Through this traffic management system, we are able to monitor our revenues, plan future investments and make strategic decisions in an effort to maintain our position as a market leader.

## **Network and Facilities**

Our network includes installed lines and switches, a network of access lines connecting customers to switches and trunk lines connecting switches and long-distance transmission equipment. As of December 31, 2004, our regional telephone network included approximately 14.2 million installed access lines, including public telephone lines, of which 12.5 million access lines were in service. Of the access lines in service, approximately 74.8% were residential, 20.1% were commercial, 2.6% were public telephone lines and 2.4% were for our own use including testing. Intraregional long-distance transmission is provided by a microwave network and by fiber optic cable. Our network strategy is to develop a broadband integrated network that is compatible with several types of telecommunications services and multimedia applications.

As a telecommunications services provider, we do not physically build our own network and facilities. We purchase the equipment through which we provide our services from third-parties and, accordingly, do not buy the raw materials that comprise our network and facilities. The following table sets forth selected information about our network in aggregate, at the dates and for the years indicated:

	<b>At and for Year ended December 31,</b>				
	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Installed access lines (millions)	14.2	14.2	14.4	14.3	12.5
Access lines in service (millions) (1)	12.5	12.3	12.5	12.6	10.6



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Average access lines in service (millions)	12.3	12.4	12.6	11.9	9.3
Access lines in service per 100 inhabitants	31.7	31.6	32.9	33.8	30.4
Percentage of installed access lines connected to digital switches	98.7	96.9	96.1	95.7	93.8
Employees per 1,000 access lines installed	0.5	0.6	0.7	0.8	1.3
Number of public telephones (thousands)	331.2	331.1	330.9	342.8	246.8
Registered local call pulses (billions)	33.5	35.9	35.9	33.7	29.9
Domestic long-distance call billed minutes (billions)	9.5	10.1	8.4	8.1	8.1
International call billed minutes (millions)	96.0	87.9	29.0		

(1) Data includes public telephone lines.

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### **Technology**

We are incorporating new digital technology into our network in order to offer more integrated services. In 2002, we began to offer international and interregional long-distance telecommunications services known as Super 15. We are the leading company providing VoIP technology (voice over IP) in the Brazilian telecommunications market. Since 1999, we have been heavily investing in the offering of broadband access through asymmetric digital subscriber line, or ADSL, technology under the brand Speedy. ADSL is a technology that allows more data to be sent over existing copper telephone lines. In 2004, we reached 826,400 broadband access connections. We introduced the innovative concept of a management portal in our ADSL network called *Portal de Serviços* through which our clients are able to select our services.

Our current Wi-Fi network consists of 500 hot spots which provide wireless Internet access and mobility to our Internet clients. These hot spots are installed mainly in major Brazilian airports, large hotel chains, certain restaurants and various coffee shops in the City of São Paulo.

Our development plan targets state of the art communication technology, focusing on the integration with the Internet and an increase in the number of multimedia transmission services.

As of December 31, 2004, our network was approximately 98.7% digital.

### **Competition**

Companies seeking to operate in the telecommunications industry in Brazil are required to apply to Anatel for a concession or an authorization. Concessions and authorizations are granted for services in the public or the private regime, respectively. The public regime differs from the private regime primarily in the obligations imposed on the companies rather than the type of services offered by such companies. We are one of four companies that operate within the public regime. All other telecommunications companies, including those that provide the same services as the four public regime companies, operate under the private regime.

In order to stimulate growth and increase competition, the Brazilian government issued new authorizations within our area of operations to Vésper, Embratel and Intelig. In April 1999, Vésper won the bid in connection with operating licenses for local and long-distance fixed-line services in Region III, our concession region. Vésper only started its operations in January 2000. In July 1999, Embratel and Intelig were also authorized to provide long-distance telecommunications services in our concession region. In addition, in July 1999, Anatel introduced the operator selection code, so that customers may choose, at each call, the operator for their long-distance calls. Therefore, in 2000, competition in the long-distance service market increased, reducing our market share from previous years.

Currently, we face fierce competition in the corporate and residential segments for several types of services. In the corporate segment, we face strong competition in both voice services (local and long-distance) and data transmission, resulting in client migration and the need for greater discounts to maximize client retention. Our main competitors in the corporate segment are Telefones de México, S.A. de C.V. (Telmex), Telemar and Intelig. In the high-income residential service segment, we compete for long-distance and broadband services with Telmex, Intelig and cable TV providers. For the local voice and high-income segments, we also face increasing competition from cellular telecommunications services, which have lower rates for certain types of calls such as mobile destination calls. Competition increases our advertising and marketing costs.

In the low-income local fixed telecommunications segment, we face less direct competition because of the low profitability of this market. However, the competition from pre-paid cellular telecommunications providers is significant. Such services are relatively profitable because of the fees generated by the interconnection of fixed and cellular networks. Although the values fixed by the mobile interconnection tariff remain under consideration by Anatel and the subject of evolving industry discussion, we believe that there may be future changes possibly resulting in a positive impact on our cost structure.

Vésper was formed by Qualcomm, VeloCom and Bell Canada International in 1999. According to the rules enacted by Anatel, Vésper was required to quickly develop its local service business.

In 2002, Vésper started to offer portable telephones, which did not require physical installation in a customer's premises and which could be operated remotely, similarly to cellular phones. However, the coverage of this device

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extended for several kilometers, and Anatel prevented its sale based on the assumption that it violated the terms of Vésper's wire line telecommunications license. Vésper modified the system and decreased its range, and was thus allowed to resume the sale of its device. Based on the positive acceptance of this product when it did not present any range limits, Vésper tried to extend its operations to the wireless telecommunications business through the acquisition of licenses to operate in SMP (Personal Mobile Service), an authorization for a general mobile services operation, in the State of São Paulo (but not in the city). However, Anatel did not authorize the use of the frequency in which Vésper operated to cellular telecommunications services and, subsequently, Vésper's operations were offered for sale by its controlling shareholders in April 2003. In the third quarter of 2003, Vésper was sold to Embratel.

Embratel was acquired by MCI WorldCom in the privatization of the Telebrás System in 1998. In July 2001, MCI filed for bankruptcy under Chapter 11 in U.S. federal bankruptcy court. According to the management of Embratel, despite the problems of its controlling shareholder, Embratel maintained fully its managerial and financial independence from its controlling shareholder. We understand that MCI WorldCom's reorganization did not have any impact on Embratel's operations. Since 2002, Embratel has been subject to long-distance service competition as a result of our operations and those of Telemar. During the second quarter of 2004, Embratel was sold to Telmex, the leading provider of fixed-line telecommunications services in Mexico.

Intelig was granted a license to provide long-distance services throughout Brazil and implemented its intraregional long-distance service in our region in July 1999. The shareholders of Intelig include National Grid, the owner and operator of the electricity transmission network in the United Kingdom, France Telecom, one of the world's leading telecommunications carriers and Sprint, a global U.S.-based communications company. Intelig's strategy has been characterized by extensive marketing efforts, including substantial discounts and attractive customer plans. However, Intelig has not managed to reach the same market penetration achieved by Embratel. In 2002, Intelig's partners expressed their intention to sell the company and received offers, but no sale was consummated.

In 2002, Anatel certified that Telemar and we had achieved the targets for 2003 and we were granted concessions to operate as interregional and international long-distance providers, thus starting to compete directly with Embratel and Intelig. Embratel and Intelig also achieved their targets and were granted concessions to operate as local telecommunications providers in the three Brazilian concession regions. Embratel started its local services operations in January 2003, and Intelig has been offering local services to its corporate clients since early 2003. Brasil Telecom announced that it achieved its targets in February 2003. Anatel certified such achievement in January 2004 and Brasil Telecom started its long-distance operations in the second quarter of 2004.

For mobile operations, our concession region is divided into two sub-areas. In each sub-area there are currently three cellular service providers.

We face competition from three cellular services providers in the State of São Paulo:

Vivo (formerly Telesp Celular), which we spun off in January 1998 and is now controlled by a joint venture between Portugal Telecom and Telefónica, our controlling shareholder;

Claro, a unified brand name used since the end of 2003 by several cellular operating companies controlled by America Móvil, S.A. de C.V., the leading cellular services provider in Mexico (which was spun off from Telmex in September 2000). America Móvil is controlled by Carso Telecom Group S.A. de C.V., a closely-held holding company incorporated in Mexico that is controlled by Carlos Slim Helú and family. Carso Telecom Group also indirectly controls Embratel through its control of Telmex; and

TIM, controlled by Telecom Italia, which began operations in October 2002.

In 2002, the Brazilian government auctioned another license to operate cellular PCS (Personal Communications Systems) systems under the E Band frequency. In the City of São Paulo, Claro won the auction, while Vésper prevailed on E Band rights in the rest of the State of São Paulo. Despite the success of each company in the E Band auction, each announced the return of its respective license for different reasons. Claro stated that it had already started operations in the São Paulo cellular market as a result of its acquisition of BCP. Vésper announced that it would return the license because it had been acquired by Embratel, the leading long-distance carrier and devoid of any interest in the cellular market. In September 2004, Anatel again attempted to auction the E Band licenses for the City of São Paulo and the rest of the State of São Paulo. Despite Telemar's request to delay the auction, the auction went forward and no company elected to submit

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a bid. The Brazilian government intends to auction the E Band licenses again at some point in the future in response to interest from two other telecommunications companies.

In the second quarter of 2003, the number of cellular phones surpassed the number of fixed-line phones in Brazil, and, in the first quarter of 2004, the same phenomenon occurred in the State of São Paulo. At the end of 2004, there were approximately 17 million cellular telephones in the State of São Paulo. Despite this escalation suggesting, in part, a preference for cellular phones instead of fixed-line phones, the negative impact on our revenues from competition with cellular services providers is partially offset by interconnection fees we charge such providers for use of our network. See Item 5.A Operating Financial Review and Prospects Operating Results Net Operating Revenues Network Services. However, subsidiaries of America Móvil operating under the brand name Claro and Embratel, each controlled by Carso Telecom Group, may begin a trend of combination offerings involving fixed-line and mobile services. The acquisition of AT&T Latin America by Carso Telecom Group-controlled Telmex also represented an important development in the data transmission segment. In addition, Embratel announced in the first quarter of 2005 that it would concentrate on creating synergies with subscription television operator Net and others to offer phone services with the objective of competing with us, Telemar and Brasil Telecom. Such combination offerings and consolidations are likely to fuel additional competition in the marketplace.

## **Sales, Marketing and Customer Services**

### ***Sales***

We use different methods to provide solutions to the corporate market:

Personal sales: our business managers team provides personalized attention to selected customers and strives to earn the customer loyalty by providing consulting services in telecommunications as well as technical and commercial support;

Telesales: sales through telemarketing;

Indirect channels: sales through third parties accredited telecommunications and information technology companies building up a network of representative that market our products and services;

Internet Virtual Stores (for corporate customers): a front door to enable our corporate clients to learn about our portfolio of products through the Internet.

### ***Marketing***

We actively track the telecommunications market to spot new business opportunities, meet the needs of our existing clients, develop new products and services and identify future markets, trends as well as potential clients. We have developed a successful business intelligence unit that enables us to allocate our resources more effectively by utilizing a combination of specialized teams (human resources), technological resources (Business Intelligence tools) and specific studies (market research).

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We believe that the strong Telefónica brand and our client-centered approach to customer service, marketing and communication activities help to generate new sales and customer loyalty.

**Table of Contents****Customer Services**

One of our primary goals is to provide subscribers with excellent customer care. We continue to improve the quality of our services through network upgraded and the addition of automated operational support systems. The following table sets forth information on service quality for the periods indicated.

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Repair requests of residential telephones (as a % of lines in service)	1.5	1.4	1.7
Repair requests of public telephones (as a % of lines in service)	5.4	7.0	8.3
Call completion local rate during the peak night period (% of calls attempted)	77.0	74.7	75.6
Call completion national long-distance rate during the peak night period (% of calls attempted)	71.8	70.9	72.3
Billing complaints (% of bills) (1)	0.2	0.2	0.2

(1) Local calls.

We are also required under the Brazilian telecommunications regulations to meet certain service quality targets relating to call completion rates, repair requests, response rates to repair requests and operator response periods. See Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies Quality of Service General Plan on Quality Targets.

In order to improve the quality of our services we developed several new and ongoing measures to guarantee customer satisfaction including:

bi-annual customer satisfaction surveys;

review of communications procedures with customers, including meetings and conference calls in which our customers, management and employees take part in order to achieve the best solution for the customer;

use of specific call center lines segmented by product and service;

establishment of various programs and projects focused on customer satisfaction;

establishment of a quality management model which focuses on customer satisfaction;

establishment of an executive sub-committee focusing on services quality and customer satisfaction;



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implementation of the 6 Sigma method, which is an enhanced human resource process tool methodology that will decrease our costs and increase the level of satisfaction of our clients;

continued maintenance of and compliance with ISO 9001:2000 certifications for the scope of our management, customer service and support, as well as other certifications; and

continued evaluation and maintenance of certification of our billing process by the independent institution ABNT (*Associação Brasileira de Normas Técnicas*).

### **Seasonality**

Our business and results of operations are not materially affected by seasonal fluctuations in the consumption of our services.

### **Regulation of the Brazilian Telecommunications Industry**

#### ***General***

Our business, including the services we provide and the rates we charge, is materially affected by comprehensive regulation under the General Telecommunications Law and various administrative rules thereunder. Each of the former subsidiaries of Telebrás operates under a concession that authorizes the provision of specified services and sets forth

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certain obligations, according to the *Plano Geral de Metas de Universalização*, or General Plan on Universal Service Targets and the *Plano Geral de Metas de Qualidade*, or General Plan on Quality Targets.

Anatel is the regulatory agency established by the General Telecommunications Law and the *Regulamento da Agência Nacional de Telecomunicações*, known as the Anatel Decree issued on October 1997. Anatel is administratively and financially independent from the Brazilian government. Any proposed regulation by Anatel is subject to a period of public comment, including public hearings, and its decisions may be challenged in the Brazilian courts.

## ***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, known as the 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, known as the 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. Companies that operate under the public regime include us, Embratel, Telemar, Brasil Telecom and other local providers. The primary public regime companies provide fixed-line telecommunications services in Brazil that include local, intraregional, interregional and international long-distance services. All other telecommunications service providers, including the other companies authorized to provide fixed-line services in our concession region, operate under the private regime.

Public regime companies, including us, can also offer certain telecommunications services in the private regime, of which the most significant are data transmission services.

*Fixed-line Services Public Regime.* Our current Concession Agreement expires December 31, 2005, and, subject to our satisfactory completion of certain network expansion, modernization and service quality obligations, contemplates a full renewal for an additional 20 years or revocation. In accordance with the notice provisions of the current Concession Agreement, we formally notified Anatel of our intention to renew such Concession Agreement on June 30, 2003. Subject to our satisfaction of the network expansion, modernization and service quality obligations set forth in the current Concession Agreement through December 2005, the renewed Concession Agreement will become effective on January 1, 2006. While the basic form of the renewed Concession Agreement has been finalized by Anatel and subject to extensive public comment, certain regulatory terms and conditions that will, or may be incorporated, into the renewed Concession Agreement remain pending.

Certain regulatory terms and conditions that will be incorporated into the renewed Concession Agreement have been published as Public Consults (*Consultas Públicas*). Other regulatory terms and conditions that may be incorporated have not yet been addressed in Public Consults. Public Consults have been published regarding, among others, the following regulatory terms and conditions to be incorporated in the renewed Concession Agreement:

*industrial exploration* rules addressing the offering of dedicated industrial service lines and criteria for pricing such services based on long run incremental cost models;

*interconnection services and costs* rules addressing the offering of fixed and mobile interconnection services, criteria and models for pricing such services and the classification of customer accounts; and

*competition and market practices for entities considered a Significant Market Power (Poder de Mercado Significativo - PMS)* rules designed to limit a Significant Market Power's ability to restrict competition in the marketplace, promote uniformity in the structuring and classification of customer accounts and delineate methods for the recognition of certain costs for telecommunications service providers.

While Anatel has not yet published Public Consults regarding certain other regulatory terms and conditions that may affect the renewed Concession Agreement, Anatel is considering the various issues set forth below and we anticipate that Anatel may publish Public Consults regarding the following:

possible regulations affecting the portability of access codes and networks as well as pricing criteria for such services;

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possible regulations affecting tariff rates and measured service, including legal minimums, system pulses per minute and alternative pricing methods for valuing system use;

possible regulations affecting the offering, marketing and selling of STFC, including the consideration of alternative systems that would be based on minutes used and not the pulses of measured service;

possible regulations affecting tariff calculation methods and indexes, including the Telecommunications Sector Index (*Índice Setorial de Telecomunicações - IST*), a new index that uses a different inflation measure than the measure currently used (the IGP-DI) for tariff adjustments;

possible regulations affecting the calculation of Factor X, a productivity measure that is reduced upon a tariff adjustment in order to share costs with the consumer; and

general regulations affecting competition and parameters for regulators to evaluate and track competition in the telecommunications services industry.

In addition, the renewed Concession Agreement contemplates possible changes to its terms by 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.

Anatel's initial grant of our Concession did not require us to pay any concession fees. Under the renewed Concession Agreement and during the 20-year renewal period, we will be required to pay a biannual fee equal to 2% of our annual net revenue from the provision of fixed-line public telecommunications services in our concession area for the prior year (excluding taxes and social contributions). See *Obligations of Telecommunications Companies - Public Regime - Service Restrictions*. Each of the foregoing regulatory terms and conditions affecting (or potentially affecting) the renewed Concession Agreement, as well as current obligations under the existing Concession Agreement, may impact our business plan and results of operations.

Other regional fixed-line companies and us were not permitted to offer interregional or international long-distance services or other specified telecommunications services until December 31, 2003, unless we attained the network expansion and universal service targets by December 31, 2001. We achieved the network expansion and universal service targets on September 30, 2001, which was acknowledged by Anatel through Act No. 23.395 of March 1, 2002. Accordingly, on May 7, 2002, we began providing international long-distance services. A subsequent act, Act No. 26.880, allowed to operate interregional service originating in Sectors 31, 32 and 34 to other sectors, with the exception of Sector 33. See *Obligations of Telecommunications Companies - Public Regime-Service Restrictions*.

Act No. 25.120, enacted on April 25, 2002, allowed us to provide local and interregional services in Regions I and II and Sector 33 of Region III, and international long distance services in Regions I, II and III.

*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, our concession region. Anatel also granted other private regime companies authorizations to operate in other fixed-line regions and authorizations to provide intraregional, interregional and international long-distance services throughout Brazil in competition with Embratel. Several companies have already applied for the authorization and Anatel may authorize additional private regime companies to provide intraregional, interregional and international

long-distance services. See Competition.

***Obligations of Telecommunications Companies***

We and other telecommunications service providers are subject to obligations concerning quality of service, network expansion and modernization. The four public regime companies are also subject to a set of special restrictions regarding the services they may offer, which are listed in the *Plano Geral de Outorgas*, or General Plan of Grants, and special obligations regarding network expansion and modernization contained in the General Plan on Universal Service Targets.

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*Public Regime Service Restrictions.* The General Plan of Grants previously prohibited regional fixed-line service providers from offering cellular, interregional long-distance or international long-distance services and prohibited Embratel from offering local or cellular services until December 31, 2003. These service restrictions were lifted after December 31, 2001 for companies like us, which, within their respective regions, had collectively met the 2003 targets by December 31, 2001. Anatel monitors the progress of regional fixed-line service providers in meeting their obligations. Each regional fixed-line provider will be authorized to provide all other telecommunications services (except for fixed-line private services in the private regime within their own respective regions and cable TV services) if the company has already achieved the 2003 targets or has done so by the beginning of 2004.

Public regime companies are also subject to certain restrictions on alliances, joint ventures, mergers and acquisitions, including:

a prohibition on holding more than 20% of the voting stock in any other public regime company, unless previously approved by Anatel, according to the General Telecommunications Law;

a prohibition on public regime companies that provide different services restricting the provision of more than one service at a time;

a prohibition on mergers between regional fixed-line service providers and cellular service providers; and

various restrictions on the offering of cable television by companies offering telephone services.

*Network Expansion & Quality of Service.* We are subject to the General Plan on Universal Service Targets and the General Plan on Quality Targets, each of which respectively requires that we undertake certain network expansion activities with respect to our fixed-line services and meet specified quality of service targets. The timing for network expansion and benchmarks for quality of service are revised by Anatel from time-to-time. No subsidies or other supplemental financings are anticipated to finance our network expansion obligations.

If a public regime company fails to meet its obligations in a particular fixed-line concession region, Anatel may apply certain penalties set forth in the concessions, and fines and penalties of up to R\$50.0 million per event. Failure to meet the quality of services and modernization obligations may result in fines and penalties of up to R\$40.0 million per event, as well as potential revocation of the concessions granted to the company. If a public regime company endangers the provision of basic telecommunications services to a concession region, and upon proof that the public regime company is incapable of providing such service, Anatel is obligated to cancel the concession agreement and allow another telecommunications service provider to provide the service on a temporary basis until another auction takes place and a new concession is granted.

*Interconnection.* All public regime companies are required to provide interconnection upon request to any provider of public telecommunications services. The terms and conditions of interconnection are freely negotiated between the parties, subject to a price cap established by Anatel. If the parties fail to agree, Anatel can establish the terms of the interconnection. If a company offers any party an interconnection tariff below the price cap, it must offer that tariff to any other requesting party on a non-discriminatory basis.

## **C. Organizational Structure**

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At December 31, 2004, our voting shares were controlled by two major shareholders: SP Telecomunicações with 50.23% and Telefónica Internacional with 34.48%. Telefónica Internacional is, in turn, the controlling shareholder of SP Telecomunicações and, consequently, holds directly and indirectly 84.71% of our common shares and 88.90% of our preferred shares.

### **Subsidiaries**

Assist Telefônica is our wholly-owned subsidiary. Assist Telefônica, which was incorporated in Brazil on October 29, 1999, performs on-site technical assistance related to the installation, maintenance and management of telecommunication services under a Building Local Exchange Carrier ( BLEC ) model, and also provides free ISP service under the brand name I-Telefônica . In addition, on December 30, 2004, we entered into a transaction to acquire indirect control of Atrium Telecomunicações Ltda. The transaction was approved by our shareholders on January 19, 2005. The

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acquisition was carried out through the purchase of the total share capital of Santo Genovese Participações Ltda., which held 99.99% of the representative share capital of Atrium. See Item 4B Business Overview Services Acquisition of Atrium.

## **Associated Companies**

Since June 30, 2000, we have consolidated, under the Corporate Law Method, the operations of Aliança Atlântica Holding B.V., an investment company incorporated under the laws of the Netherlands. As of December 31, 2004, we held a 50% share ownership and Telefónica S.A. held the remaining 50%.

Furthermore, on December 31, 2003, we also consolidated, under the Corporate Law Method, our investment under proportional consolidation in Companhia AIX de Participações, or AIX. At December 31, 2004, we held a 50% share ownership in AIX and Telemar Participações S.A. held the remaining 50%. AIX was formed in 2001 to explore, directly and indirectly, activities related to the execution, conclusion and commercial exploitation of underground cables to optic fiber. See Notes 1 and 34 to the consolidated financial statements. We also consolidate, as required under the Corporate Law Method, Companhia ACT de Participações, in which we hold a 50% interest.

## **D. Property, Plants and Equipment**

Our main physical properties include transmission equipment (including outside plant and trunk lines), switching equipment and various sites throughout the State of São Paulo. Our land and buildings primarily consist of telephone switches and other technical, administrative and commercial properties. Switches include local switches, toll switches that connect local switches to long-distance transmission facilities and tandem switches that connect local switches with each other and with toll switches.

Our properties are located throughout the State of São Paulo. At December 31, 2004, we used 1,978 properties in our operations, 1,478 of which we own, and we enter into standard leasing agreements to rent the remaining properties. We own a building in the City of São Paulo where the majority of our management activities are conducted.

At December 31, 2004, property related to construction in progress represented 2.3% of the net book value of our total fixed assets, automatic switching equipment represented 31.1%, transmission and other equipment represented 27.7%, underground and marine cables, poles and towers represented 1.5%, subscriber and public booth equipment represented 6.1%, electronic data progress equipment represented 0.6%, buildings and underground equipment represented 23.4%, land represented 1.9%, and other assets represented 5.4% of total fixed assets. As of December 31, 2004, the net book value of our property, plant and equipment was R\$13.7 billion.

Pursuant to Brazilian legal procedures, liens have been attached to several properties pending the outcome of various legal proceedings to which we are a party. See Item 8.A Consolidated Statements and Other Financial Information Legal Proceedings.

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



**A. Operating Results**

The following discussion should be read in conjunction with our consolidated financial statements and accompanying notes and other information appearing elsewhere in this annual report and in conjunction with the financial statements included under Item 3A Key information Selected Financial Data. Except as otherwise indicated, all financial information in this annual report has been prepared in accordance with the Corporate Law Method and presented in *reais*. For certain purposes, such as providing reports to our Brazilian shareholders, filing financial statements with the CVM, and determining dividend payments and other distributions and tax liabilities in Brazil, we have prepared and will continue to be required to prepare financial statements in accordance with the Corporate Law Method.

**Overview**

Our results of operations are principally affected by the following key factors.

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### ***Brazilian Political and Economic Environment***

The Brazilian economy experienced robust growth in 2004. Brazil's GDP expanded 5.2% in 2004 according to the IBGE, the fastest pace in a decade and a much higher rate than the 0.5% growth registered in 2003. Similarly, the world economy continued its recovery and experienced widespread growth.

Consumer prices, as measured by the Consumer Price Index (IPCA, published by the *Instituto Brasileiro de Geografia e Estatística*), reached their lowest point in four years and finished 2004 at 7.6% compared to 9.3% in 2003. However, inflation, as measured by the General Price Index (IGP-DI, calculated by the *Fundação Getúlio Vargas*), which includes wholesale, retail and home-building prices, increased 12.1% in 2004 compared to 7.7% in 2003.

In response to rising inflation, the Central Bank of Brazil interrupted the trend of lowering interest rates, with rates holding steady at 16.00% until September 2004, and then tightened monetary policy. In an effort to curb inflation and achieve target rates, the Central Bank increased interest rates to 17.75% in December 2004 and 19.25% in March 2005.

Brazil finished 2004 with a trade balance surplus of US\$33.7 billion, compared to US\$24.8 billion in 2003. Exports went up by 32% to US\$96.5 billion, while imports increased by 30% to US\$62.8 billion.

Public finance surpassed government forecasts, and the initial target of 4.25% of GDP for primary surplus was increased to 4.50% of GDP. The total primary surplus for 2004 was 4.6% of GDP. The net public sector debt, as a proportion of GDP, decreased to 51.8% as of December 2004, compared to 57.2% in December 2003.

The overall improvement in Brazil's domestic economic indicators (external and fiscal accounts, greater GDP performance), together with an environment of greater liquidity in the international capital markets, led to a fall in country-risk. The JP Morgan Emerging Markets Bond Index Plus (EMBI+), which tracks total returns for traded external debt instruments in the emerging markets (mainly concentrated in instruments from Argentina, Brazil, and Mexico), fell to 382 basis points as at December 31, 2004, compared to 463 basis points as at December 31, 2003.

The Brazilian *real* appreciated during 2004 in the wake of increasingly promising economic indicators and falling country risk. The exchange rate was R\$2.65 to US\$1.00 at December 31, 2004 compared to R\$2.89 to U.S.\$1.00 at December 31, 2003. On average, the exchange rate in 2004 was R\$2.93 to U.S.\$1.00 compared to R\$3.07 to U.S.\$1.00 in 2003. The appreciation of the *real* in this context is also related to the devaluation of the U.S. dollar against other currencies.

Our business is directly affected by trends in the global economy and the Brazilian economy. If interest rates rise and the Brazilian economy enters a period of continued recession, then demand for telecommunications services is likely to decline. Similarly, depreciation of the Brazilian *real* against the U.S. dollar could reduce the purchasing power of Brazilian consumers and negatively affect the ability of our customers to pay for our telecommunications services. *Real* devaluations would also affect our profit margins by increasing the carrying costs of our U.S. dollar and other foreign currency denominated debt, and our other costs and expenses based on the U.S. dollar and other foreign currencies.

*Impact of Inflation on Our Results of Operations*

If Brazil experiences significant inflation, we may be unable to increase service rates to our customers in amounts that are sufficient to cover our operating costs, and our business may be adversely affected as a consequence. Inflation also directly impacts the fees we charge to our customers: such fees are periodically adjusted by Anatel based on the variation of inflation rates published in the General Price Index.

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The table below shows the Brazilian general price inflation (according to the IGP-DI and the IPCA) for the years ended December 31, 1998 through 2004:

	<u>Inflation Rate (%) as Measured by IGP-DI (1)</u>	<u>Inflation Rate (%) as Measured by IPCA (2)</u>
December 31, 2004	12.1	7.6
December 31, 2003	7.7	9.3
December 31, 2002	26.4	12.5
December 31, 2001	10.4	7.7
December 31, 2000	9.8	6.0
December 31, 1999	20.0	8.9
December 31, 1998	1.7	1.7

(1) Source: IGP-DI, as published by the *Fundação Getúlio Vargas*.

(2) Source: IPCA, as published by the Instituto Brasileiro de Geografia e Estatística.

**Regulatory and Competitive Factors**

Our business, including the services we provide and the rates we charge, is subject to comprehensive regulation under the General Telecommunications Law. As a result, our business, results of operations and financial conditions could be impacted by the actions of the Brazilian authorities, including:

delays in the granting, or the failure to grant, approvals for rate increases;

the granting of concessions to new competitors in our region; and

the introduction of new or stricter requirements to our operating concession.

On June 3, 2004, we became subject to Regulation 373, a regulation governing the applicable criteria for the provision of STFC services for public use in local areas, which we refer to as the Local Areas Regulation. The Local Areas Regulation affected local service fees by eliminating conurban areas (*Áreas Conurbadas*); calls between conurban areas were previously treated as long distance calls (*Degrau DC*). Such calls are now treated as local calls.

On September 4, 2004, we implemented the first phase of local area service reconfiguration to comply with the Local Areas Regulation. In greater Sao Paulo, we aggregated 39 municipalities into a single local area. We also aggregated municipalities in Baixada Santista and in the regions of Campinas, Sorocaba and Barra Bonita.

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On December 4, 2004, we implemented the second phase of local area service reconfiguration, introducing local area service between distinct municipalities as required by the Local Areas Regulation. As a result, we charge local fees for calls between certain municipalities and localities in the region of Jundiaí, Campinas/Americana, Baixada Santista, among others, that were previously charged as long distance calls. This reconfiguration reduces both intraregional and local call revenues.

The Local Areas Regulation provides for future changes to fees, stating that local area service fees will apply to calls between localities in separate municipalities that are separated by a distance of up to 1,000 meters or rivers, lagoons, bays or certain parts of the ocean. Such calls are currently billed as interregional long distance calls.

In addition to evolving regulatory considerations, our business is affected by competition from other telecommunications providers. We began to face competition in our region in July 1999 and anticipate that competition will contribute to declining prices for fixed-line telecommunications services and increasing pressure on operating margins. Our 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.

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### ***Revenue Increase as a Result of Anatel's Authorization to Provide Interregional and International Long-Distance Services***

As we achieved our universal service targets before Anatel's deadline, we were authorized by Anatel to launch long-distance services outside our concession region. We started our international long-distance services on May 7, 2002 and our interregional long-distance services on July 29, 2002. In 2004, our revenues from interregional and international long-distance services amounted to R\$845.0 million as compared to R\$740.0 million in 2003. By the end of 2004, we had estimated market shares of approximately half in each of the international and interregional long-distance services.

### ***Foreign Exchange and Interest Rate Exposure***

We face significant foreign exchange risk due to our foreign currency-denominated indebtedness and our capital expenditures, particularly equipment. A *real* devaluation may increase the cost of certain of our capital expenditures. Our revenues are earned almost entirely in *reais*, and we have no material foreign currency-denominated assets other than derivative instruments.

At December 31, 2004, 44.6% of our R\$2.8 billion of indebtedness was denominated in foreign currencies (U.S. dollar, Canadian dollar and Japanese yen). See Note 23 to the consolidated financial statements. Devaluation of the *real* causes exchange losses on foreign currency-denominated indebtedness and exchange gain on foreign currency-denominated assets.

We use derivative instruments that limit our exposure to exchange rate risk. Since September 1999, we have hedged virtually all of our foreign currency-denominated debt, using swaps and options structures. However, we remain exposed to market risk deriving from changes in local interest rates (principally the Certificate for Interbank Deposits (*Certificado de Depósito Interbancário*), or CDI; CDI is an index based upon the average rate per cost of loans negotiated among the banks within Brazil).

Substantially all of our debt is exposed to interest rate risk. At December 31, 2004, we had R\$2.8 billion in total loans and financing outstanding. From the total amount, R\$563.0 million was subject to fixed rates, and the balance was subject to floating rates (London Interbank Offered Rate, or LIBOR and CDI). However, virtually all of our foreign currency debt is swapped under hedging arrangements for variable rate *real*-denominated obligations based on CDI. As of December 31, 2004, we had swap transactions CDI against fixed rate in the amount of R\$665.5 million to partially hedge against internal interest rate fluctuations. We invest our cash and cash equivalents mainly in short-term instruments that earn interest based on CDI. See Note 30 to the consolidated financial statements and Item 11 Quantitative and Qualitative Disclosures about Market Risk.

Since we have foreign currency derivatives substantially equivalent to our borrowings denominated in foreign currency, we do not have material exchange rate exposure with respect to these contracts. However, we could still continue to have exchange rate exposure with respect to our planned capital expenditures, approximately 30% of which are made in foreign currencies (mostly U.S. dollars). Nevertheless, according to our corporate policy, we are consistently hedging these specific contracts in order to minimize our capital expenditure exposure, as long as they are being contracted.

### **Discussion of Critical Accounting Estimates and Policies**

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The preparation of financial statements in accordance with the Corporate Law Method included in this annual report involves certain assumptions and estimates, which are based upon historical experience and various other factors that we deemed reasonable and relevant. Although we review these estimates and assumptions in the ordinary course of business, the portrayal of our financial condition and results of operation often requires our management to make judgments regarding the effects on our financial condition and results of operations of matters that are inherently uncertain. Actual results may differ from those estimated under different variables, assumptions or conditions. Note 3 of our consolidated financial statements includes a summary of the significant accounting policies and methods used in the preparation of those statements. In order to provide an understanding of how we form the foregoing judgments and estimates, we have summarized certain critical accounting policies below.

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### ***Estimated useful lives of property, plant and equipment and intangible assets***

We estimate the useful lives of property, plant and equipment in order to determine the amount of depreciation and amortization expense to be recorded during any reporting period. The useful lives are estimated at the time the asset is acquired and are based on historical experience with similar assets, as well as taking into account technological or other changes. If technological changes were to occur more rapidly than anticipated, the useful lives assigned to these assets may need to be shortened, resulting in the recognition of increased depreciation and amortization expenses in future periods. Alternatively, these types of technological changes could result in the recognition of a devaluation charge to reflect the write-down in value of the asset. We review these types of assets for devaluation annually, or when events or circumstances indicate that the carrying amount may not be recoverable over the remaining lives of the assets. In assessing devaluations, we employ the cash flow method, which takes into account management's estimates of future operations.

As of December 31, 2004, we had R\$13.4 billion recorded as property, plant and equipment under the Corporate Law Method, accounting for approximately 71% of our total assets.

### ***Revenue recognition and accounts receivable***

Under the Corporate Law Method and U.S. GAAP, revenues from interconnection fees are calculated based on the duration of each call and, as determined by Brazilian law, recognized at the time the interconnection services are rendered. Under the Corporate Law Method, revenues from the sale of pre-paid phone cards to be used in public telephones are recognized at the time the card is used. Deferred revenues are determined based on estimates of outstanding credits of pre-paid phone cards that were sold but have not been used as of the date of each balance sheet. Under the Corporate Law Method, revenues from activation or installation services are recognized upon the activation or installation of services to the customer. Under U.S. GAAP, revenues from activation and installation services are deferred and amortized over three years, which is the estimated average customer life.

We consider revenue recognition a critical accounting policy because of uncertainties caused by different factors such as the complex information technology required, the high volume of transactions, problems related to fraud and piracy, accounting regulations, management's determination of our ability to collect fees and uncertainties relating to our right to receive certain revenues (mainly revenues for use of our network). Significant changes in these factors could cause us to fail to recognize revenues or to recognize revenues that we may not be able to realize in the future, despite our internal controls and procedures. We have not identified any significant need to change our recognition policy for U.S. GAAP or the Corporate Law Method.

### ***Allowance for doubtful accounts***

In preparing our financial statements, we must estimate our ability to collect payment for our accounts receivable. We constantly monitor our past due accounts receivable. If we become aware of a specific customer's inability to meet its financial obligations, we record a specific allowance against amounts due in order to reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other accounts receivable, we recognize allowances for doubtful accounts based on our past write-off experience (i.e., average percentage of receivables historically written-off, economic conditions and the length of time the receivables are past due). Our reserves have generally been adequate to cover our actual credit losses. However, because we cannot predict with certainty the future financial stability of our customers, we cannot guarantee that our reserves will continue to be adequate. Actual credit losses may be greater than the allowance we have established, which could have a significant negative impact on our selling expenses.



*Provision for contingencies*

We are subject to legal and administrative proceedings related to tax, labor and civil matters. We are required to assess the likelihood of any adverse decision or outcome of these matters as well as the range of probable losses. A determination of the amount of reserves required, if any, for these contingencies is made after careful analysis of each individual matter and in consultation with our internal and external legal counsel. We record provisions for contingencies only when we believe that it is probable that we will incur loss in connection with the matter in dispute. We have recorded no provisions for a number of significant tax disputes with the Brazilian tax authorities because we do not believe we are likely to incur losses in connection therewith. Our required reserves for contingencies may change in the future based on

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new developments or changes in our approach to these proceedings (e.g., change in our settlement strategy). Such changes could result in a negative impact on future results and cash flows.

### ***Future liability for our post-retirement benefits (pension fund and medical health care)***

We provide various pension and medical benefits for our employees. We must make assumptions in connection with the provision of such benefits as to interest rates, investment returns, inflation, mortality rate and future employment rate levels in order to quantify our post-retirement liabilities. The accuracy of these assumptions will determine whether or not we have sufficient reserves for accrued pension and medical health care costs.

### ***Deferred Taxes***

By carrying value into our net deferred tax assets, we imply that we will generate sufficient future taxable income in certain tax jurisdictions, based on estimates and assumptions, and will continue operating under the current and future applicable provisional measures. If these estimates and related assumptions change in the future, we may be required to record additional provisions to be offset against our deferred tax assets, and thus be liable for an additional income tax expense in our financial statements. Management evaluates the reasonableness of the deferred tax assets and assesses the need for additional valuation allowances at the end of the year. As of December 31, 2004, we did not believe a provision to offset our net deferred tax assets was required.

### ***Financial instruments and other financing activities***

In order to manage foreign exchange transactions we may from time to time invest in derivative financial instruments. Under the Corporate Law Method, foreign currency swap agreements are recorded at notional amounts, in accordance with the contractual terms, plus interest and exchange variation incurred up to the balance sheet date. As of December 31, 2004, we recognized net losses of R\$298.9 million (net losses of R\$1.2 billion as of December 31, 2003) on our hedge transactions and liabilities of R\$235.9 million (assets of R\$359.5 million as of December 31, 2003) in order to recognize existing temporary losses. The gains or losses on hedge transactions were calculated based on the notional amount plus interest and exchange variation incurred up to the balance sheet date, net of CDI rate variation on the notional amount.

We adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities, under U.S. GAAP, as of January 1, 2001. The accounting required under SFAS 133 is broader than the Corporate Law Method, especially with respect to the overall treatment and definition of a derivative, when to record derivatives, classification of derivatives, and when to designate a derivative as a hedge. All derivatives, whether or not related to a hedging transaction, must be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and the hedged item are recognized in earnings. If the derivative is designated as a cash flow hedge, changes in the fair value of the derivative are recorded in other comprehensive income, or OCI, a component of U.S. GAAP shareholders equity, and are recognized in the income statement when the hedged item results in earnings. Portions of ineffective changes in the fair value of cash flow hedges are recognized in earnings.

At December 31, 2004 we had US\$117.0 million and JPY27.9 billion of notional value swap contracts designated as fair value hedges of a portion of our foreign currency denominated debt.

On December 31, 2002, we recorded under SFAS 133 an adjustment in derivatives that were not designated as accounting hedges for the difference between the book value and the fair value of such derivatives. The fair value of derivatives on December 31, 2002 was impacted by the high interest rates used in the foreign interest rate swap market (basis of computation of derivatives' fair value) mainly due to the uncertainties regarding the political and economical future of Brazil and the uncertainties about Brazilian foreign policy. The negative adjustment in our results of operations under U.S. GAAP was R\$454.0 million on December 31, 2002.

Despite a period of instability in 2002, the Brazilian political and economic environment improved during 2003. As a consequence, we reverted the negative adjustments in the amount of R\$454.0 million that had been registered in 2002 and recognized a gain in the amount of R\$60.5 million on December 31, 2003 for U.S. GAAP purposes. In addition, the derivative operations contracted during 2003 gave rise to a positive adjustment of R\$147.5 million in profit and loss under U.S. GAAP as at December 31, 2003. Therefore, the adjustment under SFAS 133 totaled R\$662.0 million in 2003. As at December 31, 2004, we recognized a loss of R\$109.0 million for such transactions for the purposes of U.S. GAAP.

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In applying generally accepted accounting principles in connection with these derivative instruments, management took into consideration interest rates, discount rates, foreign exchange rates, future cash flow, and the effectiveness of hedges. These judgments directly affect the value of derivative instruments recorded on the balance sheet, and the amount of gains and losses included in the calculation of comprehensive income. Should actual interest rates, discount rates, foreign exchange rates, future cash flow and ultimate hedge effectiveness differ from our estimates, the amounts recorded within the period of realization will have to be revised.

**Results of Operations**

The following table sets forth certain components of our net income, as well as the percentage change of each component from the prior year, for each of the years in the three-year period ended December 31, 2004.

	Year ended December 31,			% Change	
	2004	2003	2002	2004 - 2003	2003 - 2002
	(in millions of reais, except percentages)				
Net operating revenue	13,309	11,805	10,088	12.7%	17.0%
Cost of services	(7,496)	(6,715)	(5,770)	11.6%	16.4%
Gross profit	5,813	5,090	4,318	14.2%	17.9%
Operating expenses:					
Selling expense	(1,607)	(1,286)	(1,010)	25.0%	27.3%
General and administrative expense	(747)	(964)	(840)	(22.5)%	14.8%
Other net operating expense	(190)	(393)	(357)	(51.7)%	10.1%
Total operating expenses	(2,544)	(2,643)	(2,207)	(3.7)%	19.8%
Operating income before financial income	3,269	2,447	2,111	33.6%	15.9%
Financial income expense, net	(404)	(630)	(755)	(35.3)%	(16.6)%
Operating income	2,865	1,817	1,356	57.7%	34.0%
Net non-operating income (expense)	40	50	(33)	(20.0)%	251.5%
Income before taxes and minority interests	2,905	1,867	1,323	(55.6)%	(41.1)%
Income and social contribution taxes	(724)	(279)	(247)	159.5%	13.0%
Net income	2,181	1,588	1,076	37.3%	47.6%

**Results of Operations for Year Ended December 31, 2004 Compared to Year Ended December 31, 2003****Net Operating Revenue**

Our revenues are derived primarily from the following:

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local service charges, which include monthly subscription charges, measured service charges, activation fees, and charges for use of public telephones (including prepaid cards);

intraregional long-distance service charges, which include service charges for calls that originate and terminate within our concession region;

interregional and international long-distance service charges, as we achieved Anatel's targets and started to provide these services in 2002;

charges for data transmission;

charges for network services, which include fees paid by our customers for the use of our fixed-mobile network when they place a call and fees paid by other telecommunications service providers on a per-call basis or on a contractual basis to use part of our network; and

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charges for other services, including telephone mailing lists, equipment rentals and miscellaneous revenue from other services (including call waiting, call forwarding, voice and fax mailboxes, speed dialing, caller ID and digital access service).

Gross operating revenues are reduced by value-added and other indirect taxes and discounts to customers. The composition of operating revenues by category of service is presented in our consolidated financial statements and discussed below. We do not determine net operating revenues for each category of revenue.

The following table sets forth certain components of our operating revenues, as well as the percentage change of each component from the prior year, for 2004 and 2003.

	Year ended December 31,		% Change
	2004	2003	2004-2003
(in millions of reais, except percentages)			
Gross operating revenue:			
Local services:			
Monthly subscription charges (1)	4,971	4,456	11.6%
Activation fees	68	104	(34.6)%
Measured service charges	3,057	3,017	1.3%
Public telephones	381	247	54.3%
<b>Total</b>	<b>8,477</b>	<b>7,824</b>	<b>8.3%</b>
Long-distance services:			
Intraregional	2,334	1,821	28.2%
Interregional and international	845	740	14.2%
<b>Total</b>	<b>3,179</b>	<b>2,561</b>	<b>24.1%</b>
Data transmission (1)	997	592	68.4%
Network services	5,129	4,654	10.2%
Goods sold	21	23	(8.7)%
Other services	623	568	9.7%
<b>Total gross operating revenue</b>	<b>18,426</b>	<b>16,222</b>	<b>13.6%</b>
Value added and other indirect taxes	(4,902)	(4,321)	13.5%
Discounts	(215)	(96)	124.0%
<b>Net operating revenue</b>	<b>13,309</b>	<b>11,805</b>	<b>12.7%</b>

(1) In December 2003, we reclassified revenues from digital access and other (previously classified as other services) to Monthly subscription charges in the amount of R\$214.0 million and to Data transmission in the amount of R\$7.0 million.

**Net Operating Revenue**

Net operating revenue increased 12.7% to R\$13.3 billion in 2004 from R\$11.8 billion in 2003. The increase in net operating revenue is mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2004, based on the accumulated IPCA of the previous

12 months and the increase in revenue from our data transmission services.

***Local Services***

Revenues from local services increased 8.3% to R\$8.5 billion in 2004 from R\$7.8 billion in 2003. The growth is mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2004.

*Monthly subscription charges.* Revenues from monthly subscription charges increased 11.6% to R\$5.0 billion in 2004 from R\$4.5 billion in 2003. The growth in 2004 was due primarily to the increase in local and intraregional long-distance tariffs that took place in June 2004, partially offset by a reduction in the average number of fixed lines in service.

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*Activation fees.* Revenues from monthly activation fees decreased 34.6% to R\$68.0 million in 2004 from R\$104.0 million in 2003. The decrease is the result of the Company's low-income fixed-line service program, which began in July 2004, pursuant to which we did not charge activation fees for promotional reasons.

*Measured service charges.* Revenues from measured service charges increased 1.3% to R\$3.1 billion in 2004 from R\$3.0 billion in 2003. The increase in 2004 was mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2004, offset in part by decreases in measured service traffic of approximately 7.4% (surplus pulses *pulsos excedentes*).

*Public telephones.* Revenues from charges for the use of public telephones increased 54.3% to R\$381.0 million in 2004 from R\$247.0 million in 2003 as a result of the June 2004 tariff increase, driven by an increase in sales of our telephone cards, primarily our alternative lower fee card programs (Bargain Line *Linha Econômica* and Super-Bargain Line *Linha da Super Economia*). Revenues from the sale of public phone cards are recognized in our results from the moment the phone card is used in accordance with a change in an accounting method introduced in December 2002.

### ***Long-Distance Services***

*Intraregional services.* Revenues from intraregional services increased 28.2% to R\$2.3 billion in 2004 from R\$1.8 billion in 2003. The increase was mainly due to the increase in local and intraregional long-distance tariffs that took place in June 2004, however, an increase in revenue from SMP services and our growth in market share also contributed in part to the foregoing increase.

*Interregional and international.* We launched our long-distance interregional and international services in May and July 2002. Revenues from international and interregional services increased 14.2% to R\$845.0 million in 2004 from R\$740.0 million in 2003, driven primarily by an increase in revenue from SMP services and also, in part, by the tariff adjustments that occurred in June 2004 as well as our estimated growth in market share.

### ***Data Transmission***

Revenues from data transmission services increased 68.4% to R\$997.0 million in 2004 from R\$592.0 million in 2003. The growth in 2004 was due to an approximately 62% increase in the use of our SPEEDY service.

### ***Network Services***

Revenues from network services consist of interconnection fees paid to us by other telecommunications service providers for the use of our network to complete calls and carry traffic. Revenues from network services increased by 10.2% to R\$5.1 billion in 2004 from R\$4.6 billion in 2003 mainly due to the increase in tariffs for calls originating at fixed lines and terminating at mobile units that took place in February 2003, offset by a decrease in market share resulting from the implementation of the operator code selection for both interregional calls originating from fixed-lines (which took place in 2002) and interregional calls originating from mobile phones (which took place in July 2003).



***Goods Sold***

Revenues from goods sold decreased 8.7% to R\$21.0 million in 2004 from R\$23.0 million in 2003 driven by our increased costs associated with modems for SPEEDY broadband service and pricing pressure. The technology of the modems improved, making such equipment more expensive, and, at the same time, the modems began selling in the open market placing pricing pressure on us to price such equipment more competitively. The foregoing factors resulted in decreased revenues and smaller margins in 2004.

***Other Services***

Revenues from other services primarily include revenues from telecommunications services for the installation of phone lines, electronic mail and other local services including call waiting, call forwarding, voice and fax mailboxes, speed dialing and caller ID. Revenues from other services increased 9.7% to R\$623.0 million in 2004 from R\$568.0 million in 2003. The increase was due primarily to the increase in our revenues from *Linha Inteligente*, our name brand for our service package which includes call waiting, call forwarding, voice and fax mailboxes, speed dialing and caller ID, offset by a decrease in our digital access service known as 2M-ATB (2 Megabytes Basic Tariff Area).

**Table of Contents****Cost of Services**

Cost of services includes primarily depreciation and amortization expenses, interconnection services, personnel expenses and costs of services provided by third parties. Cost of services increased 11.6% to R\$7.5 billion in 2004 compared to R\$6.7 billion in 2003, mainly due to an increase in expenses related to interconnection services.

The following table sets forth certain components of our cost of services, as well as the percentage change of each component from the prior year, for 2004 and 2003.

	Year ended December 31,		% Change
	2004	2003	2004 2003
	(in millions of <i>reais</i> , except percentages)		
Cost of services:			
Depreciation and amortization	2,496	2,616	(4.6)%
Outsourced services	1,059	786	34.7%
Interconnection services	3,512	2,836	23.8%
Operational personnel	188	256	(26.6)%
Materials	41	42	(2.4)%
Goods sold	19	17	11.8%
Other costs	181	162	11.1%
Total cost of services	7,496	6,715	11.6%

**Depreciation and amortization**

Depreciation and amortization expenses decreased totaling R\$2.5 billion in 2004 and R\$2.6 billion in 2003, driven primarily by capital expenditures in compliance with Anatel's network expansion targets and reductions for obsolescence.

**Outsourced Services**

Expenses relating to services from third parties increased 34.7% to R\$1.1 million in 2004 from R\$786.0 million in 2003 driven by a combination of factors, including the payment for services relating to increased operational plant services, IP networking services and co-billing.

**Interconnection Services**

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Expenses relating to interconnection services increased 23.8% to R\$3.5 billion in 2004 from R\$2.8 billion in 2003, as a result of an increase in the traffic volume, especially from interregional and international long-distance services and the increase in tariffs that took place in June 2004. This increase also reflects expenses arising from SMP selections, which began in July 2003, and the resulting payments made to other telecommunications services providers.

### *Operational Personnel*

Operational personnel expenses consist of expenses relating to salaries, bonuses and other benefits of employees dedicated to operating and maintaining our services. Operational personnel expenses decreased 26.6% to R\$188.0 million in 2004 from R\$256.0 million in 2003 due to a reorganization in personnel outsourcing services offset in part by salary adjustment.

### *Materials*

We include in materials, among other items, materials used for maintenance of our assets, replacement parts and automobile gas. The costs of materials decreased 2.4% to R\$41.0 million in 2004 from R\$42.0 million in 2003 as a function of a reduction in costs related to vehicles used in our operations and offset by an increase in costs for materials used in ordinary operations.

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### ***Goods Sold***

Expenses associated with the sale of telephone equipment increased 11.8% to R\$19.0 million in 2004 from R\$17.0 million in 2003 due, as noted above, to an increase in the costs associated with improved technology for modems used to access our SPEEDY broadband service.

### ***Other Costs***

Other costs relate to costs associated with the lease of certain infrastructure equipment, poles and underground cables used to operate our telephone lines. Other costs increased 11.1% to R\$181.0 million in 2004 compared to R\$162.0 million in 2003 primarily as a result of an increase in the rental cost for infrastructure, offset in part by a reduction in the rental cost for ducts housing various types of telephone cable.

### ***Operating Expenses***

Operating expenses decreased 3.7% to R\$2.5 billion in 2004 from R\$2.6 billion in 2003 mainly as a result of a reduction in provisions for contingencies and reduced personnel costs as a result of restructuring. These reductions were offset by the increase in expenses related to third-party services, primarily marketing services.

### ***Selling Expenses***

Selling expenses increased 25.0% to R\$1.6 billion in 2004 from R\$1.3 billion in 2003. Part of this increase resulted from the outsourcing of systems production (R\$79.2 million), telemarketing (R\$33.2 million), co-billing to other operators (R\$31.8 million), traffic imbalance (R\$25.9 million), advertising (R\$21.1 million), Internet systems maintenance (R\$23.8 million), mailing and administrative costs for billing (R\$16.0 million) and other personnel expenses (R\$48.7 million).

### ***General and Administrative Expenses***

General and administrative expenses decreased by 22.5% to R\$747.0 million in 2004 from R\$964.0 million in 2003. The decrease is attributable to a reduction in personnel expenses of R\$85.8 million stemming from a reduction from expenses related to the PDI, and a reduction in the outsourcing of systems production in the amount of R\$126.5 million.

### ***Other Net Operating Expense***

Other net operating expense includes a variety of revenues and costs. See Note 7 to the consolidated financial statements. Other net operating expense decreased 51.7% to R\$190.0 million in 2004 from R\$393.0 million in 2003. This decrease is due to a reduction in expenses related to provisions for contingencies in the amount of R\$182.6 million, comprised primarily of the provision made in 2003 with respect to INSS - SAT and *Plano Verão* and *Plano Bresser* in the amount of R\$174.1. See Item 8A Financial Information Consolidated Statements and Other Financial Information Legal Proceedings Litigation with INSS.

***Financial Expense, Net***

We recognized a net financial expense of R\$404.0 million in 2004 compared to a net financial expense of R\$630.0 million in 2003, representing the net effect of financial income, financial expense and exchange gains and loss. See Note 8 to the consolidated financial statements. The decrease in net financial expenses recorded in 2004 versus 2003 was primarily driven by a decrease in interest rates of our loans and commitments. At December 31, 2004, 44.6% of our debt was denominated in foreign currency (U.S. dollar, Canadian dollar and Japanese yen), and 98.6% of our debt was hedged by asset positions in foreign currency swap transactions. See Item 11 Quantitative and Qualitative Disclosures about Market Risk.

***Net Non-Operating Income (Expense)***

We recorded a net non-operating income of R\$40.0 million in 2004, compared to a net non-operating expense of R\$50.0 million in 2003. This reduction was driven by gains associated with the restructuring of our associated company Companhia AIX de Participações in 2003 and by a positive result in 2004 in the sale of fixed assets.

**Table of Contents****Income and Social Contribution Taxes**

Our income and social contribution tax expenses increased to R\$724.0 million in 2004 as compared to R\$279.0 million in 2003 as a result of a confluence of factors, including overall improved financial performance, a reduction in the payment of interest on shareholders' equity (*juros sobre capital próprio*) and a reduction in certain amortization of goodwill expenses. Our effective tax rate in 2004 was 24.9%. See Note 24 to our consolidated financial statements.

**Net Income**

As a result of the foregoing factors, net income increased to R\$2.2 billion in 2004 from R\$1.6 billion in 2003.

**Results of Operations for Year Ended December 31, 2003 Compared to Year Ended December 31, 2002**

The following table sets forth certain components of our operating revenues, as well as the percentage change of each component from the prior year, for 2003 and 2002.

	Year ended December 31,		% Change
	2003	2002	2003-2002
(in millions of reais, except percentages)			
Gross operating revenue:			
Local services:			
Monthly subscription charges (1)	4,456	4,017	11.0%
Activation fees	104	110	(5.4)%
Measured service charges	3,017	2,637	14.4%
Public telephones	247	187	32.1%
<b>Total</b>	<b>7,824</b>	<b>6,951</b>	<b>12.6%</b>
Long-distance services:			
Intraregional	1,821	1,347	35.1%
Interregional and international	740	295	150.8%
<b>Total</b>	<b>2,561</b>	<b>1,642</b>	<b>55.9%</b>
Data transmission (1)	592	438	35.3%
Network services	4,654	4,176	11.4%
Goods sold	23	19	21.0%
Other services	568	451	26.0%
<b>Total gross operating revenue</b>	<b>16,222</b>	<b>13,677</b>	<b>18.6%</b>
Value added and other indirect taxes	(4,321)	(3,572)	21.0%
Discounts	(96)	(17)	464.7%

Net operating revenue	11,805	10,088	17.0%
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- (1) In December 2003 and 2002, we reclassified revenues from digital access and other (previously classified as other services ) to Monthly subscription charges in the amount of R\$214.0 million and R\$231.0 million, respectively, and to Data transmission in 2003 in the amount of R\$7.0 million.

***Net Operating Revenue***

Net operating revenue increased 17.0% to R\$11.8 billion in 2003 from R\$10.1 billion in 2002. The increase in net operating revenue is mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2003, based on the accumulated IPCA of the previous 12 months and an increase in tariffs for calls originating at fixed lines and terminating in mobile lines that took place in February 2003, combined with the continuing growth in volume in the interregional and international long-distance services which together generated revenues in the amount of R\$740 million.

***Local Services***

Revenues from local services increased 12.6% to R\$7.6 billion in 2003 from R\$6.9 billion in 2002. The growth is mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2003.

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*Monthly subscription charges.* Revenues from monthly subscription charges increased 11.0% to R\$4.4 billion in 2003 from R\$4.0 billion in 2002. The growth in 2003 was due primarily to the increase in local and intraregional long-distance tariffs that took place in June 2003, offset by a 1.3% reduction in the average number of fixed lines in service.

*Activation fees.* Revenues from monthly activation fees decreased 5.4% to R\$104.0 million in 2003 from R\$110.6 million in 2002. The decrease is the result of a smaller aggregate number of phone line subscribers in 2003.

*Measured service charges.* Revenues from measured service charges increased 14.4% to R\$3.0 billion in 2003 from R\$2.6 billion in 2002. The increase in 2003 was mainly a result of the increase in local and intraregional long-distance tariffs that took place in June 2003.

*Public telephones.* Revenues from charges for the use of public telephones increased 32.1% to R\$247.0 million in 2003 from R\$187.0 million in 2002 as a result of the June 2003 tariff increase, an increase in revenues from the use of our telephone cards in São Paulo received from other telephone operators and a reduction in interconnection costs paid to other telephone operators. Revenues from the sale of public phone cards are recognized in our results from the moment the phone card is used in accordance with a change in an accounting method introduced in December 2002.

### ***Long-Distance Services***

*Intraregional services.* Revenues from intraregional services increased 35.1% to R\$1.8 billion in 2003 from R\$1.3 billion in 2002. The increase was mainly due to the increase in local and intraregional long-distance tariffs that took place in June 2003 combined with a 9.5% increase in the number of minutes used.

*Interregional and international.* As we launched our long-distance interregional and international services in May and July 2002, respectively, revenues from international and interregional services increased 150.8% to R\$740.0 million from R\$295.0 million in 2002. In December 2003, our market share was estimated between 45% and 50% for interregional services and between 35% and 40% for international services.

### ***Data Transmission***

Revenues from data transmission services increased 35.3% to R\$592.0 million in 2003 from R\$438.0 million in 2002. The increase in 2003 was a result of an increase in our SPEEDY service, combined with a higher number of activation fees and the rental and sale of modems.

### ***Network Services***

Revenues from network services consist of interconnection fees paid to us by other telecommunications service providers for the use of our network to complete calls and carry traffic. Revenues from network services increased by 11.4% to R\$4.6 billion in 2003 from R\$4.2 billion in



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2002 mainly due to the increase in tariffs for calls originating at fixed lines and terminating in mobile lines that took place in February 2003, offset by a decrease in market share due to the implementation of the operator code selection for interregional calls originating from fixed lines which took place in 2002 and implementation of the same code selection for interregional calls originating from mobile lines in July 2003.

### ***Goods Sold***

Revenues from goods sold increased 21.0% to R\$23.0 million in 2003 from R\$19.0 million in 2002 due to an increase in the amount of equipment sold by our subsidiary, Assist Telefônica S.A.

### ***Other Services***

Revenues from other services primarily include revenues from telecommunications services for the installation and activation of phone lines, electronic mail and other local services including call waiting, call forwarding, voice and fax mailboxes, speed dialing and caller ID. Revenues from other services increased 26.0% to R\$568.0 million in 2003 from R\$451.0 million in 2002. The increase was due primarily to the increase in our revenues from *Linha Inteligente*, our name brand for our service package which includes call waiting, call forwarding, voice and fax mailboxes, speed dialing and caller ID, offset by a decrease in our digital access service known as 2M-ATB (2 Megabytes Basic Tariff Area).

**Table of Contents****Cost of Services**

Cost of services includes primarily depreciation and amortization expenses, interconnection services, personnel expenses and costs of services provided by third parties. Cost of services increased 16.4% to R\$6.7 billion in 2003 compared to R\$5.8 billion in 2002, mainly due to an increase in expenses related to interconnection services.

The following table sets forth certain components of our cost of services, as well as the percentage change of each component from the prior year, for 2003 and 2002.

	Year ended December 31,		% Change	
	2003	2002	2003	2002
	(in millions of reais, except percentages)			
Cost of services:				
Depreciation and amortization	2,616	2,647		(1.2)%
Outsourced services	786	614		28.0%
Interconnection services	2,836	1,979		43.3%
Operational personnel	256	297		(13.8)%
Materials	42	36		16.7%
Goods sold	17	11		54.5%
Other costs	162	186		(12.9)%
Total cost of services	6,715	5,770		16.4%

**Depreciation and amortization**

Depreciation and amortization expenses remained stable totaling R\$2.6 billion in 2003 and the same amount in 2002, in line with the investments made during the year.

**Outsourced Services**

Expenses relating to services from third parties increased 28.0% to R\$786.0 million in 2003 from R\$614.0 million in 2002 mainly due to the payment of expenses relating to maintenance of the network, partially offset by a decrease in the maintenance of telephone switches and lower costs associated with the production of phone books.

**Interconnection Services**

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Expenses relating to interconnection services increased 43.3% to R\$2.8 billion in 2003 from R\$2.0 billion in 2002, as a result of an increase in the traffic volume, especially from interregional and international long-distance services for the use of other telecommunications service operators network since 2002, which long-distance services have also been offered to SMP mobile operators since July 2003.

### *Operational Personnel*

Operational personnel expenses consist of expenses relating to salaries, bonuses and other benefits of employees dedicated to operating and maintaining our services. Operational personnel expenses decreased 13.8% to R\$256.0 million in 2003 from R\$297.0 million in 2002, due to a reduction in the number of our plant employees.

### *Materials*

The costs of materials increase 16.7% to R\$42.0 million in 2003 from R\$36.0 million in 2002 primarily as a result of an increase in materials used in the maintenance of our network.

### *Goods Sold*

Expenses associated with the sale of telephone equipment increased 54.5% to R\$17.0 million in 2003 from R\$11.0 million in 2002 due to an increase in the sale of equipment.

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### ***Other Costs***

Other costs relate to costs associated with the lease of certain infrastructure equipment, poles and underground cables in order to run our telephone lines. Other costs decreased 12.9% to R\$162.0 million in 2003 compared to R\$186.0 million in 2002 primarily as a result of a lower average number of access lines.

### ***Operating Expenses***

Operating expenses increased 19.8% to R\$2.6 billion in 2003 from R\$2.2 billion in 2002 mainly as a result of higher expenses in connection with outsourced services and an increase in provisions for contingencies.

### ***Selling Expenses***

Selling expenses increased 27.3% to R\$1.3 billion in 2003 from R\$1.0 billion in 2002. Part of the increase, in the amount of R\$160.9 million, was accounted for by an increased in the amounts paid to third parties, especially related to call center and increase in volume of advertising due mainly to the launch of our long-distance services and our operator selection code 15 promotions. Although we keep improving our credit and collection policies, we experienced an increase in the amount of R\$70.6 million in our provisions for past due credits as a result of an increase in the number of customers.

### ***General and Administrative Expenses***

General and administrative expenses increased by 14.8% to R\$964.0 million in 2003 from R\$840.0 million in 2002. The increase is attributable to the reorganization of our employees, as well as salary increases, and although we downsized a portion of our plant employees, we were required to pay certain incentives to accomplish our payroll reorganization.

### ***Other Net Operating Expense***

Other net operating expense includes a variety of revenues and costs. See Note 7 to the consolidated financial statements. Other net operating expense increased 5.1% to R\$393.0 million in 2003 from R\$357.0 million in 2002. The increase in other net operating expenses was a result of higher provisions related to tax contingencies and tax expenses (excluding income tax) related to the PIS over other revenues and the payment of ICMS due to the state government amnesty, which were offset by a lower provision to market value of our inventories.

### ***Financial Expense, Net***

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We recognized a net financial expense of R\$630.0 million in 2003 compared to a net financial expense of R\$755.0 million in 2002, representing the net effect of financial income, financial expense and exchange gains and loss. See Note 8 to the consolidated financial statements. The decrease in net financial expenses recorded in 2003 was due mainly to a decrease in interest rates of our loans and commitments. At the end of 2003, we had derivative instruments with notional amounts equivalent to virtually all of our exposure in foreign currencies debt.

### *Net Non-Operating Income (Expense)*

We recorded a net non-operating income of R\$50.0 million in 2003, compared to a net non-operating expense of R\$33.0 million in 2002. The income recorded for 2003 reflects mainly a gain in the amount of R\$25.5 related to the positive effects of the corporate restructuring of Companhia AIX de Participações. See Note 16 to the consolidated financial statements.

### *Income and Social Contribution Taxes*

Income and social contribution taxes amounted to an expense of R\$279.5 million in 2003 compared to an expense of R\$247.7 million in 2002. See Note 10 to the consolidated financial statements.

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### ***Net Income***

As a result of the above, net income increased to R\$1.6 billion in 2003 from R\$1.1 billion in 2002.

## **B. Liquidity and Capital Resources**

### **General**

We have funded our operations and capital expenditures mainly from operating cash flows and loans obtained from financial institutions. At December 31, 2004, we had R\$238.6 million in cash and cash equivalents. Our principal cash requirements include:

the servicing of our indebtedness,

capital expenditures, and

the payment of dividends.

### **Sources of Funds**

Our cash flow from operations was R\$5.6 billion in 2004 compared to R\$5.0 billion and R\$4.6 billion in 2003 and 2002, respectively. Our increase in cash flow from operating activities of 12.6% in 2004 compared to 2003 primarily resulted from increased sales of our telecommunications services, with our Speedy and other data transmission services as important drivers for such gains, as well as the increase in tariffs. The increase in cash flows of 8.7% in 2003 compared to 2002 was due to the increase in telecommunications services provided to our customers, especially long-distance interregional and international services.

Our future cash flow is subject to the rates approved by Anatel and the impact of competition on our revenues. We expect to continue to experience a reliable and steady source of internal cash flow from operations for the foreseeable future from on our base of customers and installed network.

### **Uses of Funds**

Our cash flow used in investing activities was R\$1.4 billion in 2004 compared to R\$1.3 billion in 2003 and R\$1.6 billion in 2002. The increase in 2004 from 2003 resulted from the first installment paid in connection with the acquisition of Atrium.

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Our cash flow used in financing activities was R\$4.2 billion in 2004 and R\$4.0 billion in 2003 compared to a cash flow of R\$2.7 billion used in 2002. The increase in cash flow used in financing activities in 2004 was due mainly to dividends paid in the amount of R\$3.7 billion and the payment on derivative contracts maturing in 2004 used to hedge our indebtedness against changes in foreign currency. The increase in 2003 was due to repayment of loans in the amount of R\$3.1 million and dividends paid in amount of R\$3.1 billion, which were offset by new loans obtained in the amount of R\$2.3 billion.

**Table of Contents****Indebtedness**

As of December 31, 2004, our total debt was as follows:

<b>Debt</b>	<b>Currency</b>	<b>Annual interest rate payable</b>	<b>Maturity</b>	<b>Principal amount outstanding (in thousands of reais)</b>
Mediocredito	US\$	1.75%	2014	75,846
CIDA	CAN\$	3.00%	2005	1,483
Loan in local currency	R\$	6.0%+3.75% spread and 0.40% + CDI per month	2006	15,814
Debentures (1)	R\$	103.5% of CDI	2007	1,500,000
Resolution No. 2,770	US\$	2.00% to 6.9%	2006	310,640
Resolution No. 2,770	JPY	1.40%	2005	79,736
Debt assumption	US\$	8.62% to 27.50%	2005	61,119
Untied loan JBIC	JPY	LIBOR + 1.25%	2009	643,242
DEG Deutsche	US\$	LIBOR + 6.0%	2007	18,431
Accrued Interest	R\$/US\$ JPY/CAN\$		2005 to 2006	60,028
<b>Total debt</b>				<b>2,756,243</b>
<b>Current</b>				<b>529,930</b>
<b>Long-term</b>				<b>2,226,313</b>

- (1) Non-convertible and unsecured debentures maturing on September 10, 2010 in an aggregate principal amount of R\$1.5 billion. These debentures are subject to an adjustment provision in September 2007 that would permit, among other things, payment of principal upon a favorable vote of the holders for such action. Accordingly, to be conservative, we have recorded our obligation to pay the principal on the Debentures in 2007 as opposed to their scheduled maturity date in 2010. See Note 23 to our consolidated financial statements.

Interest and principal payments on our indebtedness at December 31, 2004 due in 2005 and 2006 totaled R\$530.0 million and R\$262.1 million, respectively.

The agreements that govern the majority of our outstanding loans and financings contain certain standard restrictive covenants, which provide for the acceleration of the full balance of our obligations in the event of any default. As of December 31, 2004, we were not in default of any of our obligations and therefore none of our liabilities were subject to acceleration.

**Capital Expenditures and Payment of Dividends**



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Our principal capital requirements are for capital expenditures and payments of dividends to shareholders. Additions to property, plant and equipment totaled R\$1.3 billion, R\$1.3 billion and R\$1.7 billion for the years ended December 31, 2004, 2003, and 2002, respectively. Our capital expenditures for the year ended 2005 are expected to be approximately R\$1.7 billion. These expenditures relate primarily to expansion of our network. In addition, we expect to seek financing for part of our capital expenditures from equipment suppliers, government agencies or, depending on market conditions, the Brazilian or international capital markets. See Item 4.A History and Development of the Company Capital Expenditures.

Pursuant to our bylaws and Brazilian Corporate Law, we are required to distribute a mandatory minimum dividend of 25% of adjusted net income (as defined below) in respect of each fiscal year, to the extent earnings are available for distribution. Holders of preferred shares are assured priority in the reimbursement of capital, without a premium, and entitled to receive cash dividends 10% higher than those attributable to common shares.

Adjusted net income, as determined by Brazilian Corporate Law, is an amount equal to our net income adjusted to reflect allocations to or from (i) legal reserve, (ii) statutory reserve, and (iii) a contingency reserve for anticipated losses, if any.

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We may also make additional distributions to the extent that we have available profits and reserves to distribute. All of the above distributions may be made as dividends or as tax-deductible interest on shareholders' equity. We paid dividends of R\$3.7 billion, R\$3.1 billion and R\$1.5 billion in 2004, 2003, and 2002, respectively.

Our management expects to meet 2005 capital requirements primarily from cash provided by our operations. Net cash provided by operations was R\$5.1 billion, R\$5.0 billion and R\$4.6 billion in 2004, 2003, and 2002, respectively.

### **C. Research and Development, Patents and Licenses**

#### *Research and Development*

We conduct independent research and development in areas of telecommunications services; however, we do not independently develop new telecommunications hardware. We primarily depend on several manufacturers of telecommunications products for such development services.

In connection with the breakup of Telebrás, we were required to enter into a five-year agreement with Telebrás's Center for Research and Development (*Centro de Pesquisa e Desenvolvimento da Telebrás*), or CPQD, under which we had to contribute R\$112.0 million to CPQD. This agreement, which we refer to as Contract 7000, terminated in December 2004. We do not intend to renew Contract 7000.

For 2005, we have entered into an outsourcing arrangement, with services provided by CPQD, for software development relating to several systems used by Telefonica. This arrangement is being negotiated and we estimate that we will pay approximately R\$12 million for software and related items delivered pursuant to this agreement. During the effectiveness of our agreement with CPQD, we have access to telecommunications software developed by them and other technological services provided by them, including equipment testing, consulting and training services. CPQD has also developed a system for planning, engineering and terminal data-base maintenance of our outside plant with either copper cables or fiber optics, a data-base and provisioning system for switches and trunks, and agreed to develop systems of automation, supervision and repair of our network and certain additional technological services on a non-exclusive basis. CPQD is a privately held company that is not affiliated with Telefônica and may also provide services to third parties. We may receive technological support from CPQD beyond the period contemplated in the agreement by contributing additional funds.

Our research and development expenses, including our monetary contributions to CPQD, were R\$10.5 million for 2004, R\$11.6 million for 2003, and R\$10.8 million for 2002.

#### *Patents and Licenses*

Our principal intellectual property assets include:

our permission to use the trademark name "Telefônica" and all names derived from "Telefônica";

our name Telecomunicações de São Paulo S.A. Telesp ; and

our commercial brands, Super 15 for long-distance services, and Speedy for broadband products.

**D. Trend Information**

We expect increased competition and rapid technological changes which may negatively affect our market share and profit margins. See Item 3.D Risk Factors-Risks Relating to Us and the Brazilian Telecommunications Industry and Item 4.B Information on the Company Business Overview Competition.

We also expect to continue to make capital expenditures to improve the quality of our services and network and to launch new services. See Liquidity and Capital Resources Capital Expenditures.

While the Brazilian economy continues to experience growth, we do not anticipate a material increase in fixed lines in Brazil. We remain committed, however, to innovating and adapting our business to the changing environment and finding markets for our services. For example, in 2004, we implemented successful operations geared towards providing

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telephone service for low-income families. Given that Anatel is studying a regulated product in this area, we expect that this type of service and market will have an important role in the future. One of our competitors currently offers a similar product, but faces limitations on its ability to offer the services to all clients. Other providers do not yet have a product with the same characteristics. In sum, we believe that while the growth of fixed lines will not markedly increase, we and our competitors will have to offer new services, penetrate alternative markets in Brazil and find new methods of meeting our customers' needs.

We do, however, expect another year of growth for broadband lines in Brazil and corresponding growth for current and new providers of broadband services. We anticipate that current providers will be investing to expand network capacity. We have seen this trend not only in Brazil, but in other parts of the world such as Spain and Italy. We also anticipate investments in web content that should help Internet operators increase their value-added service (VAS) revenues. Telefônica is a market leader in this area.

**E. Off-balance-Sheet Arrangements**

None.

**F. Tabular Disclosure of Contractual Obligations**

Our contractual obligations and commercial commitments are as follows:

	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
<b>(In thousands of reais, as of December 31, 2004)</b>					
<i>Contractual obligations</i>					
Long-term debt	2,226,313		1,917,122	273,264	35,927
Other long-term obligations	917,481		672,647	244,834	
Total contractual cash obligations	3,143,794		2,589,769	518,098	35,927
<i>Commercial commitments</i>					
Suppliers	1,151,795	1,151,795			
Other commercial commitments	42,986	42,986			
Total commercial commitments	1,194,781	1,194,781			
<b>Principal amount outstanding (in thousands of reais, as of December 31, 2004)</b>					
<i>Debt</i>					
Loans					2,329,914
Financing from suppliers					426,329
Total					2,756,243

*Long-Term Debt*

<u>Year ending December 31</u>	<u>Amount</u>
	<b>(in thousands of reais, as of December 31, 2004)</b>
2006	262,057
2007	1,655,065
2008	136,632
2009	136,632
Thereafter	35,927
<b>Total</b>	<b>2,226,313</b>
<i>Other long-term obligations</i>	
Contingencies (labor, tax and civil)	800,382
Pension Plan	44,738
Other	72,361
<b>Total</b>	<b>917,481</b>

**Table of Contents****ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****A. Directors and Senior Management**

We are managed by a Board of Directors (*Conselho de Administração*) and an Executive Committee (*Diretoria*).

**Board of Directors**

Our Board of Directors is comprised of a minimum of five and a maximum of fifteen members, all shareholders, serving for a term of three years. The following is a list of the current members of the Board of Directors, their respective positions and date of their election.

<b>Name</b>	<b>Position</b>	<b>Date of Appointment</b>
Fernando Xavier Ferreira	Chairman	March 25, 2004
José María Álvarez Pallete Lopez	Vice-Chairman	March 25, 2004
Manoel Luiz Ferrão de Amorim	Director	March 25, 2004
Fernando Abril-Martorel Hernández	Director	March 25, 2004
Juan Carlos Ros Brugueras	Director	March 25, 2004
Enrique Used Aznar	Director	March 25, 2004
Javier Nadal Ariño	Director	March 25, 2004
Luciano Carvalho Ventura	Director	March 25, 2004
José Fernando de Almansa Moreno Barreda	Director	March 25, 2004
Miguel Ángel Gutiérrez Méndez	Director	January 19, 2005
Luis Bastida Ibarguen	Director	January 19, 2005
Narcís Serra Serra	Director	January 19, 2005
Guillermo Pablo Ansaldo	Director	January 19, 2005

Set forth below are brief biographies of our directors:

*Fernando Xavier Ferreira* is 56 years old and serves as our Chief Executive Officer. Mr. Ferreira also currently serves as chief executive officer of SP Telecomunicações Holding Ltda. He also serves as vice-chairman of the board of directors and chief executive officer of Telefônica Data Brasil Holding S.A. He is a member of the boards of directors of Telefônica Internacional S.A., Telefônica Móviles S.A., Brasicel N.V. and its subsidiaries. He is president of each of the boards of directors of Mercador S/A and Telefonica Factoring do Brasil Ltda. and chairman of the control committee for Telefônica Gestão de Serviços Compartilhados do Brasil Ltda. (T-Gestiona). He is also a member of the Latin American Committee of the New York Stock Exchange and of the Global Information Infrastructure Commission - GIIC. Mr. Ferreira has served as president of Telecomunicações Brasileiras S.A.- Telebrás, vice-minister in the Brazilian Ministry of Communications, chairman of the board of directors of Embratel S.A., president of Nortel do Brasil S.A., president of Telecomunicações do Paraná S.A. - Telepar and as member of Anatel's consulting committee and member of the board of directors of Empresa Brasileira de Correios e Telégrafos - ECT and Portugal Telecom. He holds a degree in electrical engineering from *Faculdade de Engenharia Elétrica da Universidade Católica do Rio de Janeiro*, the Electric Engineering Faculty of the Catholic University of Rio de Janeiro, Brazil, which he received in 1971. He attended a business administration course at Western Ontario University, Canada, in 1982.

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*José María Álvarez Pallete Lopez* is 41 years old and has been the executive president of Telefónica Internacional S.A. since July 2002. He is also a member of the board of directors of each of Telefónica de España, Telefónica Móviles, Telefónica Móviles España, Telefónica Data, Telefónica Internacional S.A., representative of Telefónica S/A as director of TPI, Telefónica de Argentina, Telefónica de Peru, Telefónica CTC Chile, Telefónica Larga Distancia Puerto Rico, Cointel y Compañía de Telefonos de Chile Transmisiones Regionales. In 1999, Mr. Álvarez-Pallete

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served as the chief financial officer of Telefónica Internacional S.A. and the chief corporate finance officer of Telefónica S.A. He holds economics degrees from the *Universidad Complutense de Madrid*, the *Complutense University of Madrid*, Spain, and the *Université Libre de Bruxelles*, Belgium.

*Manoel Luiz Ferrão de Amorim* is 46 years old and serves as our General Executive Officer. He is a member of our board of directors and serves as a member of the boards of directors of Telefônica Data Brasil Holding S.A. and of the *Câmara Americana de Comércio de São Paulo*, or the American Chamber of Commerce of São Paulo. From February 1, 2001, to May 5, 2001, Mr. Amorim was the chief executive officer of our wholly owned subsidiary Assist Telefônica S.A. From January to November of 2000, he served as chief executive officer of America Online Brasil. From 1990 to 2000, he performed several functions at Procter & Gamble in the United States, Brazil and Venezuela, including marketing manager, marketing director and general manager for Latin America. Mr. Amorim also worked at McKinsey, Petrobrás and F.I. Indústria e Comércio. He holds a degree in chemical engineering from *IME Instituto Militar de Engenharia*, the Military Engineering Institute, Brazil, and a masters degree in business administration from Harvard University, United States.

*Fernando Abril-Martorel Hernández* is 43 years old. He was the chief operating officer of the Telefónica group. From 1987 to 1997, Mr. Abril-Martorel performed several functions at JP Morgan, in New York, London and Madrid, including treasury department manager and member of the managing committee. Mr. Abril-Martorel joined the Telefónica group in January of 1997, as corporate finance general manager, having represented the group's interests in the Brazilian telecommunications industry privatization process. From December 1998 to June 2000, he served as chief executive officer and chief financial officer of Telefónica Publicidad e Información (TPI). Mr. Abril-Martorel holds a degree in law and business sciences from *ICAI-ICADE Instituto de Postgrado y Formación Continua*, Spain.

*Juan Carlos Ros Brugueras* is 43 years old and serves on our board of directors and that of Telefônica Data Brasil Holding S/A. Since May 1998, Mr. Ros has been a vice-secretary to the board of directors of, and a secretary general to Telefónica Internacional S.A. in Madrid, Spain, and also a director of Telefônica de Argentina S.A. (Argentina), Telefônica Larga Distância de Porto Rico Inc. (Porto Rico), Companhia de Telecomunicações do Chile S.A. (Chile) and Telefônica do Peru S.A. (Peru). He served on our board and that of Companhia Telefônica da Borda do Campo from December 1998 through November 1999, and also on the boards of Companhia Riograndense de Telecomunicações CRT, Tele Sudeste Celular Participações S/A, Telerj Celular S/A and Telest Celular S/A. From 1985 to 1997, he was a partner in a law firm with in Barcelona, and, during such time, he served as Secretary on the boards of directors of various Spanish and foreign companies. Mr. Ros holds a law degree from *Universidad Central de Barcelona*, the Central University of Barcelona, Spain.

*Enrique Used Aznar* is 63 years old. He is also the chief executive officer of Amper, S.A., in Madrid, a member of the boards of directors of Telefónica Peru and Terra Lycos, the chief executive officer of Amperprogramas and the vice-chairman of the board of directors of Mediadata Brasil. He is also a member of the board of directors of Telefônica S.A., member of the Assembléia Directiva of IESE of Madrid and patron of Fundação Científica contra o Câncer. He has also served as chief executive officer of Telefónica Internacional S.A., Telefónica Móviles and Telefónica I+D, as vice-chairman of the delegate committees of TPI Páginas Amarelas, Telefônica do Chile and Telintar (investor from Argentina), and as member of the boards of directors of Telefônica da Argentina, AT&T Network System International and of Ericsson in Spain. He holds a degree in telecommunications engineering from the *Universidad de Madrid*, the University of Madrid. He also holds a degree from IESE (*Alta Direção de Empresas*).

*Javier Nadal Ariño* is 55 years old and serves as General Director of Institutional Relations and the Telefónica S.A. Foundation. From December 1998 to November 1999, he served on our board and those of Companhia Telefônica da Borda do Campo and Companhia Riograndense de Telecomunicações CRT. He served as executive President of Telefônica do Peru, President of Telefônica da Argentina (March 1995 to December 1997), General Director of Telecomunicações do Reino da Espanha (1985 to 1995), President of Retevisión (1989 to 1994), Chief of Centers and Networks for the Central Region of Telex da Espanha's network (1979 to 1982), collaborator for the United Nations as an expert in data transmission programs for activities support (1978) and participated in the development of affairs for Telettra SpA in Vimercate (Italy) and Torrejón de Ardoz (Spain) (1972 to 1977) and served as General Director of Regulation for Telefónica Internacional S.A. (December 1997 through January 2003). Mr. Nadal holds a degree in telecommunications engineering from *Universidad Politécnica de Madrid*, the Technical University of Madrid, Spain.



*Luciano Carvalho Ventura* is 58 years old and the officer responsible for LCV Governança Corporativa. He is a member of the board of auditors of Perdigão, Indústrias Bardella, Karsten Globex (Ponto Frio) and Lochpe Maxion. He serves as member of the board of directors of Grupo Tavares de Melo, Gtmprevi Sociedade Previdenciária, Norderia Plus

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Bag, Agrofertil from Grupo Fertilbrás and Y. Takaoka Empreendimentos. Since 1980, he has been dedicated to corporate governance consulting and in serving as member of corporate boards. He is the founding member of the board of directors of *Instituto Brasileiro de Governança Corporativa* IBGC Brasil. He is a member of the International Corporate Governance Network England and National Association of Corporate Directors USA. He is professor of the course for formation of directors of Brazilian Corporate Governance Institute and speaker at various masters courses and seminars. He holds an MBA from *Escola de Administração de Empresas de São Paulo* Fundação Getúlio Vargas, a graduate degree in finance from *Escola de Administração de Empresas de São Paulo da Fundação Getúlio Vargas*, a degree in business management from *Escola de Administração de Empresas da Universidade Federal de Pernambuco*, and a degree in economics from *Faculdade de Ciências Econômicas da Universidade Federal de Pernambuco*.

*José Fernando de Almansa Moreno Barreda* is 56 years old. He is a member of the board of directors of Telefônica and chairman of the board's international affairs committee. He is also a member of the boards of directors of Telefônica de Peru S.A., Telecomunicações de São Paulo S.A., Telefônica Móviles S.A., Telefônica de Argentina S.A. and BBVA Bancomer. He is currently a sponsor of the foundations *Reina Sofía*, *Conde de Barcelona*, *Diputación de San Andrés de los Flamencos* Fundação Carlos de Amberes, Padre Arrupe-Activa, Príncipe de Astúrias, Fundação Euroamérica and Fundação MAA. Mr. Almansa initiated his diplomatic career in 1974 and served as the Secretary of the Spanish Embassy in Belgium in 1976. In 1979 he was appointed as the Cultural Counselor for the Spanish Delegation in Mexico and, in 1982, he was named as embassy advisor to the Spanish Ministry of Foreign Relations. During the same year, he was appointed as chief director to the coordination section of the Spanish diplomatic office in Eastern Europe and as a director for Atlantic matters for the Spanish foreign policy office for Europe and Atlantic matters. In 1983, Mr. Almansa served as a press and political advisor for the Spanish diplomatic mission at the North Atlantic Council in Brussels. In April 1988, he was assigned to the Spanish Embassy in the Soviet Union, where he served as a minister advisor, and in August of the same year he became a plenipotentiary minister. In 1990, Mr. Almansa was appointed as general secretary for the National Commission of the V Centennial of the Discovery of America, and, in 1991, he served as the general sub-director for Eastern Europe under the Spanish general office of foreign policy for Europe. In 1993, His Majesty the King of Spain named Mr. Almansa as chief of the Royal House, with ministerial status, where he served until December 2002. Mr. Almansa holds a law degree from the *Universidad de Deusto*, the University of Deusto, Spain.

*Miguel Ángel Gutiérrez Méndez* is 46 years old and a member of our board of directors, and a director of Telefónica Internacional, S.A, where he is responsible for Institutional and Public Policy for Grupo Telefónica in Latin America. He also serves a director for Telefónica de Argentina S.A. (where he also served as president and chief operating officer from February 2002 through June 2003); president of the board of directors for Autopistas Del Oeste S.A and president of the board of directors of ABERTIS of Spain Group (controlled by La Caixa de Barcelona). He is also a consultant and member of the consulting committee to The Rohatyn Group Asset Management in New York. Since December 2003, he has served as Chief Executive Officer of the Association of Public Service Businesses of Argentina (*Asociación de Empresas de Servicios Públicos Argentinos ADESPA*), and since January 2002, he has served as Vice-President of the Chamber of Commerce of Spain (*Fundación Cámara Española de Comercio*). He is also a member of the Executive Committee of the Chamber of Commerce of Argentina (*Cámara Argentina de Comercio*), a member of the Business Development Institute for Argentina (*Instituto Para El Desarrollo Empresarial de La Argentina IDEA*) and a member of the Consulting Committee of the Center for the Implementation of Public Policy for Equity and Growth (*Centro de Implementación de Políticas Públicas para la Equidad el Crecimiento CIPEC*). Until October 2001, Mr. Mendez was employed by J.P. Morgan where he spent over twenty years as a Managing Director for Global Emerging Markets and member of the Emerging Markets Committee. He is a certified public accountant with a degree from the University of Buenos Aires, and an MBA from IAE Universidad Austral (Argentina).

*Luis Bastida Ibarguen* is 59 years old and a member of our board of directors. He serves as a director for various companies, and is an independent consultant, author and lecturer on business economics. From 2000 to 2001, he served as general director for global asset administration and member of the steering committee for Banco Bilbao Viscaya Argentaria. From 1988 to 2000, he held various posts at Banco Bilbao Viscaya, and in 2000 became General Finance Director, reporting directly to the President. From 1976 to 1987, he worked generally in finance at Banco Bilbao. From 1971 to 1976, he worked in various capacities at General Electric's International Division in New York and General Electric Española, including accounting, management and strategic planning. He holds degrees in international and financial management, and is licensed in business sciences by E.S.T.E. He also holds an MBA from Columbia University.

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*Narcís Serra Serra* is 61 years old and serves as a member of our board of directors. From 1991 to 1995, he was Vice President of the Government of Spain, and from 1982 to 1989, served as Minister of Defense. From 1979 to 1982, he was the Mayor of Barcelona. Mr. Serra holds a doctorate in political science from the Universidad Autónoma de Barcelona; and is a professor of economic theory at the Universidad Autónoma de Barcelona.

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*Guillermo Pablo Ansaldo* is 43 years old and serves as a member of our board of directors. From 2000 to 2004, he served as General Manager of Telefónica de Argentina S.A., and from 1989 to 2000, he worked at McKinsey & Company. He holds a degree in industrial engineering from the Universidad de Buenos Aires, and an MBA from Dartmouth College.

**Executive Committee**

The executive committee consists of at least three and no more than twelve members, who may or may not be our shareholders, all of them appointed by our board of directors for a period of three years and may remain in office until reappointed or replaced. Any of our executive officers may be removed at any time by a decision of the board of directors.

The following are the current members of the executive committee, their respective positions and the date of their appointment.

<b>Name</b>	<b>Position</b>	<b>Date of Appointment</b>
Fernando Xavier Ferreira	Chief Executive Officer	March 23, 2004
Pedro Lucas Antón Lázaro	Vice-President of Administration and Finance and Director of Investor Relations (CFO)	October 28, 2004
Manoel Luiz Ferrão de Amorim	General Executive Officer	March 23, 2004
Eduardo Navarro de Carvalho	Vice-President of Regulation and Business with Operators	January 19, 2005
Stael Prata Silva Filho	Executive Vice-President of Strategic Planning	March 23, 2004
Gilmar Roberto Pereira Camurra	Vice-President of Financial Planning	March 23, 2004
Mariano Sebastian De Beer	Vice-President of Corporate Business	March 23, 2004
José Carlos Misiara	Vice-President of Human Resources	March 23, 2004
Fábio Silvestre Micheli	Vice-President of Network	March 23, 2004
Odmar Geraldo Almeida Filho	Vice-President of Residential Clients	March 23, 2004
Bento José de Orduña Viegas Louro	Vice-President of Domestic Business	January 19, 2005
Manuel José Benazet Wilkens	Vice-President of Organization and Information Systems	March 23, 2004

Set forth below are brief biographies of our executive officers:

*Pedro Lucas Antón Lázaro* is 44 years old and has served as Vice-President of Administration and Finance and Director of Investor Relations (CFO) since October 2004. In February 2000, he was named General Corporate Subdirector of Economic Processes-Finance in Telefónica S.A. He lead the creation of the Share Services Centers (*Centro de Serviços Compartilhados*) of Telefônica Group and served as its Global Manager and Administrator of Telefónica Gestión de Servicios Compartidos (t-gestiona) of Spain SAU through June 2004. In November 1998, he was named Vice-President of Finance, Control and Resources for Telesp and TeleSudeste Participações, and CFO of Telefônica in Brazil, overseeing all financial and corporate operations, such as the merger of Grupo Telesp. In 1997, he served as General Subdirector of Accounting and Consolidation at Telefônica, reporting to the CFO of Grupo Telefônica. Once having



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segregated the business of fixed telephone service in Spain, he began to report to the CEO of Telefónica de España S.A. as General Subdirector of Economy and Finance and member of the Management Committee. In 1987, he moved to JP Morgan and, after serving in various capacities, was named, in 1995, Chief Operating Officer of JP Morgan in Madrid with direct responsibilities for Systems and Operations, indirect oversight of all support areas in that branch and as a member of the Management Committee. From 1981 to 1987, he worked for Telefônica in the areas of network and systems. He holds degree in naval engineering from Universidade Politécnica de Madrid, and a MBA in Economics and Management from IESE Business School.

*Eduardo Navarro de Carvalho* is 42 years old and serves as Vice-President of Regulation and Business with Operators. He is also a Vice-President of Telefônica Data Brasil Holding S.A., SP Telecomunicações Holding Ltda., Sudestecel Participações S.A., Iberoleste Participações S.A. and TBS Celular Participações S.A. Mr. Navarro served as regulatory and corporate strategist of Tele Sudeste Celular Participações S.A., Tele Leste Celular Participações S.A. and Celular CRT Participações S.A. and as a member of the board of directors of Ceterp Centrais Telefônicas de Ribeirão Preto S.A., senior project director of McKinsey & Company, Inc., and factory manager of Belgo-Mineira Telesp (Arbed Group). He holds a degree in metallurgy engineering from *Universidade de Minas Gerais*, the University of Minas Gerais, Brazil.

*Stael Prata Silva Filho* is 53 years old and serves as Executive Vice-President of Strategic Planning. He is chairman of the board of directors of Companhia AIX de Participações and Companhia ACT de Participações. From 1972 to 1998, he served in several capacities at our predecessor company, Telecomunicações de São Paulo S.A., including business and client manager and business planning and data processing department manager. In 1997, Mr. Prata was appointed as a consultant for Sistel, and, from September 1998 to November 1999, he served as business executive manager, vice-president for personal customer services, vice-president for corporate services, and vice-president for special clients and small business services of our predecessor company, Telecomunicações de São Paulo S.A. and CTBC. From January 2000 to December 2000, Mr. Prata was the chief executive officer and commercial manager of Ceterp Centrais Telefônicas de Ribeirão Preto S.A. and Ceterp Celular S.A. His previous experience also includes working as a business executive manager at Assist Telefônica S.A. He was involved in the coordination of the management committee of Telefônica da Borda do Campo and in the planning of its IT area. Mr. Prata holds a degree in business administration from *Faculdade Luzwell*, the Luzwell Faculty, Brazil.

*Gilmar Roberto Pereira Camurra* is 49 years old and serves as Vice-President of Financial Planning. He has 27 years of working experience in the financial system. He served for a year as member of the board of directors of Grupo Paranapanema (tin exporter). Among his experiences in the banking system, he was vice-president of Citibank N.A., performing various activities for 18 years with a focus on the international and treasury areas; founding partner of Banco ABCRoma, performing activities relating to treasury, international and controlling areas; and executive officer of BCN-Barclays, performing activities relating to the treasury, asset management and corporate finance. More recently, he served as foreign exchange director and deputy treasurer for HSBC Bank. He has been chief financial officer of Telefônica Group in Brazil since November 1999. He holds a business management and accounting science degree with a specialization course in finance from Berkeley University University of California.

*Mariano Sebastian De Beer* is 34 years old and served as Vice-President of Strategic Planning until November 19, 2002, when he was elected to his current position as Vice-President of Corporate Business. From 1991 to 1994, Mr. De Beer served as marketing and purchasing department manager of Suiza Industrial, in Argentina. From 1996 to 1998, he served as a consultant with McKinsey Ltda., in Brazil. He holds a business administration degree from *Universidad Argentina de la Empresa*, Argentina, and a masters degree in business administration from Georgetown University, United States.

*José Carlos Misiara* is 55 years old and serves as Vice-President of Human Resources. Before being elected to his current position, he served as our human resources officer. He served as vice-president for human resources for Asea Brown Boveri in Brazil and Latin America, human resources officer for BRABB- Asea Brown Boveri in Brazil and manager of the human resources department of our predecessor company, Telecomunicações de São Paulo S.A. In the past, he was the coordinator of the business technology center of the Dom Cabral Foundation, the director of the labor relations department of ABINEE Sinaees *Associação Brasileira de Indústria Elétrica e Eletrônica Sindicato das Indústrias de Aparelhos Elétricos*, or the Brazilian Association of Electric and Electronic Industry from the Union of the Electric Appliance

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Industries, and the officer of employment relations of ABINEE-Sinaees and speaker at the courses *Curso para Dirigentes de Recursos Humanos* and *Congresso Regional de Recursos Humanos* at FGV *Fundação Getúlio Vargas* in the city of Vitória. Mr. Misiara holds a degree in economic science from *Universidade de São Paulo*, the University of São Paulo, Brazil Strategic Management Personal INSEAD.

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*Fábio Silvestre Micheli* is 42 years old and serves as Vice-President of Network. He previously served as the operation officer and resources officer of our subsidiary Assist Telefônica S.A. Mr. Micheli has worked with us for twenty years (thirteen in managerial functions) and previously served in the following positions: installation and repair department manager, external network department manager, service office department manager, commuting department manager, customer service department manager, operational district manager, territorial unit manager technical assistance (Campo Limpo), superintendent for east technical assistance and technical assistance officer. He holds a business administration degree and is in the process of acquiring an engineering degree.

*Odmir Geraldo Almeida Filho* is 41 years old and serves as Vice-President of Residential Clients. He previously served as officer for residential business in traffic and services from August 2001 to January 2004; marketing director for Procter & Gable in the division of baby care products, Latin America in Caracas from 1988 to 2001 and brand/marketing manager feminine care in Cincinnati, Ohio from 1991 to 1993. He also served for Johnson & Johnson as management trainee in manufacturing in the city of São José dos Campos from 1998 to 1989 and for Elebra/Nortel as Software Engineer in the city of Campinas from 1986 to 1988. He holds a degree in electronic engineering from UNICAMP (from 1982 to 1986) and an MBA from the University of Southern California (from 1989 to 1991) and attended the senior executive management program IESE from *Universidade de Navarra Barcelona* (from 2003 to 2004).

*Bento José de Orduña Viegas Louro* is 49 years old and serves as Vice-President of Domestic Business. He has served as vice-president of our long-distance and interconnection business since May 2002. From 1979 to 1984, Mr. Louro managed the telecommunications and electronic areas for The Chase Manhattan Bank. From 1985 to 1998, he served as general manager for AT&T, where he managed internal operations in Venezuela, Florida, Rio de Janeiro, and New Jersey. From 1998 to 2001, Mr. Louro served as area director for Northern Brazil for Nextel International, where he was responsible for direct and indirect sales channels, corporate accounts, supply operations, post-sale support, marketing, training, international engineering, finance, and human resources. From May 2001 to May 2002, Mr. Louro served as our director for long-distance business. He holds a degree in economic sciences from the *Universidade de Economia e Ciências Políticas do Rio de Janeiro*, or the Economics and Political Sciences University of Rio de Janeiro, Brazil, and a masters degree in international administration and finance from the American Graduate School of International Management at Thunderbird School, United States.

*Manuel José Benazet Wilkens* is 41 years old and serves as Vice-President of Organization and Information Systems. From March 2002 to March 2004, he served as our officer of development of residential businesses, responsible for the business development of our residential segment. In 2003, he served as general officer of technology, planning and investment programs, and worked on the advancement of the 2003 universal targets and design of the access service ADSL Speedy. Mr. Wilkens also served as officer of network management and new services, and worked on the implementation of CEOS (*Centro Estadual de Operação e Supervisão* or state center of operation and supervision). He has also served as our superintendent of network systems and participated in the initial take over in the area of network system OSL. His experience in Telefônica de Espanha S/A includes service as national administrator of JDS transmission network, administrator of management and networking system in the region of Barcelona North, and technical quality inspector with oversight of the technical courses of the *Escola de Formação Telefônica*. He also has experience in external network engineering and operation and maintenance of the commuting internal plant. He holds degrees in telecommunications engineering I.C. from ETSETB from Barcelona; economic and financial management of non-governmental entities from IPT Barcelona and attended the advance management program 2001 of IESE Barcelona.

For biographies of Fernando Xavier Ferreira and Manoel Luiz Ferrão de Amorim, see Board of Directors.

**B. Compensation**

For the year ended December 31, 2004, the aggregate amount of compensation paid to all our Directors and Executive Officers was approximately R\$19.4 million, of which R\$11.5 million corresponded to salaries and R\$7.9 million corresponded to bonuses.



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For the year ended December 31, 2004, our Directors and Officers did not receive any pension, retirement or similar benefits.

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**C. Board Practices**

**Board of Directors**

Our Board of Directors typically meets once every three months and the Chairman may call special meetings. Our Board takes action by majority vote, provided the majority of its members in office are present, with the Chairman having, in addition to his or her regular vote, the deciding vote in the event of a tie. The specific responsibilities of the Chairman include representing the board in the General Shareholders Meetings, chairing the General Shareholders Meetings and selecting the Secretary from among those present, and calling and chairing meetings of the Board.

Our Board of Directors is responsible, among other things, for:

establishing our general business policies;

electing and removing the members of our executive committee, and establishing their responsibilities with due regard for legal and statutory provisions;

supervising our management and examining our corporate records;

calling shareholders meetings;

approving the financial statements, management reports, proposals for allocation of the company's results and the submission of such documents to the shareholders meeting;

appointing external auditors;

determining the payment of interest on equity and interim dividends;

authorizing the purchase of our shares to be cancelled or kept in treasury;

appointing and removing the person responsible for internal auditing;

approving the budget and annual business plan;

deliberating on the issuance of new shares and increasing the corporate capital within the limits authorized by the bylaws;

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approving the issuance of commercial paper and depositary receipts;

authorizing the sale or pledge of fixed and concession-related assets;

approving agreements, investments and obligations in an amount greater than R\$250 million that have not been approved in the budget;

approving our jobs and compensation plans, our rules and workforce, as well as the terms and conditions for collective labor agreements to be executed with unions representing our employees categories and adherence to the policy of, or disassociation from, pension plans; and

authorizing the acquisition of interest in other companies on a definitive basis.

The members of our board of directors are all shareholders, one of them being elected by the preferred shareholders in a separate voting process, and the others being elected by the holders of common shares. The members of the board of directors are elected for a period of three years and may be reelected.

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**Executive Committee**

Our Executive Committee is responsible for our day-to-day management and for representing us in our business with third parties. Each of our current Executive Officers has been appointed by our Board of Directors for a three-year term and may remain in office until reappointed or replaced.

**Board of Auditors**

Brazilian Corporate Law and our bylaws each require that we maintain a statutory Board of Auditors (*Conselho Fiscal*). Our statutory Board of Auditors, which is a separate and distinct entity from our outside auditors, is primarily charged with certain advisory, reporting, oversight and review functions with respect to the company's financial statements. Our statutory Board of Auditors is also responsible for rendering opinions on management's annual report and management proposals to be submitted at shareholders' meetings relating to a change in the company's capital composition, budget, payment of dividends and consolidations, mergers and spin-offs. However, the statutory Board of Auditors, as required by Brazilian Corporate Law and our bylaws, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Board of Auditors are not binding on the company under Brazilian Corporate Law.

In accordance with Brazilian Corporate Law and our bylaws, the Board of Auditors consists of a minimum of three and a maximum of five members and an equal number of alternates.

One member of the Board of Auditors and his or her alternate must be elected by holders of preferred shares in a separate voting process. The following are the current members of the Board of Auditors:

<b><u>Members</u></b>	<b><u>Date Appointed</u></b>
Wolney Querino Schuler Carvalho	March 30, 2005
Cleuton Augusto Alves	March 30, 2005
Oswaldo Vieira da Luz	March 30, 2005
Isabel Silva Ramos Kimmelmeier	March 30, 2005
<b><u>Alternates</u></b>	<b><u>Date Appointed</u></b>
Suely Valério Pinoti	March 30, 2005
Milton Shigueo Takarada	March 30, 2005
Gilberto Carlos Rigamonti	March 30, 2005
Eduardo Almeida Santos	March 30, 2005

**Committees**

Brazilian Corporate Law does not require a corporation to maintain committees responsible for ethics, corporate governance or compensation. Nevertheless, our Board of Directors has created the following committees:

Control and Audit Committee;

Nominations, Compensation and Corporate Governance Committee; and

Service Quality and Marketing Committee.

***Control and Audit Committee***

Our Control and Audit Committee was created by our Board of Directors in December 2002 and is comprised of a minimum of three and a maximum of five directors, who are not members of our executive committee, appointed by the Board of Directors to serve as members of the Control and Audit Committee for the duration of their respective terms as members of the Board of Directors. The Committee has its own charter, which was approved by the Board of Directors. The Committee provides support to the Board of Directors.

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According to its charter, the Control and Audit Committee shall meet four times per year and report its conclusions to the Board of Directors. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Board of Auditors (*Conselho Fiscal*).

The Control and Audit Committee, among other responsibilities that may be required by the Board of Directors, is charged with informing and providing recommendations to the Board of Directors regarding the following:

the appointment, termination and renewal of the independent auditors, as well as the terms and conditions of the contract with the independent auditors;

the analysis of the company's accounts, compliance with certain legal requirements and the adoption of generally accepted accounting principles;

the results of each internal and independent audit and management's response to the auditor's recommendations;

the quality and integrity of the company's internal control systems;

the performance of the independent auditors, requesting opinions on the annual reports and that the main audit reports be clear and precise;

any communications with the internal auditors about any significant deficiencies in our control systems and identified financial conditions; and

The following are the current members of the Control and Audit Committee:

<b><u>Members</u></b>	<b><u>Date Appointed</u></b>
Enrique Used Aznar	July 19, 2004
Luis Bastida Ibarguen	February 21, 2005
Miguel Ángel Gutiérrez Méndez	February 21, 2005

***Nominations, Compensation and Corporate Governance Committee***

Our Nominations, Compensation and Corporate Governance Committee was established in December 1998 and is comprised of three to five directors appointed by the Board of Directors to serve for the duration of their respective terms as members of the Board of Directors. Except for our Chief Executive Officer, Mr. Fernando Xavier Ferreira, the other three members of our Nominations, Compensation and Corporate Governance Committee are non-management directors. The Nominations, Compensation and Corporate Governance Committee, among other responsibilities that may be required by the Board of Directors, is charged with informing and providing recommendations to the Board of Directors regarding the following:

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the appointment of executives and administrators for our company and our subsidiaries;

the parameters on compensation for our executives and administrators;

the terms and conditions of executive employment agreements;

the review of the Board's compensation plan and any amendments;

the incentive plans and compensation standards for members of the Board of Directors and executives;

the compensation policy for directors and statutory officers of the company; and

the annual corporate governance report.

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The following individuals are the current members of the Nominations, Compensation and Corporate Governance Committee:

<b><u>Members</u></b>	<b><u>Date Appointed</u></b>
Fernando Xavier Ferreira	October 18, 2004
Javier Nadal Ariño	October 18, 2004
Juan Carlos Ros Brugueras	October 18, 2004
José Fernando de Almansa Moreno-Barreda	February 21, 2005

***Service Quality and Marketing Committee***

The Service Quality and Marketing Committee was created on December 16, 2004 and provides assistance to our Board of Directors. The Committee is comprised of, at least 3 and at most 5, members of our board selected periodically. The Committee meets from time to time, depending on the availability of its members and when called by its chair. The Committee is responsible for review and analysis of quality indices measuring our principal services and to ensure that the requisite degree of commercial assistance is furnished to our clients.

<b><u>Members</u></b>	<b><u>Date Appointed</u></b>
Guillermo Pablo Ansaldo	February 21, 2005
Javier Nadal Ariño	February 21, 2005
Luciano Carvalho Ventura	February 21, 2005

**D. Employees**

As of December 31, 2004, we had 7,125 employees. All of our employees are on a full-time basis, divided into the following categories: 53% in our network plant operation, maintenance, expansion and modernization, 32% in sales and marketing and 15% in administration, finance and investor relations, human resources, inventory, technology, legal and strategic planning and management control.

We, in conjunction with other sponsors (the companies resulting from the breakup of Telebrás), sponsored private pension benefits and health care plans for retirees in order to supplement the salaries of retired employees. The plans are managed by Sistel (*Fundação Sistel de Seguridade Social Sistel*), a private social security entity. Until December 1999, all sponsors of the plans managed by Sistel were jointly and severally liable for all existing benefit plans. After December 1999, a single-employer sponsored pension plan for active employees was created, the PBS Telesp Plan, or PBS plan. See Note 26 to our consolidated financial statements for a more detailed description of the PBS plan. Retired employees (PBS-A) and post-retirement health care benefits, or PAMA, remained as multi-employer benefit plans. The restructuring of the benefit plans took place in January 2000.

Due to the withdrawal of other active participants in December 1999, we individually sponsored the PBS plan, which covers approximately 1.0% of our employees. In addition to the PBS plan, the multi-sponsored health care plan, or PAMA, is provided to retired employees and their dependents. Contributions to the PBS plan are determined based on actuarial valuations prepared by independent actuaries, in accordance with standards applicable in Brazil.



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On August 2000, we established the *Visão* plan, offered to participants in our PBS plan, as well as to employees who did not qualify for participation. Unlike the PBS plan, which is a defined benefits plan, the *Visão* Plan calls for contributions by participating employees, as well as by us as sponsor, which are credited to the individual accounts of the participants. We are responsible for all management and maintenance expenses of the *Visão* plan, including the risks of death and permanent injury of the participants. The employees participating in the PBS plan were granted the option to migrate to the *Visão* plan, which was also offered to those who did not participate in the PBS plan and to all newly hired employees. Our contributions to the *Visão* plan are equal to those of the individual participants, ranging from 2% to 9% of the participant's salary, depending on the percentage chosen by the participant. The *Visão* plan was offered to active employees as an alternative to the multi-employer plan and was also offered to all employees who did not participate in

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that plan. The aggregate costs under the *Visão* plan equal approximately 12.4% of the total amount of salaries paid to participating employees. Currently 84% of our employees are covered under the *Visão* plan.

In 2004, we restructured our medical assistance plan for retirees (*Plano de Assistência Médica dos Aposentados*), which is related to the mentioned PBS plan described above and we refer to as PAMA, in order to improve certain benefits. The new plan is referred to as PAMA PCE. Employees covered under PAMA were given the right to migrate to PAMA PCE and, as a result, 49% of our current and retired employees changed their coverage plan to PAMA PCE. At the end of 2004, PAMA remains a multi-employer plan.

Approximately 38% of our employees are members of the main telecommunications industry labor union, *Sindicato dos Trabalhadores em Empresas de Telecomunicações e Operadores de Mesas Telefônicas no Estado de São Paulo*, the Labor Union of Employees of Telecommunications Companies and Telecommunications Desk Operators in the State of São Paulo, or SINTETEL, which is associated with the *Federação Nacional dos Trabalhadores em Telecomunicações*, the National Federation of Telecommunications Workers or FENATTEL. Our collective labor agreements will expire on August 31, 2005. Our management considers relations with our work force to be satisfactory. We have never experienced a work stoppage that had a material effect on our operations.

## **E. Share Ownership**

None of our directors or executive officers beneficially owns, on an individual basis, 1% or more of our common or preferred shares (including ADSs representing preferred shares) or of our total equity share capital.

We do not provide any stock incentive plans to our management or employees; however, our controlling shareholder, Telefónica S.A. offers stock incentive plans relating to its own shares (the Telefónica Stock Option Plans). The Telefónica Stock Option Plans implemented in 2001 are designed to retain the services of our officers and to obtain highly qualified employees.

The Telefónica Stock Option Plans are managed by the Telefónica stock option committee (the Committee), which is comprised of members who are elected by Telefónica S.A.'s board of directors. The Committee periodically grants and sets the terms of the share options and determines which officers and employees will be included in the plans. The Telefónica Stock Option Plans relating to us are divided into two programs, TOP and TIES.

In April 2001, we approved an incentive program (the TOP Program) following the guidelines of a plan designed by Telefónica S.A. for certain of its key executives. The TOP Program consists of granting stock options of Telefónica S.A. to 22 of our key executives who are bound to hold these stock options for the entire term of the TOP Program. Each stock option under the TOP Program gives the holder the right to acquire shares of Telefónica S.A. linked to either Telefónica S.A. common shares, Telefónica S.A. ADRs or Telefónica S.A. BDRs (Brazilian Depositary Receipts). The term of the TOP Program was three years during which the stock options could be exercised no more than three times.

The TOP Program ended on September 25, 2003. Under the program's regulations, Telefónica S.A. was required to settle all exercised options. However, since the market price of the shares on the subsequent five days after the end of the program was lower than the option price, no option was exercised. The beneficiaries became able to freely trade the shares they acquired over the course of the program.

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In February 2000, Telefónica S.A approved a program (the TIES Program ) whereby all of our employees who choose to participate in the TIES Program are able to acquire a number of Telefónica S.A. common shares. Under the TIES Program, the number of shares employees are able to acquire is based on their annual compensation, for an amount equivalent to five euros per share. In addition, Telefónica S.A. granted the participants 26 stock options for every Telefónica S.A. share purchased at five euros per option. The actual number of stock options eligible for exercise depends on the appreciation, if any, of the share price of Telefónica S.A. over the reference value established at 20.50 euros. The term of the TIES Program is four years and participating employees may exercise the stock options granted on three different occasions during the four-year term. The exercise dates for the stock options were in January 2003, 2004 and 2005. No option was exercised on such dates because the market price of the shares was lower than the option price. The TIES Program ended in February 2005 and the beneficiaries were granted to the right to freely trade the shares they acquired over the course of the TIES Program.

**Table of Contents****ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****A. Major Shareholders**

In accordance with our bylaws, we have two classes of capital stock authorized and outstanding, common shares (*ações ordinárias*) and preferred shares (*ações preferenciais*). Our common shares have full voting rights. Our preferred shares have voting rights only under limited circumstances. At December 31, 2004 and for at least the past three years, Telefónica Internacional owned 34.48% of our common shares and SP Telecomunicações, formerly Tele Brasil Sul Participações S.A. and a wholly owned subsidiary of Telefónica International, owned 50.23% of our common shares. Since Telefónica International owns 100% of the equity share capital of SP Telecomunicações, it has effective control over 84.71% of our outstanding common shares. Accordingly, Telefónica International has the ability to control the election of our Board of Directors and to determine the direction of our strategy and corporate policies. Neither Telefónica International nor SP Telecomunicações has any special voting rights beyond those ordinarily accompanying the ownership of our common or preferred shares.

The following tables set forth information relating to the ownership of common and preferred shares by SP Telecomunicações, its parent company Telefónica Internacional and our officers and directors. We are not aware of any other shareholder that beneficially owns more than 5% of our common shares.

Shareholder's Name	Number of common shares owned (in thousands)	Percentage of outstanding common shares
SP Telecomunicações	83,038,517	50.23%
Telefónica Internacional	57,002,343	34.48%
All directors and executive officers as a group	201	

Shareholder's Name	Number of preferred shares owned (in thousands)	Percentage of outstanding preferred shares
SP Telecomunicações	23,983,414	7.31%
Telefónica Internacional	267,836,148	81.59%
All directors and executive officers as a group	189	

Telefónica Internacional is a wholly owned subsidiary of Telefónica S.A., or Telefónica. Telefónica's shares are traded on various stock exchanges, including Madrid, Barcelona, Bilbao, Valencia, London, Paris, Frankfurt, New York, Lima, Buenos Aires and São Paulo. Telefónica's business operations are concentrated in a number of sectors, including fixed and mobile telecommunications services, data communications, integrated business solutions, e-commerce, Internet, telephone book publishing and marketing, marketing information and services, media content creation, production and distribution and marketing and call center services.

**B. Related Party Transactions**

Note 28 to our consolidated financial statements presents, in tabular format, more detailed financial information with respect to transactions and balances with related parties. We provide below a summary description of transactions with related parties.

We entered into a consulting service agreement, known as the Consulting Agreement, with Telefónica Internacional, on May 17, 1999, pursuant to which Telefónica Internacional provides advice regarding our management, operations and business. Under the Consulting Agreement, we paid Telefónica Internacional in 2000, for its consulting services, an amount equal to one percent of our 2000 net operating income. In 2001 and 2002 under the same agreement we paid one half of one per cent of our net operating income in each of 2001 and 2002, and since 2003 we have been paying Telefónica Internacional two-tenths of one percent of our net operating income per year.

In February 1999, we entered into a service agreement with Atento Brasil S.A, an indirect majority owned subsidiary of Telefónica S.A. (Telefónica controls 91.35% of Atento Brasil's equity), for the provision of certain customer

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services, principally services related to our call center. Transactions under this service agreement with Atento Brasil involved approximately R\$208 million in 2004.

In April 2001, we entered into a service agreement for the provision of administrative, accounting and other services with Telefônica Gestão de Serviços Compartilhados do Brasil Ltda, or T-Gestiona, an indirect wholly owned subsidiary of Telefônica. Transactions with T-Gestiona under this service agreement involved approximately R\$79 million in 2004.

We also entered into certain agreements for the provision of telecommunications services to several of our affiliates, each under the indirect control of Telefônica, including Telefônica Empresas S.A., Atento Brasil S.A., Terra Networks Brasil S.A., T-Gestiona, Telefônica Publicidade e Informação Ltda., Emergia Brasil Ltda. and Grupo Brasilcel (Vivo) and others listed in Note 28 to our consolidated financial statements. Transactions pursuant to these various service agreements, in the aggregate, involved approximately R\$332 million.

### *CVM Administrative Proceeding Relating to Agreement with Atento*

There is a CVM administrative proceeding arising out of a certain service agreement with an affiliate of Telefônica Group, Atento Brasil S/A ( Atento ). The CVM initiated an administrative proceeding with respect to the execution of the service contract between Telesp and Atento (the Atento Agreement ). On October 2, 2003, the CVM held that although the terms and conditions of the Atento Agreement were equivalent to those normally applied in agreements of the same nature and that are considered arms-length conditions, the Atento Agreement had not obtained the required approvals. The CVM, therefore, fined one of our current officers and three of our former officers each in the amount of R\$75,000.00. The company disagreed with the CVM's administrative resolution and filed an appeal to the Treasury Department's Appeals Council for the National Finance System (*Conselho de Recursos do Sistema Financeiro Nacional*), which currently remains pending.

## **C. Interests of Experts and Counsel**

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### **A. Consolidated Statements and Other Financial Information**

See Item 18 for our consolidated financial statements.

### **Legal Proceedings**

We are party to legal proceedings incidental to the normal course of our business. The main categories of such proceedings include:

administrative and judicial litigation with *Instituto Nacional da Seguridade Social*, the National Institute of Social Security or INSS;

lawsuits brought by employees, former employees and trade unions relating to alleged infringements of labor rights;

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administrative and judicial proceedings relating to tax payments; and

other civil suits, including litigation arising out of the breakup of Telebrás and events preceding the breakup.

Our policy with respect to provisioning for contingencies classifies the various legal proceedings to which we are party as probable, possible and remote. In general, 100% of the total claim value for legal proceedings classified as probable are provisioned. Senior management classifies each legal proceeding into one of these three categories (probable, possible and remote) based upon the advice of internal and external counsel and specialized technical advisors in charge of each matter. Due to the level of provisioning and based on its analysis of the individual cases, our management believes that no liabilities related to any legal proceedings will have a material effect on our financial condition or results of operations.

### *Litigation with INSS*

We are defendants in several lawsuits filed by the INSS, in the federal courts of São Paulo, including:

Several legal proceedings for the collection of *Seguro de Acidente de Trabalho* (Workers Accident Insurance Compensation, or SAT) from January 1986 to June 1997 and charges of sole responsibility regarding the alleged failure to collect contributions which were not performed by certain contracted parties in the approximate amount of R\$270.4 million. Based on a partially unfavorable court decision, our senior management decided to provision R\$94.5 million relating to the portion of the total amount for which the likelihood of loss is considered probable. No provision was made as to the balance for which the likelihood of loss is considered possible.

Legal proceedings filed by third parties – employees alleging joint and several liability; these employees claim welfare contributions in the approximate amount of R\$98.0 million. No provision was made for this amount for which the likelihood of loss is considered possible.

Negotiations relating to certain amounts paid under our collective labor agreements, as a result of inflationary adjustments arising out of *Planos Bresser* and *Verão*, in the aggregate amount of R\$125.5 million for which the likelihood of loss is considered possible. Based on jurisprudence and a court decision for a similar proceeding involving one of our affiliates, our senior management decided to provision R\$86.7 million relating to the portion of the total amount for which the likelihood of loss is considered probable.

Administrative proceeding relating to joint and several liabilities for payment of 1993 welfare contributions. The amount at issue is approximately R\$169.9 million. The likelihood of loss is considered possible and, accordingly, no provision was made for the entire amount.

Administrative proceedings with respect to fines of approximately R\$162.0 million for the alleged improper distribution of dividends while the company supposedly was indebted to the INSS. The likelihood of loss resulting from these proceedings is considered possible and no provision has been made.

While we await the outcome of the foregoing lawsuits, we have pledged, for judicial attachment purposes, real property owned by us, and offered bank guarantees and cash deposits, in accordance with Brazilian legal procedures. If we prevail in the foregoing lawsuits, such attachments will be cancelled, guarantees released and deposits returned.



***Labor Litigation***

We are also a defendant in several legal proceedings filed by former employees and third parties – employees (the latter alleging joint and several liability), who claim, among other things, deficient overtime payment, unequal compensation, retirement wage supplements, and health and security hazard compensation.

The following lawsuits are pending:

A claim by a labor union representing 9,000 of our employees (SINTETEL) relating to an obligation under a collective labor agreement between us and SINTETEL providing for the delivery of certain studies on the

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productivity of Telebrás. Despite the fact that this was an obligation to perform (as opposed to an obligation to deliver), SINTETEL demanded the payment of unpaid salary balances in the amount of 4%, since January 1995, which was allegedly due as productivity compensation. The lawsuit was declared groundless at the first two judicial levels, and an interim appeal filed by SINTETEL is pending judgment. We made no provisions for this lawsuit, as an unfavorable outcome is considered remote. We are unable to estimate the amount involved at this point.

A claim by a labor union representing the employees of CTBC (SINTETEL) relating to an obligation under a collective labor agreement between CTBC (which was merged into our company in November 1999) and SINTETEL providing for the delivery of certain studies on the productivity of Telebrás. Despite the fact that this was an obligation to perform (as opposed to an obligation to deliver), SINTETEL demanded the payment of unpaid salary balances in the amount of 4%, since January 1995, which was allegedly due as productivity compensation. The lawsuit was declared groundless at the first judicial level; however, the higher regional labor court reversed the decision. We have filed an appeal to the superior labor court. The amount in controversy is approximately R\$87.7 million. We have made no provisions for this lawsuit because an unfavorable outcome is considered possible.

At December 31, 2004, the total cost of the labor lawsuits filed against us amounted to R\$2.0 billion, of which R\$271.8 million, corresponding to the aggregate amount of lawsuits in which an unfavorable outcome is deemed probable, were provisioned.

***Litigation Relating to FINSOCIAL, COFINS, PASEP and PIS***

Under a provision of Law 9,718/98, contributions to COFINS, PIS and *Programa de Formação do Patrimônio do Servidor Público*, or PASEP must be calculated on the basis of all revenues earned by a company (including revenues from investments, securitizations and monetary and exchange rate variations). This increased the revenue basis for calculating social contributions. However, based on the Brazilian federal constitution, we filed an action claiming that the provision under Law No. 9.718/98 was unconstitutional with respect to our PIS contributions through November 2002 and the same through February 2004 for COFINS. We obtained an injunction, whereby we are authorized not to pay the contributions in question based on any revenues other than those deriving from the sales of goods and services. Nevertheless, we have made, as of December 31, 2004, provisions totaling approximately R\$233.7 million in case the injunction is invalidated.

Ceterp, which was merged into us on November 30, 2000, is contesting the applicability of certain taxes on telecommunications services based on constitutional grounds whereby no other tax (except for the ICMS and import and export taxes) can be applied to telecommunications services, including the IRPJ (*Imposto de Renda da Pessoa Jurídica*, or the corporate income tax), the CSL, the PASEP and COFINS. The amounts that were charged but not paid by Ceterp were provisioned in the amount of approximately R\$69 million. The outcome of this litigation is deemed probable.

***Litigation Relating to ICMS***

We are a named defendant in several ICMS proceedings pertaining to:

Cellular Activation Fees. On June 19, 1998, the treasury secretaries of each Brazilian state approved an agreement to interpret Brazilian tax law to expand the application of the ICMS to cover not only telecommunications services, but also other services, including cellular handset activation, which had not been previously subject to this tax. Pursuant to this new interpretation, the ICMS might be applied retroactively with respect to cellular activation fees charged during the five years preceding the tax assessment by the appropriate authority. On February 29, 2000, the treasury secretary of the State of São Paulo issued a tax assessment against us based on our alleged failure to pay the ICMS due in connection with cellular activation fees charged over the preceding five years. The state treasury considers us responsible for this payment based on certain Brazilian tax provisions and because we operated

wireless telecommunications services through Telesp Celular until January 1998.

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Based on the Brazilian federal constitution, we are of the opinion that (i) the treasury secretaries acted beyond the scope of their authority; (ii) their interpretation would subject certain services to taxation, which are not considered telecommunications services; and (iii) new taxes may not be applied retroactively.

There can be no assurance that we will prevail in our claim that the treasury secretary's new interpretation of the ICMS tax is unconstitutional. The retroactive application of the ICMS tax to activation fees would give rise to a maximum liability estimated to be R\$262.4 million. However, since our management and consultants have estimated that the probability of loss in connection with this case is remote, we have made no provision for these taxes.

**International Long-Distance Services.** The São Paulo state treasury secretary filed three administrative violation suits in order to collect amounts allegedly due as ICMS tax in connection with international long-distance services. The aggregate amount of the lawsuits is R\$321.2 million. In connection with two of these suits, where we appear as main taxpayers and Embratel appears as a jointly and severally liable co-payer, our risk of loss is deemed possible. In connection with the other suit, where Embratel appears as the main taxpayer and we appear as a jointly and severally liable co-payer, our risk of loss is deemed remote. No amounts were provisioned with respect to any of these lawsuits.

### ***Civil Claims***

We have several civil contingencies in the total amount of R\$1.9 billion, for which R\$41.7 million was provisioned.

**Telecommunications Community Plan Claims.** There are four public civil actions filed by *Associação de Defesa do Consumidor do Grande ABC*, the Greater ABC Consumer Defense Association or PROTECON, and one public civil action filed by the *Associação de Telefonia de Mogi das Cruzes*, or the Telecommunications Association of Mogi das Cruzes, in connection with lawsuits filed in order to demand indemnification as a result of our failure to deliver shares as compensation for financial contributions made by subscribers under the telecommunications community plan, in the amount of approximately R\$465.3 million. Prior to the Telebrás breakup, telecommunications network expansions were financed with contributions made by telephone subscribers under such plans, which also entitled them to receive a number of shares of each respective operating company, based on the amount of their contributions. Because the underlying probability of loss is classified as possible, no amounts have been provisioned in connection with these actions.

**Monthly Subscription Fees.** We are party to numerous individual and collective judicial proceedings instituted at various levels and sections of the judiciary challenging our monthly subscription fees. We have experienced favorable results in these proceedings, and note that the consumer claims have been followed closely as the results provide guidance persuasive to the business of all Brazilian telecommunications concessions. Because the underlying probability of loss is classified as remote, no amounts have been provisioned in connection with these actions.

**Inclusion of PIS and COFINS in Service Rates.** The federal district attorney's office believes that the amounts collected by us as COFINS and PIS are being improperly included in the fixed telecommunications service rates, and therefore filed a public civil action in order to exclude those amounts from those charged to our customers and to demand that the amounts improperly charged be returned in double. There are other public civil actions based on the same claim, which when added to the one described above and other collective and individual lawsuits, amount to seven lawsuits. We have made no provisions for these lawsuits, as our risk of loss is deemed remote.

### ***Regulatory and Antitrust Litigation***

We are a defendant in each of the following administrative proceedings, which have been filed by long-distance service providers alleging anticompetitive practices:

We are accused of acting against competition through a squeeze in interconnection prices which result in an increase in the costs to our competitors. The claimants accuse us of charging our competitors higher

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long-distance interconnection fees than the interconnection fees we charge ourselves and subsidizing the fees we charge for our local and interregional services. This proceeding was filed with Anatel. However, the allegations are still being analyzed by the *Conselho Administrativo de Defesa Econômica* – CADE, which is the Brazilian government’s antitrust authority. We made no provisions for this claim because our risk of loss is deemed remote based on our review, as informed by our legal counsel’s assessment, and Anatel’s report, which recommends that the claim be dismissed.

We are accused of acting against competition through price discrimination based on claims that we charge our competitors higher fees for dedicated lines (EILD) than the fees we charge ourselves. This allegation is being analyzed by both Anatel and CADE. We are currently negotiating with Anatel a consent decree (*Termo de Cessação de Conduta*), which is an agreement pursuant to which we would commit to refrain from the practice of the actions challenged by this claim. If we are successful in our negotiations and enter in such agreement with Anatel, our risk of loss would be deemed remote. However, should we not be able to enter into such agreement with Anatel, we would have to dispute the allegations and our risk of loss would be deemed possible. We made no provisions for this claim because we believe that we will be successful in our negotiations with Anatel.

In addition to the two antitrust-related claims mentioned above, we are a defendant in the following proceedings:

Civil action filed by the federal district attorney’s office of the city of Marília, State of São Paulo, against Anatel and us questioning the validity of certain clauses of our concession agreement relating to the tariff adjustment mechanism, and requesting reimbursement of the balance between the amounts charged by us in 2001 and the amounts we would have charged if we had used the variation of a different price index in the adjustment of our fees. The lower court ruled in favor of the plaintiffs and determined that our fees be adjusted based on variations of the General Price Index (IGP-DI measured by *Fundação Getúlio Vargas*). We are appealing the lower court decision. We are unable to estimate how long the appeals process will take or our prospects for success. We have made no provisions for this claim because plaintiffs have not specified a sum certain for damages and the nature of the penalty that would be imposed similarly remains undetermined.

Civil action filed by the federal district attorney’s office of the city of Brasília, Federal District, against us and other STFC service providers seeking to replace the measure for variation of our fees. Specifically, the district attorney seeks to substitute the variation of the Consumer Price Index (IPCA, published by the *Instituto Brasileiro de Geografia e Estatística*) for variation of the General Price Index (IGP-DI published by *Fundação Getúlio Vargas*). A lower federal court issued an injunction mandating that we use the variation of the IPCA for the increase in our fees from 2003 until a final decision is taken by a higher court. We are appealing the lower court decision. We are unable to estimate how long the appeals process will take or our prospects for success. We have made no provisions for this claim because the lower court has not ruled on the merits of the claim.

***Litigation Arising Out of Events Prior to the Telebrás Breakup***

Telebrás, our legal predecessor, is a defendant in a number of legal proceedings and subject to certain claims and contingencies. Under the terms of the Telebrás breakup, the liability for any claims arising out of acts committed by Telebrás prior to the effective date of the breakup remains with Telebrás, except for labor and tax claims (for which Telebrás and the resulting companies incorporated as a result of the breakup are jointly and severally liable by operation of law) and any liability for which specific accounting provisions have been assigned to us or one of the other resulting companies incorporated as a result of the breakup of Telebrás. Our management believes that the chances of any of these claims materializing and having a material adverse financial effect on us are remote.

***Litigation Related to the Breakup of Telebrás***

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The legality of the breakup of Telebrás was challenged in numerous legal proceedings, some of which remain pending. Our management believes that the final outcome of these proceedings will not have a material adverse effect on our business or financial condition.

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### ***Other Proceedings***

See Item 7B Related Party Transactions CVM Administrative Proceeding Relating to Agreement with Atento.

### **Dividends and Dividend Distribution Policy**

#### ***Priority and Amount of Preferred Dividends***

The Brazilian Corporate Law generally requires that the bylaws of each Brazilian corporation specify a minimum percentage of the distributable profits comprising dividends and/or interest on shareholders' equity, or distributable amount, of the corporation for each fiscal year that must be distributed to shareholders as dividends. See Item 10.B Additional Information Memorandum and Articles of Association. Moreover, each Brazilian company may only issue new preferred shares for public distribution if one of the following terms applies to the preferred shares: (i) right to receive dividends equivalent to at least 25% of the net profit for the fiscal year, to be calculated in accordance with article 202 of the Brazilian Corporate Law as follows: (a) priority in the receipt of dividends corresponding to at least 3% of the book value per share and (b) the right to an equal share of the profits attributable to the holders of common shares, after the holders of common shares have received a dividend equal to a minimum of 3% of the book value per share; or (ii) dividends at least 10% higher than those paid for common shares; or (iii) tag along rights of at least 80% of the price paid in the sale of control to be paid by the controlling shareholder and also including the right to receive dividends at least equal to the dividend paid to common shares.

According to our bylaws, we are required to distribute as dividends in respect of each fiscal year ending on December 31, to the extent amounts are available, an aggregate amount equal to at least 25% of adjusted net income as a mandatory dividend. The annual dividend distributed to holders of our preferred shares is 10% higher than the dividend distributed to our common shareholders.

Under the Brazilian Corporate Law, a company is allowed to withhold payment of the mandatory dividend in respect of common shares and preferred shares if:

management and the board of auditors report to the shareholders' meeting that the distribution would be incompatible with the financial circumstances of the company; and

the shareholders ratify this decision at the shareholders' meeting. In this case:

management must forward to the CVM within five days of the shareholders' meeting an explanation justifying the decision at the shareholders' meeting; and

the profits that were not distributed are to be recorded as a special reserve and, if not absorbed by losses in subsequent fiscal years, are to be paid as dividends as soon as the company's financial situation permits.



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We may pay dividends out of our retained earnings or accumulated profits in any given fiscal year.

For the purposes of the Brazilian Corporate Law, net profits are defined as net income after income tax and social contribution for the fiscal year, net of any accumulated losses from prior fiscal years and any amounts allocated to beneficiary parties, employees and management's participation in a company's profits and founders' shares.

Under Brazilian Corporate Law, and in accordance with our bylaws, adjusted net income is an amount equal to our net income adjusted to reflect allocations to or from: (i) legal reserves, (ii) statutory reserves, and (iii) contingency reserves for anticipated losses, if any.

At each annual shareholders' meeting, the Board of Directors is required to suggest the allocation of net profits obtained during the preceding fiscal year. Under the Brazilian Corporate Law, we are required to maintain the legal reserve, to which 5% of our net profits must be allocated for each fiscal year, until the reserve amounts to 20% of our paid-in

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capital. Net losses, if any, shall be charged against the accumulated profits, profits reserves and legal reserve, following this order.

The Brazilian Corporate Law also provides for an additional discretionary allocation of net profits to special accounts, which is also suggested by management and subject to approval by shareholders at the annual shareholders meeting, including the amount of net profits that may be allocated to the contingency reserve for anticipated losses that are deemed probable in future years. Any amount so allocated in a previous year must be either:

reversed in the fiscal year in which the loss was anticipated, if the loss does not in fact occur; or

written-off in the event that the anticipated loss occurs.

Net profits may also be allocated to the unrealized income reserve in case the total amount of mandatory dividends exceeds the amount of realized income. Such allocation should also be suggested by management and subject to approval by shareholders at the shareholders meeting. For such purpose, realized income is the balance of net profits exceeding the sum of:

the positive net result of equity adjustment; and

earnings from transactions which must be realized after the end of the subsequent fiscal year.

The amounts available for distribution are determined on the basis of financial statements prepared in accordance with the Brazilian Corporate Law.

If the minimum dividend to be paid to the holders of preferred shares is not paid for the period set forth in our by-laws, which in no event shall be longer than three years, the holders of preferred shares will be entitled to full voting rights until such dividend is paid in full.

### ***Payment of Dividends***

We are required by law and our bylaws to hold an annual shareholders meeting before April 30 of each year at which, among other issues, the allocation of net profits obtained during the preceding fiscal year and the declaration of dividends by decision of common shareholders are decided, acting on the recommendation of the executive officers, as approved by the Board of Directors. The payment of annual dividends is based on the financial statements prepared for each fiscal year ending December 31. Under the Brazilian Corporate Law, dividends are required to be paid within 60 days following the date the dividend is declared to shareholders of record on the declaration date, unless a shareholders resolution sets forth another date of payment, which must occur prior to the end of the fiscal year.

A shareholder has a three-year period from the dividend payment date to claim dividends in respect of its shares, after which we have no liability for the payment. Because our shares are issued in book-entry form, dividends with respect to any share are automatically credited to the account holding the share and no action is required on part of the shareholder. We are not required to adjust the amount of paid-in capital for inflation.

If a shareholder is not a resident of Brazil, he or she must register with the Central Bank of Brazil in order to be eligible to receive dividends, sales proceeds or other amounts with respect to his or her shares outside of Brazil. Our preferred shares underlying ADSs are held in Brazil by a Brazilian custodian, Banco Itaú S.A., as the agent for the depositary, which is the registered owner of our shares.

Payments of cash dividends and distributions, if any, will be made in Brazilian currency to the custodian on behalf of the depositary, which will then convert those proceeds into U.S. dollars and will cause U.S. dollars to be delivered to the depositary for distribution to holders of ADRs. In the event that the custodian is unable to immediately convert the Brazilian currency received as dividends into U.S. dollars, the amount of U.S. dollars payable to holders of ADRs may be adversely affected by devaluations of the Brazilian currency that occur before dividends are converted and remitted. Dividends in respect of the preferred shares paid to resident and non-resident shareholders, including holders of ADRs, are not currently subject to Brazilian withholding tax.

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We are in compliance with all the amendments of the Brazilian Corporate Law, as resolved by our general shareholders meeting and our special preferred shareholders meeting held on December 30, 2002.

**Additional Payments on Shareholders' Equity**

Law No. 9,249, dated December 26, 1995, as amended, provides for distribution to shareholders of interest on shareholders' equity, which may be computed against the amount of dividends to be distributed to the shareholders. A company may treat these payments as financial expenses for income tax and social contribution purposes. This interest is limited to the daily *pro rata* variation of the *Taxa de Juros de Longo Prazo*, or TJLP, a nominal long-term interest rate determined by the federal government that includes an inflation factor and cannot exceed the greater of:

50% of net income (before deducting income taxes and the interest on shareholders' equity) for the period in respect of which the payment is made, or

50% of the sum of retained earnings and profit reserves.

Any payment of interest in respect of preferred shares to shareholders (including the holders of ADSs) is subject to Brazilian withholding tax at a rate of 15%, or 25% in the case of a shareholder domiciled in a tax haven, and these payments may be included, at their net value, as part of any mandatory dividend. Payments to persons who are exempt from taxation in Brazil are not subject to withholding tax. See Item 10.E Taxation - Brazilian Tax Considerations - Distributions of Interest on Capital.

We declare and pay dividends and/or interest on shareholders' equity as required by Brazilian Corporate Law and our bylaws. The declaration of annual dividends, including dividends in excess of the mandatory distribution, requires approval by the vote of the majority of the holders of common shares, and depends on many factors. These factors include our results of operations, financial condition, cash requirements, future prospects and other factors deemed relevant by shareholders. Our shareholders have historically acted on these matters based on recommendation of the Board of Directors. Within the context of tax planning, we may determine in the future that it is to our benefit to distribute interest on shareholders' equity.

The following table sets forth the dividends or interest on shareholders' equity paid to holders of our common and preferred shares since 2000 in *reais*.

Year	Description  (Dividends or Interest on shareholders equity) (1)	Common Shares  (per 1,000 shares/in R\$)	Preferred Shares
2005	Div/Int	3.429109	3.772020
2004	Div/Int	5.632389	6.195627
2003	Div/Int	6.905139	7.595652

(1) Interest on shareholders' equity is net of withholding taxes.

*Interim Dividends and Interest on Shareholders' Equity*

At our Board of Directors meetings held on April 7, 2004, October 5, 2004 and April 1, 2005, the distribution of interim dividends to our common and preferred shareholders in the amount of R\$613,570,000, R\$1,596,120,000 and R\$1,500,000,000, respectively, was approved based on the cumulative profits from the applicable previous year. The payment of the dividends declared in 2004 started to take place on April 23, 2004 and October 29, 2004, respectively. Payment on the dividends declared in April 2005 start to take place on April 20, 2005.

Our Board of Directors also approved payments of interest on shareholders' equity to our common and preferred shareholders in the amount of R\$251.4 million and R\$503.9 million net of withholding tax relating to fiscal year 2004. These payments of interest on shareholders' equity started to take place on April 23, 2004 and October 29, 2004, respectively.

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According to the sole paragraph of Article 28 of our bylaws, the interim dividends mentioned above will be charged to the mandatory minimum dividend for the year 2004, after the general ordinary shareholder's meeting approves the financial statements for 2004.

According to Article 29 of our bylaws, the interest on shareholders' equity mentioned above may be charged to the mandatory minimum dividends for 2004, after the general ordinary shareholder's meeting approves the financial statements for 2004.

**B. Significant Changes**

None.

**ITEM 9. THE OFFER AND LISTING****A. Offer and Listing Details**

The trading market for our common and preferred shares is BOVESPA.

Our preferred shares began trading on BOVESPA, on September 21, 1998. Our preferred shares trade on BOVESPA under the symbol TLPP4 and our common shares trade under the symbol TLPP3. At December 31, 2004, we had approximately 493.6 billion common and preferred shares held by approximately 2.7 million common and preferred shareholders. The following table sets forth the reported high and low closing sale prices for the preferred shares on BOVESPA, for the periods indicated.

	Prices per 1,000 preferred shares of the company	
	High	Low
	(in nominal reais)	
January 1, 2000 through March 31, 2000	64.49	37.28
April 1, 2000 through June 30, 2000	51.25	33.50
July 1, 2000 through September 30, 2000	34.45	27.15
October 1, 2000 through December 31, 2000	31.15	24.05
December 1, 2000 through December 31, 2000	28.89	24.60
January 1, 2001 through March 31, 2001	32.14	26.00
April 1, 2001 through June 30, 2001	31.50	25.85
July 1, 2001 through September 30, 2001	26.40	19.30
October 1, 2001 through December 31, 2001	32.80	21.51
January 1, 2002 through March 31, 2002	36.49	28.40
April 1, 2002 through June 30, 2002	35.69	31.49
July 1, 2002 through September 30, 2002	34.57	30.20
October 1, 2002 through December 31, 2002	38.01	30.10
January 1, 2003 through March 31, 2003	35.50	29.51
April 1, 2003 through June 30, 2003	34.97	30.50

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July 1, 2003 through September 30, 2003	39.80	28.80
October 1, 2003 through December 31, 2003	47.00	36.35
January 1, 2004 through March 31, 2004	55.00	46.00
April 1, 2004 through June 30, 2004	49.25	38.50
July 1, 2004 through September 30, 2004	55.00	46.00
October 1, 2004 through December 31, 2004	51.20	44.89

In the United States, the preferred shares trade in the form of ADSs, each representing 1,000 preferred shares, issued by The Bank of New York, as depositary, pursuant to a Deposit Agreement, among us, the depositary and the registered holders and beneficial owners from time to time of ADSs. The ADSs commenced trading on the NYSE on November 16, 1998 under the symbol TSP. At December 31, 2004, there were approximately 217 institutional owners of ADSs (registered holders). The following table sets forth the reported high and low closing sales prices for ADSs on the NYSE for the periods indicated.

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	U.S. dollars per ADS	
	High	Low
January 1, 2000 through March 31, 2000	37.13	20.00
April 1, 2000 through June 30, 2000	30.00	18.50
July 1, 2000 through September 30, 2000	18.88	15.31
October 1, 2000 through December 31, 2000	16.94	12.06
December 1, 2000 through December 31, 2000	14.11	11.96
January 1, 2001 through March 31, 2001	16.25	12.41
April 1, 2001 through June 30, 2001	14.01	10.09
July 1, 2001 through September 30, 2001	11.26	7.58
October 1, 2001 through December 31, 2001	13.70	7.76
January 1, 2002 through March 31, 2002	15.30	11.50
April 1, 2002 through June 30, 2002	15.20	10.74
July 1, 2002 through September 30, 2002	11.80	7.80
October 1, 2002 through December 31, 2002	10.82	7.65
January 1, 2003 through March 31, 2003	10.49	8.16
April 1, 2003 through June 30, 2003	11.94	9.55
July 1, 2003 through September 30, 2003	13.68	9.35
October 1, 2003 through December 31, 2003	16.47	12.65
January 1, 2004 through March 31, 2004	19.25	15.75
April 1, 2004 through June 30, 2004	17.18	12.45
July 1, 2004 through September 30, 2004	18.78	15.20
October 1, 2004 through December 31, 2004	19.43	15.60

**B. Plan of Distribution**

Not applicable.

**C. Markets****Trading on the Brazilian Stock Exchanges**

BOVESPA is a non-profit entity owned by its member brokerage firms. Trading on this exchange is limited to member brokerage firms and a limited number of authorized nonmembers.

BOVESPA has open outcry trading sessions each day, from 10:00 a.m. to 1:00 p.m. and from 2:00 p.m. to 5:00 p.m. Trading is also conducted from 10:00 a.m. to 5:00 p.m. on an automated system on BOVESPA. On September 20, 1999, BOVESPA launched the After-Market, with the objective of expanding business opportunities and offering investors a more flexible trading schedule. After-Market trading takes place from 5:30 p.m. to 7:00 p.m. All stocks traded during the regular trading session of the day may be traded on the After-Market. However, only cash market trading via BOVESPA's electronic trading system is allowed. The maximum variation allowed for stock prices, whether positive or negative, corresponds to 2% in relation to the closing price at the regular trading session.



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In order to better control volatility, BOVESPA has adopted a circuit breaker system pursuant to which trading sessions may be suspended for a period of 30 minutes or one hour whenever the indices of these stock exchanges fall below the limits of 10% and 15%, respectively, in relation to the index registered in the previous trading session.

Settlement of transactions is effected three business days after the trade date without adjustment of the purchase price for inflation. Payment for shares is made through the facilities of a separate clearinghouse, which maintains accounts for member brokerage firms. The seller is ordinarily required to deliver the shares to the exchange on the second business day following the trade date. The clearinghouse for BOVESPA is *Companhia Brasileira de Liquidação e Custódia S.A. CBLC*, which is wholly owned by the exchange.

At December 31, 2004, the aggregate market capitalization of the 358 companies listed on BOVESPA was approximately US\$340.9 billion. Although all the outstanding shares of an exchange-listed company may trade on a Brazilian stock exchange, in most cases less than half of the listed shares are actually available for trading by the public, the remainder being held by small groups of controlling entities or persons that rarely trade their shares. For this reason,

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data showing the total market capitalization of Brazilian stock exchanges tend to overstate the liquidity of the Brazilian equity securities market.

The Brazilian equity market is relatively small and illiquid compared to major world markets. In 2004, the combined monthly trading volumes on BOVESPA averaged approximately US\$8.7 billion. In 2004, the ten most actively traded issues represented approximately 45.3% of the total trading in the cash market on BOVESPA. Trading on Brazilian stock exchanges by nonresidents of Brazil is subject to certain limitations under Brazilian foreign investment legislation.

The institution of a securities market maker was introduced in the Brazilian market through CVM Directive No. 384/2003 and São Paulo Stock Exchange Resolution No. 293/2003-CA. The market maker is a liquidity agent or specialist that guarantees minimum liquidity and price reference for specific assets, thus promoting the efficiency of the Brazilian capital markets. At the end of 2004, there were five market makers operating on BOVESPA.

## **Regulation of Brazilian Securities Markets**

The Brazilian securities markets are regulated by the CVM, which has authority over stock exchanges and the securities markets generally, the CMN and the Central Bank, which has, among other powers, licensing authority over brokerage firms and regulates foreign investment and foreign exchange transactions. The Brazilian securities market is governed by Law No. 6,385, as amended, known as the Brazilian Securities Law, and by the Brazilian Corporate Law.

Law No. 10,303 of December 31, 2001 amended the Brazilian Corporate Law and the Brazilian Securities Law. Consequently, some major modifications resulted for the businesses of the publicly traded companies. Among the changes, Law No. 10,303, along with Executive Order No. 8 and Decree No. 3.995, all dated as of October 31, 2001, established that the CVM would have the scope of its authority altered and expanded. Additionally, the CVM's positioning in the regulatory hierarchy, as well as its autonomy, was modified. The modifications include changes in the proportions of common and preferred shares, new rules for the issuance of debentures, other parameters governing the exercise of the right of withdrawal, duties and powers of the members of the audit committee and the board of directors, and the ability of publicly traded companies to make publications available over the Internet. Also provided is the pooling agreement, the block voting system by which the shareholders agree during a prior meeting on the direction of the votes that will be cast at the general meetings. The purpose of this type of vote is to prevent any possible individual dissidents or interests from harming corporate interests.

The period established for companies to adapt their bylaws is one year starting from the publication of the law on November 1, 2001. Our shareholders held a general shareholders meeting on December 30, 2002, at which they addressed these modifications in our bylaws.

The CVM, which is the agency in charge of regulating the market, now handles some functions that were reserved to the Central Bank, including the regulation and organization of the futures and commodities markets.

Under the Brazilian Corporate Law, a company may be a listed company, a *companhia aberta*, as we are, or a non-listed company, a *companhia fechada*. All listed companies are registered with the CVM and are subject to reporting requirements. A company registered with the CVM may have its securities traded either on BOVESPA or on the Brazilian over-the-counter market. The shares of a listed company may also be traded privately, subject to certain limitations. In order to be listed on the BOVESPA, a company must apply for registration with the CVM and the stock exchange. Once the stock exchange lists a company and the CVM accepts its registration as a listed company, its securities may start to be

traded.

Trading in securities on the stock exchange may be suspended under a request from a company in anticipation of a material announcement. Trading in the securities of a particular company may also be suspended under the initiative of BOVESPA or the CVM, among other reasons, due to the belief that the company has provided inadequate information regarding a material event or has provided inadequate responses to inquiries by the CVM or the stock exchange.

The Brazilian securities law, the Brazilian Corporate Law and the regulations issued by the CVM, the CMN and the Central Bank provide, among other things, disclosure requirements and restrictions on insider trading, price manipulation and protection of minority shareholders.

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### Corporate Governance Practices

We are a *sociedade anônima*, a corporation incorporated under the laws of Brazil, and are subject to the corporate governance provisions of Brazilian Corporate Law. We comply with the regulatory requirements of the Brazilian Corporate Law regarding the independence of our Board of Directors, the establishment and composition of certain board committees and the adoption and disclosure of corporate governance guidelines.

We comply with several requirements of Brazilian and international laws in order to promote strong corporate governance, reduce investor uncertainties and enhance disclosure of material and other information.

With the approval of our Board of Directors, we concluded the implementation of several measures in 2004 designed to improve our transparency and disclosure practices. We believe these measures will benefit our shareholders, current and future investors as well as the marketplace in general. Among the measures we have implemented, we have:

developed a disclosure policy for material facts and corporate actions;

developed a policy for internal controls related to financial information;

created a Service Quality and Marketing committee;

created a Control and Audit committee;

created a Nominations, Compensation and Corporate Governance committee; and

developed and published a company Corporate Governance Report (*Informe de Governança Corporativa*) with information regarding the corporate governance principles we follow, our shareholder structure and characteristics, the composition and competence of administrative entities, the obligations and responsibilities of administrators and equity interests held by corporate officers and administrators.

As determined by the Brazilian Corporate Law, the aggregate annual compensation of senior management is approved by our shareholders at an annual shareholders meeting. The Nominations, Compensation and Corporate Governance Committee provides information and recommendations to the Board of Directors regarding the criteria for compensation.

Our internal rules relating to insider trading are determined in our charter for internal conduct. Senior management and members of our Board of Directors and any other employee exposed to sensitive information are subject to the restrictions imposed by such charter. In addition to the prohibition on trading of our shares by such individuals when in possession of insider information, the charter establishes blackout trading periods for those periods when insider information is available. As an example, the month before the formulation and approval of our annual income statements by our Board of Directors is considered a blackout period under the charter. In addition, the charter sets forth instructions for dealing with conflicts of interest and mandates disclosure of any such situation.

**Principal Differences Between U.S. and Brazilian Corporate Governance Practices**

On November 4, 2003, the SEC approved new corporate governance rules established by the NYSE. Pursuant to these rules, foreign private issuers that are listed on the NYSE, such as our company, must disclose any significant ways in which its corporate governance practices differ from those followed by U.S. companies under the listing rules of the NYSE.

The significant differences between our corporate governance practices and the NYSE corporate governance standards are as follows:

***Independence of Directors and Independence Tests***

The Brazilian Corporate Law and our bylaws require that our directors be elected by our shareholders at a general shareholders meeting. Twelve of our directors are appointed by our common shareholders, and one director is appointed by representatives of our minority preferred shareholders. Six of our directors are independent.

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Both the Brazilian Corporate Law and CVM establish rules in relation to certain qualification requirements and restrictions, investiture, compensation, duties and responsibilities of the companies' executives and directors. We believe these rules provide adequate assurances that our directors are independent and such rules would permit us to have directors that would not otherwise pass the independence tests established by the NYSE.

### ***Executive Sessions***

According to the Brazilian Corporate Law, up to one-third of the members of the board of directors can be elected to executive positions. The remaining non-management directors are not expressly empowered to serve as a check on management, and there is no requirement that those directors meet regularly without management. Notwithstanding, our Board of Directors consists of eleven non-management directors, six of which are independent directors, and as such we believe we are in compliance with this standard.

### ***Control and Audit Committee / Additional Requirements***

Brazilian Corporate Law and our bylaws each require that we have a statutory Board of Auditors (*Conselho Fiscal*). See Item 6(C) Directors, Senior Management and Employees Board Practices Board of Auditors. Our statutory Board of Auditors meets the requirements of the general exemption from the listing standards for audit committees set forth in Exchange Act Rule 10A-3(c)(3). See Item 16D Exemptions from the Listing Standards for Audit Committees. Our statutory Board of Auditors is primarily charged with certain advisory, oversight and review functions with respect to the company's financial statements. However, the statutory Board of Auditors, as required by Brazilian Corporate Law, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Board of Auditors are not binding on the company under Brazilian Corporate Law. See Item 6(C) Directors, Senior Management and Employees Board Practices Board of Auditors.

In addition to our statutory Board of Auditors, we have established a Control and Audit committee as a best corporate governance practice in order to comply with the requirements of the Sarbanes-Oxley Act as described in Item 6C. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Board of Auditors.

### **Code of Business Conduct and Ethics**

Although adoption of a code of ethics is not required by Brazilian Corporate Law, we are in the process of implementing a code of ethics regulating the conduct of our managers in connection with the registration and control of financial and accounting information and their access to privileged and non-public information and data in order to comply with the requirements of the Sarbanes-Oxley Act and NYSE rules. See Item 16B Code of Ethics.

In addition to complying with the rules of corporate governance applicable to us under Brazilian law, we intend to gradually comply with substantially all of the new rules established by the NYSE and the SEC applicable to domestic U.S. companies.

**D. Selling Shareholders**

Not applicable.

**E. Dilution**

Not applicable.

**F. Expenses of the Issue**

Not applicable.

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**ITEM 10. ADDITIONAL INFORMATION**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

Set forth below is certain information relating to our capital stock and a summary of certain significant provisions of our bylaws and the Brazilian Corporate Law.

**General**

We are registered with the *Junta Comercial de São Paulo*, the Board of Trade of São Paulo, or JUCESP, under no. 35.3.001588-14. According to Section 2 of our bylaws, our main corporate purpose is to provide telecommunications services and to develop those activities necessary or useful for the performance of these services, in accordance with the concessions, authorizations and permits granted to us.

There are no provisions in our bylaws with respect to:

an officer's power to vote on proposals in which the officer has a personal interest;

an officer's power to vote on his own compensation, even in the absence of an independent quorum;

age limits for retirement of officers;

required shareholding to qualify as a manager (officer); or

anti-takeover mechanisms or other procedures designed to delay, defer or prevent changes in our control.

Brazilian Corporate Law requires ownership of shares in order for a person to qualify as a member of the board of directors (*conselho de administração*) of a corporation (*sociedade por ações*).

Issuance of commercial paper and incurrence of certain debt shall be preceded by approval from our Board of Directors, according to the provisions set forth in section 17 of our bylaws.



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Our capital stock is comprised of preferred shares and common shares, all without par value. At December 31, 2004, there were 328,272,072,739 outstanding preferred shares and 165,320,206,602 outstanding common shares. Our share capital may be increased by resolution of the Board of Directors, up to the limit authorized by our bylaws. Any increase above the authorized capital must be approved by a general shareholders meeting.

The preferred shares are non-voting, except under limited circumstances. They are given priority in the reimbursement of capital, without premium, and are entitled to receive a dividend 10% higher than that attributable to common shares.

Pursuant to Law 10,303/01, the following changes were introduced to the Brazilian Corporate Law:

preferred shares representing 10% of our total number of outstanding shares would be entitled to appoint a representative to our Board of Directors;

disputes among our shareholders would be subject to arbitration, if provided for in our by-laws;

a tender offer at a purchase price equal to fair value for all outstanding shares would be required upon a delisting or a substantial reduction in liquidity of our shares as a result of purchases by the controlling shareholders;

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any sale of control would require the shareholders to tender for the minority shareholders' common shares and, if provided for in our charter, for the minority shareholders' preferred shares, at a purchase price at least equal to 80% of the price per share with voting rights paid to the controlling shareholder;

shareholders would be entitled to withdraw from us upon a spin-off only if it entailed a change in the corporate purpose, a reduction in mandatory dividends or the participation in a centralized group of companies;

the controlling shareholders, the shareholders that elect members to our Board of Directors and Board of Auditors, the members of our Board of Directors and Board of Auditors and our Executive Officers would be required to disclose any purchase or sale of our shares to the CVM and BOVESPA; and

we would be permitted to satisfy our information disclosure requirements through the Internet.

## **Voting Rights**

Each common share entitles the holder to one vote at general shareholders' meetings. Preferred shares do not entitle the holder to vote at shareholders' meetings, except under specific circumstances and with respect to certain matters, as specified below. Holders of preferred shares are only entitled to attend and to discuss, but not to vote on, the issues discussed at our general shareholders' meetings.

The appointment of one member of our statutory Board of Auditors, including the alternate member, takes place at the annual ordinary general shareholders' meeting, upon separate vote of the holders of preferred shares, for the position available at the Board of Auditors. The election of a member of the Board of Directors by preferred shareholders also occurs on a separate vote, with no participation of the controlling shareholder.

Brazilian Corporate Law provides that certain non-voting shares, such as our preferred shares, shall be entitled to voting rights in the event a corporation fails for three consecutive fiscal years to pay any fixed or minimum dividends to which non-voting shares are entitled. In this case, the voting rights of these shares shall extend until the date on which the payment of the accrued and unpaid dividend is made.

Preferred shares are entitled to full voting rights with respect to:

the approval of any non-standard long-term agreement between us and our affiliates, on the one hand, and (i) our controlling shareholder, or (ii) an affiliate of our controlling shareholder, on the other hand;

any agreements for the rendering of management services (including technical assistance services) between us and any foreign affiliate of our controlling shareholder;

resolutions amending certain provisions of our bylaws; and

any resolution submitted to the general shareholders' meeting during our liquidation process.

Any change in the preference, benefits, conditions of redemption and amortization of preferred shares or the creation of a more favored class would require the approval or ratification by holders of a majority of the preferred shares at a special meeting of the preferred shareholders. This meeting would be called by publication of a notice in two Brazilian newspapers during three days, at least thirty days prior to the meeting; however, it would not generally require any other form of notice.

In any circumstances in which holders of preferred shares are entitled to vote, each preferred share will entitle the holder to one vote.

**Preemptive Rights**

Each shareholder has a general preemptive right to subscribe for shares of the same class in any capital increase, in an amount sufficient to keep the same proportional participation of each shareholder in the total capital of the

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corporation. A minimum period of 30 days following the publication of the capital increase notice shall be observed by the corporation for the exercise of the preemptive right by the shareholder. The right of participation in capital increases is assignable under Brazilian Corporate Law. However, the bylaws of a publicly held company that allows capital increases may provide for the issuance, without granting any preemptive rights to prior shareholders, of stocks, debentures convertible into stocks, or subscription bonuses, the placement of which shall be made:

upon sale on a stock exchange or public subscription,

through an exchange of shares in a public offering, with the purpose of acquiring control of another company, or

for the use of certain tax incentives.

In the event of a capital increase, which would maintain or increase the proportion of capital represented by preferred shares, holders of ADSs, or of preferred shares, would have preemptive rights to subscribe only to our newly issued preferred shares. In the event of a capital increase, which would reduce the proportion of capital represented by preferred shares, holders of ADSs, or of preferred shares, would have preemptive rights to subscribe to our new preferred shares, in proportion to their shareholdings and to our new common shares only to the extent necessary to prevent dilution of their interest.

## **Redemption and Right of Withdrawal**

According to the Brazilian Corporate Law, dissenting shareholders in a shareholders' meeting shall have a right of redemption, with reimbursement of the value of their shares, in case the following matters are approved:

- (i) creation of a new class of preferred shares or an increase in preferred shares of an existing class, without maintaining the proportion with the remaining classes;
- (ii) change in the preferences, advantages and conditions of redemption or amortization of one or more classes of preferred shares, or the creation of a class with more favorable rights or preferences;
- (iii) reduction of the mandatory dividend;
- (iv) merger into another company or consolidation with another company;
- (v) participation in a group of companies;
- (vi) change in the purpose of the corporation; and
- (vii) split-up of the corporation.

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It is important to point out that (a) in items (i) and (ii), only the holders of shares of the affected type or class will be entitled to redemption; (b) in items (iv) and (v), the holders of shares of a type or class with liquidity and dispersion in the market will not have the right; and (c) in item (vii), the dissenting shareholders shall only have a right of redemption if the split-up implies a change in the corporate purpose, a reduction of the compulsory dividend or the participation in a group of companies.

The reimbursement must be required by the dissenting shareholders within 30 days after the publication of the minutes of the general shareholders meeting or special meeting, as the case may be. Within 10 days after the expiration of the period, management is authorized to call a general shareholders meeting to ratify or reconsider the decision, if management understands that the payment of reimbursement to the dissenting shareholders who have exercised their redemption right may jeopardize the financial stability of the company. A shareholder who fails to exercise the right within the assign term shall no longer be entitled to redemption.

According to the Brazilian Corporate Law, the amount to be reimbursed may only be lower than the share net value ascertained in the last balance sheet approved by the general shareholders meeting if this amount is based on the economic value of the corporation, to be duly appraised. If the decision of the general shareholders meeting takes place

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more than 60 days after the issuance of the last approved balance sheet, the shareholder shall be entitled to demand, together with the reimbursement, the preparation of a special balance sheet that complies with the time frame previously described.

### **C. Material Contracts**

We have not entered into any material contract as of the date and term covered by this annual report.

### **D. Exchange Controls**

There are no restrictions on ownership of preferred shares or common shares by individuals or legal entities domiciled outside of Brazil.

The right to convert dividend or interest payments and proceeds from the sale of shares into foreign currency and to remit such amounts outside Brazil is subject to restrictions under foreign investment legislation which generally requires, among other things, that the relevant investments have been registered with the Central Bank and the CVM. The restrictions on the remittance of foreign capital abroad may hinder or prevent the custodian for the preferred shares represented by ADSs or holders of preferred shares from converting dividends, distributions or the proceeds from any sale of these preferred shares into U.S. dollars and remitting the U.S. dollars abroad. Holders of ADSs could be adversely affected by delays in, or refusal to grant any, required government approval to convert Brazilian currency payments on the preferred shares underlying the ADSs and to remit the proceeds abroad.

Resolution No. 1,927 of the CMN provides for the issuance of depositary receipts in foreign markets in respect of shares of Brazilian issuers. It restates and amends Annex V to Resolution No. 1,289 of the National Monetary Council, known as the Annex V Regulations. The ADS program was approved under the Annex V Regulations by the Central Bank and the CVM prior to the issuance of the ADSs. Accordingly, the proceeds from the sale of ADSs by ADR holders outside Brazil are free of Brazilian foreign investment controls, and holders of the ADSs are entitled to favorable tax treatment. See [Taxation](#) [Brazilian Tax Considerations](#).

Under Resolution 2,689 of the CMN, foreign investors registered with the CVM may buy and sell Brazilian securities, including the preferred shares, on Brazilian stock exchanges without obtaining separate certificates of registration for each transaction. Registration is available to qualified foreign investors, which principally include foreign financial institutions, insurance companies, pension and investment funds, charitable foreign institutions and other institutions that meet certain minimum capital and other requirements. Resolution 2,689 also extends favorable tax treatment to registered investors. See [Taxation](#) [Brazilian Tax Considerations](#).

Pursuant to Resolution 2,689 foreign investors must: (i) appoint at least one representative in Brazil with the ability to perform actions regarding the foreign investment; (ii) complete the appropriate foreign investor registration form; (iii) obtain registration as a foreign investor with the CVM; and (iv) register the foreign investment with the Central Bank.

The securities and other financial assets held by a foreign investor pursuant to Resolution 2,689 must be registered or maintained in deposit accounts or under the custody of an entity duly licensed by the Central Bank or by the CVM or be registered in register, clearing and custody systems authorized by the Central Bank or by the CVM. In addition, the trading of securities is restricted to transactions carried out on the stock exchanges or over-the-counter markets licensed by the CVM.

**Registered Capital**

Amounts invested in preferred shares by a non-Brazilian holder who qualifies under Resolution 2,689 and obtains registration with the CVM, or by the depositary representing an ADS holder are eligible for registration with the Central Bank. Such registration (the amount so registered is referred to as registered capital) allows the remittance outside Brazil of foreign currency, converted at the commercial market rate, acquired with the proceeds of distributions on, and amounts realized through, dispositions of such preferred shares. The registered capital per preferred share purchased in the form of an ADS, or purchased in Brazil and deposited with the depositary in exchange for an ADS, will be equal to its purchase price (stated in U.S. dollars). The registered capital per preferred share withdrawn upon cancellation of an ADS will be the U.S. dollar equivalent of (i) the average price of a preferred share on the Brazilian stock exchange on which the most preferred shares were traded on the day of withdrawal or (ii) if no preferred shares were traded on that day, the

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average price on the Brazilian stock exchange on which the most preferred shares were traded in the fifteen trading sessions immediately preceding such withdrawal. The U.S. dollar equivalent will be determined on the basis of the average commercial market rates quoted by the Central Bank on such date or dates.

An electronic registration has been issued in the name of the depositary with respect to the ADSs and is maintained by the custodian on behalf of the depositary. Pursuant to the registration, the custodian and the depositary are able to convert dividends and other distributions with respect to the preferred shares represented by ADSs into foreign currency and remit the proceeds outside Brazil. In the event that a holder of ADSs exchanges such ADSs for preferred shares, such holder will be entitled to continue to rely on the depositary's registration for five business days after such exchange, following which such holder must seek to obtain its own electronic registration with the Central Bank. Thereafter, any holder of preferred shares may not be able to convert into foreign currency and remit outside Brazil the proceeds from the disposition of, or distributions with respect to, such preferred shares, unless such holder is a duly qualified investor under Resolution 2,689 and obtains its own electronic registration.

If the holder appoints a representative in Brazil to act directly in the Brazilian market to acquire preferred shares, the holder will be subject to a less favorable Brazilian tax treatment than a holder of ADSs. Regardless of registration under Resolution 2,689, residents in tax havens are subject to less favorable tax treatment than other foreign investors. See **Taxation** Brazilian Tax Considerations.

Under current Brazilian legislation, the federal government may impose temporary restrictions on remittances of foreign capital abroad in the event of a serious imbalance or an anticipated serious imbalance of Brazil's balance of payments. For approximately six months in 1989 and early 1990, the federal government froze all dividend and capital repatriations held by the Central Bank that were owed to foreign equity investors, in order to conserve Brazil's foreign currency reserves. These amounts were subsequently released in accordance with federal government directives. There can be no assurance that the federal government will not impose similar restrictions on foreign repatriations in the future.

## **E. Taxation**

The following discussion contains a description of the material Brazilian and U.S. federal income tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs by certain holders. This summary is based upon the tax laws of Brazil and the United States as in effect on the date of this annual report, which are subject to change, possibly with retroactive effect, and to differing interpretations. You should consult your own tax advisors as to the Brazilian, U.S. federal or other tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs, including, in particular, the effect of any state, local or non-U.S., non-Brazilian tax laws.

Although there is presently no income tax treaty between Brazil and the United States, the tax authorities of the two countries have had discussions that may culminate in such a treaty. No assurance can be given, however, as to whether or when a treaty will enter into force or how it will affect the U.S. holders of preferred shares or ADSs.

## **Brazilian Tax Considerations**

The following discussion mainly summarizes the principal Brazilian tax consequences of the acquisition, ownership and disposition of preferred shares or ADSs by a U.S. holder not deemed to be domiciled in Brazil for Brazilian tax purposes (a U.S. holder). This discussion does not address all the Brazilian tax considerations that may be applicable to any particular non-Brazilian holder, and each non-Brazilian holder should



consult its own tax advisor about the Brazilian tax consequences of investing in preferred shares or ADSs.

*Taxation of Dividends*

Dividends paid by us in cash or in kind from profits generated on or after January 1, 1996 (i) to the depositary in respect of preferred shares underlying ADSs or (ii) to a U.S. holder or non-Brazilian holder in respect of preferred shares will generally not be subject to Brazilian withholding tax. We do not have any undistributed profits generated before January 1, 1996.

*Distributions of Interest on Capital*

Brazilian corporations may make payments to shareholders characterized as interest on capital as an alternative form of making dividend distributions. The rate of interest may not be higher than the federal government's long-term interest rate, or the TJLP, as determined by the Central Bank from time to time (10% per annum for the three month period

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beginning January 2004). The total amount distributed as interest on capital may not exceed the greater of (i) 50% of net income (before taking the distribution and any deductions for income taxes into account) for the year in respect of which the payment is made or (ii) 50% of retained earnings for the year prior to the year in respect of which the payment is made. Payments of interest on capital are decided by the shareholders on the basis of recommendations of the company's board of directors.

Distributions of interest on capital paid to Brazilian and non-Brazilian holders of preferred shares, including payments to the depositary in respect of preferred shares underlying ADSs, are deductible by us for Brazilian corporate income tax purposes. These payments to U.S. holders or non-Brazilian holders are subject to Brazilian withholding tax at the rate of 15%. If the recipient of the payment is domiciled in a tax haven jurisdiction (i.e., a country that does not impose any income tax or that imposes tax at a rate of less than 20%), the rate will be 25%.

No assurance can be given that our Board of Directors will not recommend that future distributions of profits will be made by means of interest on capital instead of by means of dividends.

Amounts paid as interest on capital (net of applicable withholding tax) may be treated as payments in respect of the dividends we are obligated to distribute to our shareholders in accordance with our by-laws (*estatuto social*) and Brazilian Corporate Law. Distributions of interest on capital in respect of the preferred shares, including distributions to the depositary in respect of preferred shares underlying ADSs, may be converted into U.S. dollars and remitted outside of Brazil, subject to applicable exchange controls.

## ***Taxation of Gains***

Gains realized outside Brazil by a U.S. holder or a non-Brazilian holder on the disposition of property located in Brazil, including preferred shares, to another U.S. holder or non-Brazilian holder are subject to Brazilian tax, as of February 2004. In this case, gains would be subject to a 15% withholding tax rate, except if the beneficiary is located in a low-tax jurisdiction, as defined by Brazilian law, in which case the applicable rate would be 25%.

Our understanding is that ADSs do not qualify as property located in Brazil and, therefore, are not subject to Brazilian taxes upon disposition to other non-Brazilian or U.S. holders. Insofar as the regulatory norm referred to in Article 26 is recent and generic and has not been tested through the administrative or judicial courts, we are unable to evaluate what the final ruling on the matter will be.

Gains realized by a U.S. holder or a non-Brazilian holder on dispositions of preferred shares in Brazil or in transactions with Brazilian residents may be free of Brazilian tax, taxed at a rate of 25% or taxed at a rate of 15%, depending on the circumstances.

Gains on the disposition of preferred shares obtained upon cancellation of ADSs are not taxed in Brazil if the disposition is made and the proceeds are remitted abroad within five business days after cancellation, unless the investor is a resident of a jurisdiction that, under Brazilian law, is deemed to be a tax haven.

Gains realized on preferred shares through transactions with Brazilian residents or through transactions in Brazil off of the Brazilian stock exchanges are generally subject to tax at a rate of 15%.

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Gains realized on preferred shares through transactions on Brazilian stock exchanges are generally subject to tax at a rate of 15%, as of January 2005, unless the investor is entitled to tax-free treatment for the transaction under Resolution 2,689 of the National Monetary Council Regulations, described immediately below.

Resolution 2,689, which as of March 31, 2000 superseded the Annex IV Regulations that previously provided tax benefits to foreign investors, extends favorable tax treatment to a U.S. holder or non-Brazilian holder of preferred shares who has (i) appointed a representative in Brazil with power to take action relating to the investment in preferred shares, (ii) registered as a foreign investor with the CVM and (iii) registered its investment in preferred shares with the Central Bank. Under Resolution 2,689 securities held by foreign investors must be maintained under the custody of, or in deposit accounts with, financial institutions duly authorized by the Central Bank and the CVM. In addition, the trading of securities is restricted under Resolution 2,689 to transactions on Brazilian stock exchanges or qualified over-the-counter markets. The preferential treatment generally afforded under Resolution 2,689 and afforded to investors in ADSs is not available to residents of tax havens. All preferred shares underlying ADSs qualify under Resolution 2,689.

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There can be no assurance that the current preferential treatment for U.S. holders and non-Brazilian holders of ADSs and U.S. holders and non-Brazilian holders of preferred shares under Resolution 2,689 will be maintained.

Gain on the disposition of preferred shares is measured by the difference between the amount in Brazilian currency realized on the sale or exchange and the acquisition cost of the shares sold, measured in Brazilian currency, without any correction for inflation. Although there is controversy surrounding this issue, there are arguments to sustain the position that the acquisition cost of shares registered as an investment with the Central Bank is calculated on the basis of the foreign currency amount registered with the Central Bank. See Registered Capital.

Gains realized by a U.S. holder and non-Brazilian holder upon the redemption of preferred shares will be treated as gains from the disposition of such preferred shares to a Brazilian resident occurring off of a stock exchange and will accordingly be subject to tax at a rate of 15%. In case the non-Brazilian holder is domiciled in a tax haven jurisdiction, the applicable rate would be 25%.

As of January 1, 2005, the purchase price of preferred shares sold on the Brazilian stock exchange is subject to withholding tax at a rate of 0.005%, except in the case of non-Brazilian holders that invest through Resolution No. 2,689. This tax may be offset against the 15% income tax due on the gains realized upon the sale of the shares.

Any exercise of preemptive rights relating to the preferred shares or ADSs will not be subject to Brazilian taxation. Gains on the sale or assignment of preemptive rights relating to the preferred shares will be treated differently for Brazilian tax purposes depending on (i) whether the sale or assignment is made by the depository or the investor and (ii) whether the transaction takes place on a Brazilian stock exchange. Gains on sales or assignments made by the depository on a Brazilian stock exchange are not taxed in Brazil, but gains on other sales or assignments may be subject to tax at rates up to 15%.

The deposit of preferred shares in exchange for the ADSs is not subject to Brazilian income tax if the preferred shares are registered under Resolution 2,689 and the respective holder is not in a tax haven jurisdiction. If the preferred shares are not so registered or the holder is in a tax haven jurisdiction, the deposit of preferred shares in exchange for ADSs may be subject to Brazilian capital gains tax at a rate of 15%.

The withdrawal of preferred shares in exchange for ADSs is not subject to Brazilian tax. On receipt of the underlying preferred shares, a U.S. holder or non-Brazilian holder entitled to benefits under Resolution 2,689 will be entitled to register the U.S. dollar value of such shares with the Central Bank as described above, under Registered Capital. If a U.S. holder or non-Brazilian holder does not qualify under Resolution 2,689, he will be subject to the less favorable tax treatment described above in respect of exchanges of preferred shares. Brazil's tax treaties do not grant relief from taxes on gains realized on sales or exchanges of preferred shares.

### *Beneficiaries Residing or Domiciled in Tax Havens or Low Tax Jurisdictions*

Law No. 9,779, dated as of January 19, 1999, states that, with the exception of limited circumstances, any income derived from operations by a beneficiary that resides or is domiciled in a country considered to be a tax haven is subject to income tax to be withheld by the source at a rate of 25%. Accordingly, if the distribution of interest attributed to shareholders' equity is made to a beneficiary residing or domiciled in a tax haven, the applicable income tax will be at a rate of 25% instead of 15%. The increased rate also applies for capital gains paid to residents of low-tax jurisdictions as of February 2004.

In accordance with Law No. 9,959, non-Brazilian holders of ADSs or preferred shares who are residents of tax havens have been excluded from the tax incentives granted to holders of ADSs and investors under Resolution No. 2,689 since January 1, 2000 and are subject to the same tax treatment applicable to holders that are residents of or domiciled in Brazil.

*Other Brazilian Taxes*

There are no Brazilian inheritance, gift or succession taxes applicable to the ownership, transfer or disposition of preferred shares or ADSs by a non-Brazilian holder except for gift and inheritance taxes levied by some states in Brazil on gifts made or inheritances bestowed by individuals or entities not resident or domiciled in Brazil or in the relevant state to individuals or entities that are resident or domiciled within this state in Brazil. There are no Brazilian stamp, issue, registration, or similar taxes or duties payable by holders of preferred shares or ADSs.

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A financial transaction tax, or the IOF tax, may be imposed on a variety of transactions, including the conversion of Brazilian currency into foreign currency (*e.g.*, for purposes of paying dividends and interest). The IOF tax rate on such conversions is currently 0%, but the Minister of Finance has the legal power to increase the rate to a maximum of 25%. Any increase will be applicable only prospectively.

The IOF may also be levied on transactions involving bonds or securities, or IOF/Títulos, even if the transactions are effected on Brazilian stock, futures or commodities exchanges. The rate of the IOF/Títulos with respect to preferred shares and ADSs is currently 0%. The minister of finance, however, has the legal power to increase the rate to a maximum of 1.5% of the amount of the taxed transaction per each day of the investor's holding period, but only to the extent of gain realized on the transaction and only on a prospective basis.

In addition to the IOF tax, a second, temporary tax that applies to the removal of funds from accounts at banks and other financial institutions, the CPMF tax, will be imposed on distributions in respect of ADSs at the time these distributions are converted into U.S. dollars and remitted abroad by the Custodian. The CPMF tax is due to expire on December 31, 2007. It is currently imposed at a rate of 0.38%. Transactions conducted through the Brazilian stock exchanges in current accounts specified for stock exchange transactions have been exempt from the CPMF tax since July 13, 2002. Additionally, as of August 2004, Brazilian holders may elect to make investments through a special investment account, which is exempt from CPMF. In this case, the tax only applies upon the transfer of funds from the banking account to the investment account. Once deposited in this account, funds may be withdrawn without the CPMF. However, funds deposited in the investment account must only be used for investments.

## **U.S. Federal Income Tax Considerations**

The following discussion is a summary of the material U.S. federal income tax consequences of the acquisition, ownership and disposition of our preferred shares or our ADSs by U.S. Holders, as defined below. This summary is based on the Internal Revenue Code of 1986, as amended (referred to herein as the Code), final, temporary and proposed Treasury regulations, administrative pronouncements of the U.S. Internal Revenue Service (the IRS) and judicial decisions, all as currently in effect and all of which are subject to change (possibly with retroactive effect), and to different interpretations. It is also based in part on representations by the depositary and assumes that each obligation under the Deposit Agreement and any related agreement will be performed in accordance with its terms. This discussion deals only with preferred shares and ADSs held as capital assets (generally, for investment purposes). It does not discuss all of the tax consequences that may be relevant to a U.S. Holder in light of the U.S. Holder's particular circumstances or to U.S. Holders subject to special rules, such as financial institutions, insurance companies, tax-exempt entities, dealers in securities or foreign currencies, partnerships and other pass-through entities, investors liable for the alternative minimum tax, persons who hold preferred shares or ADSs as part of an integrated investment (including a hedge, straddle or conversion transaction) comprised of a preferred share or ADS and one or more other positions for tax purposes, persons whose functional currency is not the U.S. dollar or persons who actually or constructively own (directly or indirectly) 10% or more of our voting stock or persons who acquired preferred shares or ADSs pursuant to the exercise of any employee stock option or otherwise as compensation. Holders of preferred shares or ADSs should consult their own tax advisors with regard to the application of the U.S. federal income tax laws to their particular situations as well as any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

As used herein, the term U.S. Holder means a beneficial owner of preferred shares or ADSs that is, for U.S. federal income tax purposes, (1) a citizen or individual resident of the United States, (2) a corporation (or other entity treated as a corporation for U.S. federal income tax purposes) organized under the laws of the United States or of any political subdivision thereof or (3) an estate or trust the income of which is subject to U.S. federal income taxation regardless of its source. The U.S. federal income tax treatment of a partner in a partnership that holds our preferred shares or ADSs will depend on the status of the partner and the activities of the partnership. Partners in such partnerships should consult their own tax advisors.

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THE SUMMARY OF U.S. FEDERAL INCOME TAX CONSEQUENCES SET OUT BELOW IS INTENDED FOR GENERAL INFORMATION PURPOSES ONLY. PROSPECTIVE PURCHASERS OF PREFERRED SHARES OR ADSs ARE URGED TO CONSULT WITH THEIR OWN TAX ADVISORS WITH RESPECT TO THE PARTICULAR TAX CONSEQUENCES TO THEM OF ACQUIRING, OWNING OR DISPOSING OF PREFERRED SHARES OR ADSs, INCLUDING THE APPLICABILITY AND EFFECT OF STATE, LOCAL, NON-U.S. AND OTHER TAX LAWS AND POSSIBLE CHANGES IN TAX LAWS.

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**Table of Contents*****General***

In general, for U.S. federal income tax purposes, holders of American depositary receipts evidencing ADSs will be treated as the beneficial owners of the preferred shares represented by those ADSs. Deposits and withdrawals of preferred shares in exchange for ADSs will not result in the realization of gain or loss for U.S. federal income tax purposes.

The U.S. Treasury Department has expressed concerns that parties to whom depositary shares such as the ADSs are released may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. Holders of the ADSs. Such actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain non-corporate holders. Accordingly, the analysis of the creditability of Brazilian taxes and the availability of the reduced tax rate for dividends received by certain non-corporate holders, each described below, could be affected by future actions taken by the U.S. Treasury.

***Taxation of Dividends***

Distributions made by us of cash or property (including distributions of interest on capital) generally will constitute a taxable dividend to the extent paid out of our current or accumulated earnings and profits, as determined under U.S. federal income tax principles. The full amount of any dividend paid in respect of our preferred shares or ADSs (including the amount of Brazilian withholding taxes imposed on such dividend) will be included in the gross income of a U.S. Holder, as ordinary income from sources outside the United States, at the time that the dividend is received by the U.S. Holder, in the case of our preferred shares, or by the depositary, in the case of ADSs. If a distribution made by us exceeds our current and accumulated earnings and profits, as determined under U.S. federal income tax principles, such excess will be treated first as a nontaxable return of capital to the extent of the U.S. Holder's adjusted tax basis in our preferred shares or ADSs, and thereafter as capital gain.

The amount of any dividend paid in *reais* generally will be measured by reference to the spot rate for converting *reais* into U.S. dollars in effect on the date that the dividend is received by the U.S. Holder, in the case of our preferred shares, or by the depositary, in the case of ADSs. A U.S. Holder may recognize foreign currency gain or loss, which would be treated as ordinary gain or loss, upon a subsequent conversion of *reais* into U.S. dollars. U.S. Holders should consult their own tax advisors regarding the calculation and U.S. federal income tax treatment of foreign currency gain or loss. The amount of any distribution of property other than cash will be the fair market value of such property on the date of distribution. Dividends paid by us will not be eligible for the dividends received deduction allowed to corporations under the Code. The amount of a dividend will include any amounts withheld by us or our paying agent in respect of Brazilian taxes. Dividends paid by us will be treated as foreign source dividend income to you and will not be eligible for the dividends received deduction generally allowed to U.S. corporations under the Code.

Subject to certain exceptions for short-term and hedged positions, and subject to the discussion above regarding concerns expressed by the U.S. Treasury, the U.S. dollar amount of dividends received by an individual prior to January 1, 2009 with respect to the ADSs will be subject to taxation at a maximum rate of 15% if the dividends represent qualified dividend income. Dividends paid on the ADSs will be treated as qualified dividend income if (i) the ADSs are readily tradable on an established securities market in the United States and (ii) we were not in the year prior to the year in which the dividend was paid, and are not in the year in which the dividend is paid, a passive foreign investment company ( PFIC ), foreign personal holding company ( FPHC ) or foreign investment company ( FIC ). The ADSs are listed on the New York Stock Exchange, and may qualify as readily tradable on an established securities market in the United States so long as they are so listed. However, no assurances can be given that the ADSs will be or remain readily tradable.



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Based on existing guidance, it is not entirely clear whether dividends received with respect to the preferred shares will be treated as qualified dividends, because the preferred shares are not themselves listed on a United States exchange. In addition, the United States Treasury Department has announced its intention to promulgate rules pursuant to which holders of ADSs or preferred stock and intermediaries through whom such securities are held will be permitted to rely on certifications from issuers to establish that dividends are treated as qualified dividends. Because such procedures have not yet been issued, we are not certain that we will be able to comply with them. U.S. Holders of ADSs and preferred shares should consult their own tax advisors regarding the availability of the reduced dividend tax rate in the light of their own particular circumstances.

Subject to certain limitations and restrictions, and subject to the discussion above regarding concerns expressed by the U.S. Treasury, a U.S. Holder will be entitled to a foreign tax credit against its U.S. federal income tax liability, or a deduction in computing its U.S. federal taxable income, for Brazilian income taxes withheld by us. The limitation on foreign taxes eligible for credit is determined separately with respect to specific classes of income. For this purpose,

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dividends paid by us with respect to our preferred shares or ADSs will generally constitute *passive income* or, in the case of certain U.S. Holders, *financial services income* from sources outside the United States. The rules relating to the calculation of foreign tax credits and the applicable limitations are complex. U.S. Holders should consult their own advisors concerning the implications of the foreign tax credit rules in light of their particular circumstances.

### ***Taxation of Capital Gains or Losses***

Upon a sale or other taxable disposition of preferred shares or ADSs, a U.S. Holder will recognize capital gain or loss for U.S. federal income tax purposes equal to the difference, if any, between the amount realized on the sale or other taxable disposition and the U.S. Holder's adjusted tax basis in the preferred shares or ADSs. Such gain or loss will be capital gain or loss and will be long-term capital gain or loss if the U.S. Holder's holding period in the preferred shares or ADSs exceeds one year at the time of the sale or other taxable disposition. Certain U.S. Holders (including individuals) may be eligible for preferential rates of U.S. federal income tax in respect of long-term capital gains. The deductibility of capital losses is subject to limitations under the Code.

Gain or loss derived from the sale or other disposition of our preferred shares or ADSs generally will be treated as U.S. source income or loss for foreign tax credit purposes. Consequently, if a Brazilian withholding tax is imposed on the sale or disposition of preferred shares or ADSs, and a U.S. Holder does not receive significant foreign source income from other sources, such U.S. Holder may not be able to derive effective U.S. foreign tax credit benefits in respect of such Brazilian withholding tax. If a Brazilian tax is withheld on the sale or disposition of preferred shares or ADSs, a U.S. Holder's amount realized will include the gross amount of the proceeds of such sale or disposition before deduction of the Brazilian tax. See *Brazilian Tax Considerations Taxation of Gains* for a description of when a disposition may be subject to taxation by Brazil.

### **Passive Foreign Investment Company Rules**

We believe that we will not be considered a *passive foreign investment company*, or PFIC, for U.S. federal income tax purposes. However, because the determination of whether the preferred shares or ADSs constitute shares of a PFIC will be based upon the composition of our income and assets, and entities in which we hold a 25% interest, from time to time, there can be no assurance that the preferred shares or ADSs will not be considered shares of a PFIC for any taxable year. If we were treated as a PFIC for any taxable year during which a U.S. Holder held a preferred share or ADS, certain adverse consequences could apply to the U.S. Holder, including the imposition of higher amounts of tax than would otherwise apply to a U.S. Holder and additional tax form filing requirements. U.S. Holders are urged to consult their tax advisors regarding the consequences to them if we were considered to be a PFIC, as well as the availability and advisability of making an election to avoid the adverse United States federal income tax consequences of PFIC status should we be classified as a PFIC for any taxable year. Moreover, dividends on our ADSs would no longer be *qualified dividend income* subject to preferential rates of U.S. federal income tax, as described above. Based on our operations and business plans, we do not believe that we are currently a PFIC and do not expect to become a PFIC in the foreseeable future.

### ***Information Reporting and Backup Withholding***

Payment of dividends and sales proceeds that are made within the United States or through certain U.S.-related financial intermediaries generally are subject to information reporting and to backup withholding unless (i) you are a corporation or other exempt recipient or (ii) in the case of backup withholding, you provide a correct taxpayer identification number and certify that you are not subject to backup withholding. Backup withholding is not an additional tax. The amount of any backup withholding from a payment to a U.S. Holder will be allowed as a credit against such U.S. Holder's U.S. federal income tax liability, if any, and may entitle such U.S. Holder to a refund, provided that the required

information is timely furnished to the IRS.

U.S. HOLDERS AND PROSPECTIVE PURCHASERS OF OUR PREFERRED SHARES OR ADSs SHOULD CONSULT THEIR OWN TAX ADVISORS AS TO THE BRAZILIAN, U.S. FEDERAL, STATE, LOCAL AND OTHER TAX CONSEQUENCES OF THE ACQUISITION, OWNERSHIP AND DISPOSITION OF OUR PREFERRED SHARES OR ADSs BASED UPON THEIR PARTICULAR CIRCUMSTANCES.

**F. Dividends and Paying Agents**

Not applicable.

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**G. Statement of Experts**

Not applicable.

**H. Documents on Display**

We are subject to the information requirements of the Exchange Act, except that as a foreign issuer, we are not subject to the proxy rules or the short-swing profit disclosure rules of the Exchange Act. In accordance with these statutory requirements, we file or furnish reports and other information with the SEC. Reports and other information filed or furnished by us with the Commission may be inspected and copied at the public reference facilities maintained by the Commission at Room 1024, 450 Fifth Street, N.W., Washington, D.C. 20549, and at the Commission's Regional Offices at 233 Broadway, New York, New York 10279 and Northwestern Atrium Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661-2511. Copies of such material may be obtained by mail from the Public Reference Section of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates. You may also inspect these reports and other information at the offices of the New York Stock Exchange, 11 Wall Street, New York, New York 10005, on which our ADSs are listed.

In addition, the Commission maintains a website that contains information filed electronically, which can be accessed over the Internet at <http://www.sec.gov>.

We also file financial statements and other periodic reports with the CVM. Copies of our annual report on Form 20-F and documents referred to in this annual report and our bylaws will be available for inspection upon request at our offices at Rua Martiniano de Carvalho, 851 - 21º Floor, 01321-001 - São Paulo - SP - Brazil.

**I. Subsidiary Information**

Not applicable.

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We made an evaluation of the book values of our assets and liabilities in relation to market values, based on available information and appropriate valuation methodologies. However, the interpretation of market information, as well as the selection of methodologies, requires considerable judgment and reasonable estimates in order to produce adequate realization values. As a result, the estimates presented do not necessarily indicate the amounts which might be realized in the current market. The use of different market approaches and/or methodologies for the estimates may have a significant effect on the estimated realizable values.

Book and market values of financial instruments as of December 31 were as follows:

**Consolidated**  
**2004**

**Consolidated**  
**2003**

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	<b>Book Value</b>	<b>Market Value</b>	<b>Book Value</b>	<b>Market Value</b>
	<b>(in thousands of reais)</b>			
Loans and financing	(2,756,243)	(2,783,035)	(2,977,149)	(3,006,402)
Derivatives	(235,918)	(124,457)	(359,482)	(178,393)
Cash and cash equivalents	238,577	238,577	214,932	214,932
Portugal Telecom direct/ indirect interest through Aliança Atlântica	146,329	351,079	146,939	310,515
<b>Total</b>	<b>(2,607,255)</b>	<b>(2,317,836)</b>	<b>(2,974,760)</b>	<b>(2,659,348)</b>

We have investments carried under both the cost and equity methods. The net assets of our subsidiary, Aliança Atlântica, are represented principally by an equity interest of 0.46% in Portugal Telecom.

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We have a direct interest of 0.69% (0.64% as at December 31, 2003) and an indirect interest of 0.23% (0.21% as at December 31, 2003) in Portugal Telecom, carried at cost. The investment, at market value, is based on the last quotation of December 2004 on the Lisbon Stock Exchange for Portugal Telecom, equivalent to 9.10 euros (7.98 euros in December 2003).

	Consolidated 2004		Consolidated 2003	
	Book Value	Market Value	Book Value	Market Value
	(in thousands of reais)			
Portugal Telecom - direct interest	75,362	263,309	75,362	232,886
Portugal Telecom - indirect interest through Aliança Atlântica	70,967	87,770	71,577	77,629
<b>Total</b>	<b>146,329</b>	<b>351,079</b>	<b>146,939</b>	<b>310,515</b>

The principal market risk factors that affect our business are detailed below:

a) **Exchange rate risk**

This risk arises from the possibility that we may incur losses due to exchange rate fluctuations, which would increase the balances of loans and financing denominated in foreign currency and the related financial expenses. In order to reduce this risk, we enter into hedge contracts (swaps) with financial institutions.

Our indebtedness and results of operations are significantly affected by foreign exchange rate risk. As of December 31, 2004, 44.60% of our debt was denominated in foreign currency (U.S. dollar, Canadian dollar and Japanese yen); virtually all of our foreign currency debt was hedged by asset positions in currency transactions (swaps for Certificate for Interbank Deposits - CDI; CDI is an index based upon the average rate per cost of loans negotiated among the banks within Brazil). Gains or losses on these operations are recorded in income. In 2004, these transactions generated a net loss of R\$298.862 (consolidated). We have recorded a liability of R\$235.918 as of December 31, 2004 to reflect the unrealized loss on derivatives.

The book value and market value of our net excess (exposure) to the exchange rate risk as of December 31, 2004 and 2003 are as follows:

Consolidated			
2004		2003	
Book Value	Market Value	Book Value	Market Value

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	(in thousands of reais)			
<b>Liabilities</b>				
Loans and financing	1,228,566	1,237,400	2,945,795	2,975,048
Purchase commitments	42,986	42,986	40,846	40,846
Asset position on swaps	1,253,415	1,270,788	2,983,462	3,020,168
<b>Net excess (exposure)</b>	<b>(18,137)</b>	<b>(9,598)</b>	<b>(3,179)</b>	<b>4,274</b>

The valuation method used to calculate the market value of loans, financing and hedge instruments (foreign exchange swaps) was the discounted cash flow method, considering settlement or realization expectations of liabilities and assets, at market rates prevailing on the balance sheet date. In addition, in the table above, the value of the loans together with financing from DEG – Deutsche Investitions (DEG, a member of KfW banking group, is a European development finance institution for long-term project and company financing) for our subsidiary Santo Genovese Participações Ltda. (Atrium Telecomunicações Ltda.) reflect such entity's accounting as of November 2004 as a result of consolidation. As of

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November 30, 2004, Santo Genovese (Atrium) did not fully hedge exchange rate risk with derivatives transactions. In December 2004, Santo Genovese (Atrium), in accordance with the requirements of Telefônica Group, entered into derivative transactions with respect to 100% of its liabilities denominated in foreign currencies.

**b) Interest rate risk**

This risk arises from the possibility that we may incur losses due to internal and external interest rate fluctuations affecting our results.

As of December 31, 2004, we had R\$1,228,566 (R\$2,945,795 as of December 31, 2003) of loans and financing in foreign currency, of which R\$562,980 (R\$1,950,577 as of December 31, 2003) was at fixed interest rates and R\$665,586 (R\$995,218 as of December 31, 2003) was at variable interest rates (LIBOR). In order to hedge against the exchange risk on these foreign currency debts, we have hedged transactions in order to peg these debts to local currency, at floating rates indexed to the CDI, in a way that our financial result is affected by the CDI. To protect against part of this risk, we have entered into swap transactions (swaps for CDI) which, as of December 31, 2004, were valued at R\$665,459 (the balance of the assets in CDI). In addition, we invest our excess cash (temporary cash investments) of R\$238,577 (R\$214,932 as of December 31, 2003), mainly in short-term instruments, based on the CDI variation, which reduces this risk. The book values of these instruments approximate market values, since they may be redeemed in the short term.

We have a hedge against external variable interest rate risks on the financing obtained from JBIC – Japan Bank for International Cooperation. We continue to monitor market rates in order to evaluate the need to contract other derivatives to hedge against the volatility risk of external variable rates on the remaining balance.

A hypothetical, instantaneous, and unfavorable change of 10% in the interest rates applicable to our financial assets and liabilities in 2004 would cause us a potential loss in earnings of approximately R\$220.7 million for the period of time of one year. The above sensitivity analysis is based on the assumption of an unfavorable 10% variation of the interest rates applicable to each homogeneous category of financial assets and liabilities and sustained over a period of one year. A homogenous category is defined according to the currency in which financial assets and liabilities are denominated and assumes the same interest rate variation within each homogeneous category (e.g., *reais*). As a result, our interest rate risk sensitivity model may overstate the impact of interest rate fluctuation for such financial instruments, since consistently unfavorable variations of all interest rates are an unlikely event.

Another risk to which we are exposed is the mismatch of monetary restatement indices for our debt and for accounts receivable. Telephone tariff adjustments do not necessarily follow increases in local interest rates, which affect our indebtedness.

**c) Debt acceleration risk**

As of December 31, 2004, certain of our loan and financing agreements contain restrictive clauses (covenants), typically included in such agreements, relating to cash generation, debt ratios and other restrictions. We have complied with these restrictive clauses in full, and such covenants do not restrict our ability to conduct our ordinary course of business.

**d) Credit risk**



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This risk arises from the possibility that we may incur losses due to the difficulty of receiving amounts billed to our customers. The credit risk on accounts receivable is dispersed. We constantly monitor the level of accounts receivable and limit the risk of past-due accounts, interrupting access to telephone lines in case the customer does not pay the related bills within 30 days. Exceptions are made for telecommunications services that must be maintained for security or national defense reasons.

As of December 31, 2004, our customer portfolio had no subscribers whose receivables were individually higher than 1% of the total accounts receivable from services.

We are also subject to credit risk related to temporary cash investments and receivables from swap transactions. We reduce this exposure by diversifying it among first line financial institutions.

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**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

**PART II**

**ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

As of December 31, 2004, we were not in default under any of our obligations and there were no dividend arrearages or delinquencies.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

Law 10,303 of October 31, 2001 amended the provisions of the Brazilian Corporate Law relating to the rights of preferred shareholders. In order to comply with such modifications, at the extraordinary general shareholders meeting held on 12/30/2002, an amendment to our bylaws was approved granting the preferred shareholders the right to receive dividends 10% higher than the dividends paid to common shareholders.

**ITEM 15. CONTROLS AND PROCEDURES**

Our Chief Executive Officer, or CEO, and Chief Financial Officer (our Vice-President of Administration and Finance), or CFO, are responsible for establishing and maintaining our disclosure controls and procedures. These controls and procedures were designed to ensure that information relating to us required to be disclosed in the reports that we file under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. We evaluated these disclosure controls and procedures under the supervision of our CEO and CFO as of December 31, 2004. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were adequate and effective and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.

Our internal audit department periodically evaluates our internal controls for the main cycles, documenting by flow charts the processes used in each cycle, identifying opportunities and suggesting improvements for the existing control mechanisms. There was no change in our internal control over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 16. [RESERVED]**

**ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our Control and Audit Committee is comprised of a minimum of three and a maximum of five non-executive directors. See Item 6(C) Directors, Senior Management and Employees Board Practices Committees Control and Audit Committee. Our Board of Directors has designated Luis Bastida Ibarguen, an independent member of our Board of Directors under Brazilian rules and a member of our Control and Audit Committee, as

the company's audit committee financial expert, as such term is defined by the SEC. We anticipate that there will be some similar functions between the Control and Audit Committee and our statutory Board of Auditors (*Conselho Fiscal*), the latter of which meets the requirements of the general exemption from the listing standards for audit committees set forth in Exchange Act Rule 10A-3(c)(3). See Item 16D Exemptions from the Listing Standards for Audit Committees.

**ITEM 16B. CODE OF ETHICS**

Our Control and Audit Committee has approved a code of ethics (*Normativa de Conduta para Financeiros da Telesp S/A*). We expect our Board of Directors to act on the Control and Audit Committee's recommendation and approve and implement a code of ethics in 2005. The code of ethics will regulate the conduct of our managers in connection with the registration and control of financial and accounting information and their access to privileged and non-public information and data, in order to comply with the requirements of the Sarbanes-Oxley Act and NYSE rules. Our code of

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ethics will follow the code of our parent company, Telefônica S.A. We expect to make any adjustments that may be necessary under the Brazilian Corporate Law or our bylaws, and approve the code in the near future. The code of ethics will apply to our Chief Executive Officer, Chief Financial Officer, Chief Operating Officer (which we refer to as our General Executive Officer), our Vice-Presidents and corresponding foregoing positions at our subsidiaries, as well as to our executives in the areas for financial, management and internal controls. The code will apply generally to all those with responsibilities similar to those listed above.

Following our ongoing commitment to transparency to markets and to supervisory authorities, as well as the adoption of high ethical standards in business, and based on the guidelines set forth by Telefônica S.A.'s code of ethics, our code of ethics will provide for values, such as:

Transparency;

Honesty and integrity;

Compliance with laws and regulations, including, but not limited to, the securities markets rules and regulations and the rules and regulations related to insider trading and market manipulation;

Protection of confidential information and property, except when disclosure thereof is authorized or legally required; and

Reporting of suspected illegal or unethical behavior.

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Deloitte Touche Tohmatsu Auditores Independentes ( Deloitte ) acted as our independent auditor for the fiscal years ended December 31, 2004, 2003 and 2002. The chart below sets forth the total amount billed to us by Deloitte for services performed in the years 2004 and 2003, and breaks down these amounts by category of service:

	<b>Total Fees</b>	
	<b>2004</b>	<b>2003</b>
	<i>(in thousands of reais)</i>	
Audit Fees	1,059	751
Audit-Related Fees		
Tax Fees		
All Other Services	3	
<b>Total</b>	<b>1,062</b>	<b>751</b>

**Audit Fees**

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Audit fees are fees billed for the audit of our annual consolidated financial statements prepared for purposes of filings with the CVM and the SEC and for the reviews of our quarterly financial statements submitted on Form 6-K.

### **Audit-Related Fees**

Not applicable.

### **Tax Fees**

Not applicable.

### **All Other Fees**

Not applicable.

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### **Pre-Approval Policies and Procedures**

Our Control and Audit committee evaluates the results of all audit and audit-related services provided by Deloitte. However, our Control and Audit committee does not currently have the authority to approve such services or any other services provided by Deloitte that are not specifically included within the scope of the audit. Our Board of Directors, with advice from the Control and Audit Committee, is responsible for authorizing the audit services provided by Deloitte Touche Tohmatsu Auditores Independentes. Non-audit services may be approved by members of our executive committee in accordance with the terms and conditions set forth in the engagement policies established by Telefônica Group.

### **ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Brazilian Corporate Law requires that we have a statutory Board of Auditors (*Conselho Fiscal*). Our statutory Board of Auditors meets the requirements of the general exemption set forth in Exchange Act Rule 10A-3(c)(3). See Item 6(C) Directors, Senior Management and Employees Board Practices Board of Auditors. Our statutory Board of Auditors is primarily charged with certain advisory, oversight and review functions with respect to the company's financial statements, however, the statutory Board of Auditors, as required by Brazilian Corporate Law, has only an advisory role and does not participate in the management of the company. Indeed, decisions of the statutory Board of Auditors are not binding on the company under Brazilian Corporate Law. Our Board of Directors, under Brazilian Corporate Law, is the only entity with the legal capacity to appoint and retain any independent registered public accounting firm, and decide the budget appropriation with respect to such auditors.

Since Brazilian Corporate Law does not specifically grant our statutory Board of Auditors the power to establish receipt, retention and complaint procedures regarding accounting, internal control and audit matters, or create policies for the confidential, anonymous treatment of employee concerns regarding accounting or auditing matters, we have established a Control and Audit Committee as a best corporate governance practice to address these various issues. See Item 6(C) Directors, Senior Management and Employees Board Practices Committees Control and Audit Committee.

We do not believe that our use of a board of statutory auditors (*conselho fiscal*) in accordance with Brazilian Corporate Law, as opposed to the provisions set forth in Exchange Act Rule 10A-3(b), materially adversely affects the ability of the *conselho fiscal* to act independently, satisfy the other applicable requirements of Exchange Act Rule 10A-3 or to fulfill its fiduciary and other obligations under Brazilian law.

### **ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

None.

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**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

We have responded to Item 18 in lieu of responding to this Item.

**ITEM 18. FINANCIAL STATEMENTS**

Reference is made to pages F-1 through F-69.

**ITEM 19. EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
1.1	Bylaws of Telecomunicações de São Paulo S.A. Telesp, as amended (unofficial English translation)***
2.(a)	Deposit Agreement dated as of July 27, 1998 among Telesp Participações S.A., The Bank of New York, as Depositary, and Owners and Beneficial Owners of American Depositary Receipts issued thereunder*
4.(a)1	Consulting Services Agreement dated May 17, 1999 (Portuguese original)* *
4.(a)2	Consulting Services Agreement dated May 17, 1999 (English version)* *
8.1	List of Subsidiaries (See Item 4.C Organizational Structure )
12.1	Section 906 Certification of the Chief Executive Officer***
12.2	Section 906 Certification of the Chief Financial Officer***
13.1	Section 302 Certification of the Chief Executive Officer***
13.2	Section 302 Certification of the Chief Financial Officer***

\* Incorporated by reference to our predecessor holding company s, Telesp Participações S.A., registration statement on Form F-6 (No. 333-9474) filed with the Commission on September 30, 1998.

\*\* Incorporated by reference to our annual report on Form 20-F for the fiscal year ended December 31, 2000 filed with the Commission on June 29, 2001.

\*\*\* Filed herewith.

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**GLOSSARY OF TELECOMMUNICATIONS TERMS**

The following explanations are not intended as technical definitions, but to assist the reader in understanding certain terms as used in this annual report.

*ADSL*: Asymmetric digital subscriber line. ADSL technology allows more data to be sent over existing copper telephone lines.

*Analog*: A mode of transmission or switching which is not digital, *e.g.*, the representation of voice, video or other modulated electrical audio signals which are not in digital form.

*BLEC*: Building local exchange carrier. A BLEC is a service provider that delivers telecommunication services within a specific building. BLECs aggregate traffic at the particular site and employ a single broadband connection for local access.

*Cellular service*: A cellular telecommunications service provided by means of a network of interconnected low-powered base stations, each of which covers one small geographic cell within the total cellular telecommunications system service area.

*Digital*: A mode of representing a physical variable such as speech using digits 0 and 1 only. The digits are transmitted in binary form as a series of pulses. Digital networks allow for higher capacity and higher flexibility through the use of computer-related technology for the transmission and manipulation of telephone calls. Digital systems offer lower noise interference and can incorporate encryption as a protection from external interference.

*Internet*: A collection of interconnected networks spanning the entire world, including university, corporate, government and research networks from around the globe. These networks all use the IP (Internet Protocol) communications protocol.

*IP (Internet protocol)*: An interconnection protocol for sub-networks, in particular for those with different physical characteristics used by the Internet.

*Network*: An interconnected collection of elements. In a telephone network, these consist of switches connected to each other and to customer equipment. The transmission equipment may be based on fiber optic or metallic cable or point-to-point radio connections.

*Network usage charge*: Amount paid per minute charged by network operators for the use of their network by other network operators. Also known as an access charge or interconnection charge.



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*PBX (Private Branch Exchange):* Telephone switchboard for private use, but linked to a telephone network.

*Private leased circuits:* Voice, data or image transmission mediums leased to users for their exclusive use.

*STFC (Serviço Telefônico Fixo Comutado):* transmission of voice and other signals between determined fixed points.

*Switch:* Devices used to set up and route telephone calls either to the number called or to the next switch along the path. They may also record information for billing and control purposes.

*Universal service:* The obligation to supply basic service to all users throughout the national territory at reasonable prices.

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**TELECOMUNICAÇÕES DE SÃO PAULO S.A. - TELESP**

CONSOLIDATED FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED

DECEMBER 31, 2004, 2003 AND 2002

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**Report of Independent Registered Public Accounting Firm**

To the Shareholders and Management of

Telecomunicações de São Paulo S.A. - Telesp:

**São Paulo - SP**

(1) We have audited the accompanying consolidated balance sheets of Telecomunicações de São Paulo S.A. Telesp (a Brazilian Corporation, formerly Telesp Participações S.A.) and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in shareholders' equity and changes in financial position for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

(2) We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included 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.

(3) In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Telecomunicações de São Paulo S.A. Telesp and subsidiaries as of December 31, 2004 and 2003, and the results of their operations, the changes in their financial position and the changes in shareholders' equity for each of the years in the three-year period ended December 31, 2004, in conformity with accounting practices adopted in Brazil.

(4) Accounting practices adopted in Brazil vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in Note 33 to the consolidated financial statements.

(5) Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The consolidated statements of cash flow for each of the years in the three-year period ended December 31, 2004 are presented for purposes of additional analysis and are not a required part of the basic consolidated financial statements prepared in accordance with accounting practices adopted in Brazil. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Deloitte Touche Tohmatsu

Auditores Independentes

April 1, 2005

São Paulo, Brazil.

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**Table of Contents****TELECOMUNICAÇÕES DE SÃO PAULO S.A. - TELESP**

## CONSOLIDATED BALANCE SHEETS AS OF

DECEMBER 31, 2004 AND 2003

(In thousands of reais)

		December 31,	
	Note	2004	2003
<b>Current assets:</b>			
Cash and cash equivalents	12	238,577	214,932
Trade accounts receivable, net.	13	2,696,000	2,430,974
Deferred and recoverable taxes	14	907,819	1,130,367
Other assets	15	319,469	344,892
		<u>4,161,865</u>	<u>4,121,165</u>
<b>Total current assets</b>			
<b>Noncurrent assets:</b>			
Deferred and recoverable taxes	14	354,382	441,099
Other assets	15	450,737	478,381
		<u>805,119</u>	<u>919,480</u>
<b>Total noncurrent assets</b>			
<b>Permanent assets:</b>			
Investments	16	284,574	165,363
Property, plant and equipment, net	17	13,369,391	14,735,494
Deferred charges	18	130,818	181,317
		<u>13,784,783</u>	<u>15,082,174</u>
<b>Total permanent assets</b>			
<b>Total assets</b>			
		<u>18,751,767</u>	<u>20,122,819</u>
<b>Current liabilities:</b>			
Payroll and related accruals	19	92,665	88,355
Accounts payable and accrued expenses	20	1,354,471	1,288,934
Taxes other than income taxes	21	711,729	624,096
Dividends payable	22	506,116	1,276,663
Income taxes	10	454,005	88,469
Loans and financing	23	529,930	1,982,062
Reserve for contingencies	25	52,847	49,408
Other liabilities	24	462,043	559,993
		<u>5,143,606</u>	<u>5,377,719</u>

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Total current liabilities		4,163,806	5,957,980
<b>Long-term liabilities:</b>			
Income taxes	10	26,007	31,373
Loans and financing	23	2,226,313	995,087
Pension and other postretirement benefits	26	44,738	82,396
Reserve for contingencies	25	800,382	676,474
Other liabilities	24	72,805	91,365
Total noncurrent liabilities		3,170,245	1,876,695
<b>Deferred income</b>	16	17,470	17,470
<b>Shareholders equity:</b>			
Share capital	27a	5,978,074	5,978,074
Capital reserves	27b	2,745,272	2,744,031
Income reserves	27c	659,556	550,498
Retained earnings	27d	2,015,730	2,996,457
Total shareholders equity		11,398,632	12,269,060
<b>Funds for capitalization:</b>			
Expansion plan contributions		215	215
Other funds		1,399	1,399
Total funds for capitalization		1,614	1,614
<b>Total liabilities and shareholders equity</b>		18,751,767	20,122,819

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****TELECOMUNICAÇÕES DE SÃO PAULO S.A. - TELESP****CONSOLIDATED STATEMENTS OF INCOME****FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002**

(In thousands of reais - except earnings per thousand shares data)

	Note	Years ended December 31,		
		2004	2003	2002
Net operating revenue	4	13,308,630	11,804,759	10,088,114
Cost of goods and services	5	(7,496,010)	(6,714,499)	(5,769,782)
Gross profit		5,812,620	5,090,260	4,318,332
Operating expenses:				
Selling expense	6a	(1,606,645)	(1,286,177)	(1,009,904)
General and administrative expense	6b	(746,802)	(963,925)	(839,867)
Other operating expense, net	7	(189,847)	(392,526)	(357,165)
Operating income from continuing operations before financial expense, net		3,269,326	2,447,632	2,111,396
Financial expense, net	8	(404,208)	(630,196)	(754,869)
Operating income		2,865,118	1,817,436	1,356,527
Nonoperating income (expense), net	9	40,102	50,025	(32,999)
Income before taxes		2,905,220	1,867,461	1,323,528
Income and social contribution taxes	10	(724,071)	(279,459)	(247,656)
Net income for the year		2,181,149	1,588,002	1,075,872
Shares outstanding at December 31		493,592,279	493,592,279	493,592,279
Earnings per thousand shares outstanding at December 31 (reais)		4.42	3.22	2.18

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****TELECOMUNICAÇÕES DE SÃO PAULO S.A. - TELESP****CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION****FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 and 2002**

(In thousands of reais)

	Years ended December 31,		
	2004	2003	2002
<b>SOURCE OF FUNDS:</b>			
<b>From operations:</b>			
Net income for the year	2,181,149	1,588,002	1,075,872
Items not affecting working capital	2,884,494	2,757,969	3,548,024
Depreciation and amortization	2,736,811	2,820,912	2,809,716
(Gain) loss from equity holdings in subsidiaries	461	1,012	(15,709)
Monetary and exchange variations on noncurrent items, net	1,444	(346,349)	622,200
Provision for losses on investments			48,800
(Gain) loss on permanent asset disposals	(6,372)	12,546	23,696
Reserves for contingencies	135,170	302,037	35,580
Amortization of goodwill on acquisition of CETERP	32,043	32,043	32,043
Pension and other postretirement plans	(37,658)	(62,688)	906
Other	(22,594)	(1,544)	(9,208)
<b>Total from operations</b>	<b>5,065,643</b>	<b>4,345,971</b>	<b>4,623,896</b>
<b>From third parties:</b>			
Increase in long-term liabilities	1,738,700	1,181,463	579,376
Unclaimed dividends	45,472	24,732	80,928
Donations and subsidies for investment	1,241	1,302	2,415
Transfer from noncurrent to current assets	242,658	455,036	473,608
Proceeds from investment disposals		222	20,766
Proceeds from sale of property, plant and equipment	14,549	64,576	45,839
Special reserve for dividends adjustment on exempt shareholders			921
Other			644
<b>Total sources</b>	<b>7,108,263</b>	<b>6,073,302</b>	<b>5,828,393</b>
<b>USES OF FUNDS:</b>			
Increase in noncurrent assets	115,007	292,454	197,698
Increase in permanent assets	1,456,441	1,346,300	1,696,312
Investments	115,879		27,750
Property, plant and equipment	1,340,562	1,322,528	1,571,166
Deferred charges		23,772	97,396



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Transfer from long-term to current liabilities	600,889	1,960,990	560,966
CTBC/CETERP dissident shareholders			2,862
Dividends/interest on shareholders' equity	3,098,290	3,800,000	1,373,960
Income tax on interest on shareholders' equity unclaimed until 2002		27,613	
Working capital consolidated from Cia AIX de Participações		19,278	
Working capital consolidated from Cia ACT de Participações	2,754		
Working capital consolidated from Santo Genovese Participações	8		
Other		12	
<b>Total uses</b>	<b>5,273,389</b>	<b>7,446,647</b>	<b>3,831,798</b>
<b>Increase (decrease) in working capital</b>	<b>(1,834,874)</b>	<b>(1,373,345)</b>	<b>1,996,595</b>
Changes in working capital represented by:			
Current assets			
At the beginning of year	4,121,165	4,703,820	3,665,493
At the end of year	4,161,865	4,121,165	4,703,820
	40,700	(582,655)	1,038,327
Current liabilities			
At the beginning of year	5,957,980	5,167,290	6,125,558
At the end of year	4,163,806	5,957,980	5,167,290
	(1,794,174)	790,690	(958,268)
<b>Increase (decrease) in working capital</b>	<b>1,834,874</b>	<b>(1,373,345)</b>	<b>1,996,595</b>

The accompanying notes are an integral part of these consolidated financial statements.

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## TELECOMUNICAÇÕES DE SÃO PAULO S.A. TELESP

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

(In thousands of reais)

	Capital Reserves				Income reserves		Retained Earnings	Total
	Share capital	Share premium	Donations and subsidies	Other capital reserves	Legal reserve	Special reserve for dividends		
<b>Balances at December 31, 2001</b>	<b>5,640,184</b>	<b>2,739,949</b>	<b>3,039</b>	<b>188</b>	<b>417,303</b>	<b>346,248</b>	<b>5,552,412</b>	<b>14,699,323</b>
Capital increase	337,890						(337,890)	
Addition to special reserve for dividends						921		921
Donations and subsidies for investments			2,415					2,415
Public offering of shares		(2,862)						(2,862)
Unclaimed dividends							80,928	80,928
Reversal of special reserve for dividends						(347,169)		(347,169)
Net income for the year							1,075,872	1,075,872
Appropriations:								
Transfer for reserves					53,795		(53,795)	
Dividends							(441,513)	(441,513)
Interest on shareholders equity							(497,486)	(497,486)
Income tax on interest on shareholders equity							(87,792)	(87,792)
<b>Balances at December 31, 2002</b>	<b>5,978,074</b>	<b>2,737,087</b>	<b>5,454</b>	<b>188</b>	<b>471,098</b>		<b>5,290,736</b>	<b>14,482,637</b>
Donations and subsidies for investments			1,302					1,302
Unclaimed dividends							24,732	24,732
Income tax on interest on shareholders equity unclaimed until 2002							(27,613)	(27,613)
Net income for the year							1,588,002	1,588,002
Appropriations:								
Transfer for reserves					79,400		(79,400)	
Dividends							(2,700,000)	(2,700,000)
Interest on shareholders equity							(935,000)	(935,000)
Income tax on interest on shareholders equity							(165,000)	(165,000)
<b>Balances at December 31, 2003</b>	<b>5,978,074</b>	<b>2,737,087</b>	<b>6,756</b>	<b>188</b>	<b>550,498</b>		<b>2,996,457</b>	<b>12,269,060</b>
Donations and subsidies for investments			1,241					1,241
Unclaimed dividends							45,472	45,472
Net income for the year							2,181,149	2,181,149
Appropriations:								
Transfer for reserves					109,058		(109,058)	
Dividends							(2,209,690)	(2,209,690)

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Interest on shareholders equity							(755,310)	(755,310)
Income tax on interest on shareholders equity							(133,290)	(133,290)
<b>Balances at December 31, 2004</b>	<b>5,978,074</b>	<b>2,737,087</b>	<b>7,997</b>	<b>188</b>	<b>659,556</b>		<b>2,015,730</b>	<b>11,398,632</b>

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****TELECOMUNICAÇÕES DE SÃO PAULO S.A. - TELESP****CONSOLIDATED STATEMENTS OF CASH FLOWS**

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

(In thousands of reais)

	Years ended December 31, (a)		
	2004	2003	2002
<b>Cash flow provided by operations:</b>			
Net income for the year	2,181,149	1,588,002	1,075,872
Adjustments to reconcile net income to cash provided by operations:			
Depreciation and amortization	2,736,811	2,820,912	2,809,716
Monetary /exchange variation on loans and financing	(94,473)	(759,253)	1,684,907
(Gain) loss on permanent asset disposals	(6,372)	12,546	23,696
(Gain) loss from equity holding of subsidiaries	461	1,012	(15,709)
Amortization of goodwill on acquisition of CETERP	32,043	32,043	32,043
Allowance for doubtful accounts	428,911	441,796	371,188
Pension and other postretirement benefit plans	(37,658)	(62,688)	906
Other	5,173		(9,208)
(Increase) decrease in operating assets:			
Trade accounts receivable	(685,553)	(889,026)	(571,857)
Other current assets	(9,003)	842,695	(655,997)
Other noncurrent assets	103,852	(30,208)	32,443
Increase (decrease) in operating liabilities:			
Payroll and related accruals	1,707	(3,386)	(14,748)
Accounts payable and accrued expenses	57,636	213,144	(189,579)
Taxes other than income taxes	85,520	112,944	63,898
Other current liabilities	138,041	233,970	(397,901)
Accrued interest	(64,028)	(55,715)	80,082
Income taxes	623,788	118,605	257,369
Reserve for contingencies	127,347	321,221	22,100
Other noncurrent liabilities	(19,021)	38,008	(25,642)
Cash provided by operations	5,606,331	4,976,622	4,573,579
<b>Cash flow used in investing activities:</b>			
Additions to investments, net of cash acquired	(95,107)		(14,080)
Proceeds from investment disposals		222	20,766
Additions to property, plant, and equipment	(1,338,907)	(1,321,226)	(1,568,751)
Additions to deferred charges		(23,772)	(97,396)
Proceeds from asset disposals	14,549	64,576	45,839
Cash received on consolidation of CIA AIX		1,906	
Cash received on consolidation of CIA ACT de Particip	1		
Cash received on consolidation of Santo Genovese Particip	4,336		

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Cash used in investing activities	(1,415,128)	(1,278,294)	(1,613,622)
<b>Cash flow used in financing activities:</b>			
Loans repaid	(2,812,988)	(3,134,122)	(3,306,301)
New loans obtained	2,726,220	2,299,236	2,123,677
Net payments on derivative contracts	(422,426)		
CTBC/CETERP dissident shareholders			(2,862)
Dividends paid	(3,658,365)	(3,139,150)	(1,490,129)
Cash used in financing activities	(4,167,559)	(3,974,036)	(2,675,615)
Increase (decrease) in cash and cash equivalents	23,645	(275,708)	284,342
Cash and cash equivalents at beginning of year	214,932	490,640	206,298
Cash and cash equivalents at end of year	238,577	214,932	490,640

(a) See supplemental cash flow information in Note 11.

The accompanying notes are an integral part of these consolidated financial statements.

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**TELECOMUNICAÇÕES DE SÃO PAULO S.A. TELESP**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As of and for the years ended December 31, 2004, 2003 and 2002

(Amounts expressed in thousands of *reais*, unless otherwise indicated)

**1. Operations and background**

**a. Formation of the Company, its controlling shareholders and corporate restructuring**

Telecomunicações de São Paulo S.A. Telesp (formerly Telesp Participações S.A. - TelespPar - TelespPar ), hereafter referred to as the Company or Telesp , was formed pursuant to Article 189 of Law No. 9,472/97 of the General Telecommunications Law based on Decree No. 2,546 on April 14, 1998, as part of the privatization of the Telebrás System. The Company is controlled by Telefônica S.A., which as of December 31, 2004, holds directly and indirectly 84.71% of the common shares and 88.90% of the preferred shares of the Company.

The Company is registered with the Brazilian Securities Commission (CVM) as a listed company and its shares are traded on the São Paulo Stock Exchange (BOVESPA). The Company is also registered with the Securities and Exchange Commission - SEC, in the United States of America, and its American Depository Shares - ADSs, level II are traded on the New York Stock Exchange - NYSE.

The Company's activities are regulated by the Brazilian Government's regulatory authority, the National Telecommunications Agency (ANATEL), in accordance with the terms of the concession granted by the Brazilian Government. The current Concession Agreement expires on December 31, 2005, and, subject to satisfactory completion of certain network expansion, modernization and service quality obligations, contemplates a full renewal for an additional 20 years or revocation. It is expected that, effective in 2006, the concession agreement will require the Company to pay 2% of its prior-year revenue, net of taxes and social contributions, as concession charges. The first installment will be due on April 30, 2007 and subsequently every 24 months.

The Company is a concessionaire that provides fixed-switch telephone service (STFC) in Region 3, which comprises the State of São Paulo, in Sectors 31, 32 and 34 established in the General Concession Plan (PGO).

**b. The telecommunications services subsidiaries and associated companies**

***Subsidiaries***

Assist Telefônica S.A., a wholly-owned subsidiary of the company, was incorporated on October 29, 1999 as a closely-held company engaged primarily in providing the following services: technical assistance for installation, operation and maintenance of internal telephony, data and IT networks; value-added services, including those related to internet content, connection and access, as well as technology services and internet support, installation, operation and maintenance of internet, intranet and extranet solutions; sale, rent and maintenance of general telecommunications and IT equipment and devices.

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On December 22, 1999, the Company acquired from the Municipal Government of Ribeirão Preto, in a public auction, 51.0% of the voting shares and 36.0% of the total shares of Centrais Telefônicas de Ribeirão Preto S.A. - Ceterp ( Ceterp ), and its subsidiary Ceterp Celular S.A. On October 4, 2000, in accordance with the rules established in the privatization process, the Company concluded the acquisition, through a tender offer, of the common and preferred shares from minority shareholders. After these acquisitions, the Company then held 96.97% of the preferred shares and 99.85% of the common shares of Ceterp. On November 27, 2000, in accordance with the rules applicable to the Brazilian telecommunications market, Ceterp sold its subsidiary Ceterp Celular S.A. On November 30, 2000, Ceterp was merged into the Company.

On August 3, 2000, the Company's wholly-owned subsidiary Telefônica Empresas S.A. was formed, with operations related to packet-switched data network service. On November 24, 2000, the Company made a capital increase in Telefônica Empresas with cash and through property items related to the packet-switched data network service, including the transfer of the authorization to explore this service.

On January 30, 2001, Telefônica Data Brasil Holding S.A. was formed, resulting from a partial spin-off of the Company's net assets. These assets were represented by the investment in the wholly owned subsidiary Telefônica Empresas S.A. and accounts receivable. The objective of the formation of Telefônica Data Brasil Holding S.A. was to segregate operating activities related to packet-switched data network services due to the operating and administrative restructuring in 2000.

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**TELECOMUNICAÇÕES DE SÃO PAULO S.A. TELESP**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As of and for the years ended December 31, 2004, 2003 and 2002

(Amounts expressed in thousands of *reais*, unless otherwise indicated)

On December 24, 2004, the Company acquired Santo Genovese Participações Ltda., a closely held company, holder of 99.99% of the representative share capital of Atrium Telecomunicações Ltda. Atrium provides various types of telecommunications services in Brazil, including internet and intranet services, telecommunications management services and the sale and rental of telecommunications representatives and related equipment.

***Jointly controlled affiliates***

Aliança Atlântica Holding B.V., a company formed under the laws of Netherlands in Amsterdam, is a joint venture originally established in 1997 by Telebrás and Portugal Telecom, in which Telebrás held a 50% share ownership and Portugal Telecom held the remaining 50%. As a result of the privatization of the Telebrás System in February 1998, Telebrás share ownership in Aliança Atlântica was transferred to the Company. As of December 31, 2004, the Company holds a 50% interest in Aliança Atlântica and Telefônica S.A. holds the remaining 50%.

Companhia AIX de Participações was formed in 2001 through a capital contribution of 32% made by the Company with advances to Barramar S.A., which were recorded under property, plant and equipment for the direct and indirect development of activities related to the construction, conclusion and operation of underground networks for fiber optics ducts. In November and December 2003, Companhia AIX de Participações underwent several corporate restructurings and as a result of the Company acquired 50% of its share capital.

Companhia ACT de Participações was formed on June 30, 2001, through a capital contribution of 32% made by the Company. Restructurings of Companhia ACT in 2003 resulted in Telesp increasing its holdings in Companhia ACT to 50%.

**2. Presentation of the financial statements**

**a. Presentation of consolidated financial statements as of and for the years ended December 31, 2004, 2003 and 2002**

The consolidated financial statements include the accounts and transactions of: (i) the Company, as the operating company for telecommunication services; (ii) its wholly-owned subsidiaries Assist Telefônica S.A. and Santo Genovese Participações Ltda, which have been consolidated since December 2004; (iii) its associated companies Aliança Atlântica Holding B.V., Companhia AIX de Participações and Companhia ACT de Participações; Companhia ACT de Participações are proportionally consolidated. All material intercompany accounts and transactions have been eliminated in consolidation.



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The presentation of the consolidated financial statements is consistent with the presentation of the published financial statements of the Company except for certain reclassifications and changes in terminology within the consolidated balance sheets and the consolidated statements of income which have been made to conform the previously published financial statements to the 2004 presentation.

### **b. Methods of presentation of the Financial Statements**

Until December 31, 1995, publicly-traded companies in Brazil were required to prepare financial statements pursuant to two methods: (i) the Corporate Law Method, which was and remains valid for all legal purposes, including the basis for determining income taxes and calculation of mandatory minimum dividends; and (ii) the constant currency method, to present supplementary price-level adjusted financial statements, pursuant to standards prescribed by the Brazilian Securities Commission (CVM).

#### (i) The Corporate Law Method

The Corpora