

TELESP HOLDING CO  
Form 20-F  
March 26, 2010

As filed with the Securities and Exchange Commission on March 26, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 20-F

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2009

OR

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

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: \_\_\_\_\_

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

01321-001 São Paulo, SP, Brasil

(Address of principal executive offices)

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

Title of each class

Preferred Shares, without par value

Name of each exchange on which registered

New York Stock Exchange\*

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American Depositary Shares (as evidenced by American Depositary Receipts), each representing 1 share of Preferred Stock

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.

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

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

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

The number of outstanding shares as of December 31, 2009 was:

Title of Class	Number of Shares Outstanding
Shares of Common Stock	168,609,291
Shares of Preferred Stock	337,232,189

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

Yes  No

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

Yes  No

Note – Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those sections.

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

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

U.S. GAAP

Board

Other

The financial statements included in this filing were prepared in accordance with the accounting practices adopted in Brazil, as prescribed by Brazilian Corporate Law (Brazilian GAAP).

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

Item 17  Item 18

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

Yes  No

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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 one share of our non-voting preferred shares;
- “ANATEL” are to Agência Nacional de Telecomunicações – ANATEL, the National Telecommunications Agency of Brazil;
  - “BM&FBOVESPA” are to the Bolsa de Valores, Mercadorias e Futuros;
- “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;
  - “CADE” are to Conselho Administrativo de Defesa Econômica, the Brazilian competition authority;
    - “Ceterp” are to Centrais Telefônicas de Ribeirão Preto;
  - “CDI” are to Certificado de Depósito Interbancário, the Certificate for Interbank Deposits;
  - “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;
  - “CTBC Telecom” are to Companhia de Telecomunicações do Brasil Central;
  - “CTBC Borda” are to Companhia Brasileira Borda do Campo – CTBC;
  - “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;
  - “IPCA” are to Índice de Preços ao Consumidor, the consumer price index;
  - “IST” are to Índice Setorial de Telecomunicações, the inflation index of the telecom sector;
    - “JPY” are to Japanese Yen;
-

“Number Portability” are to “Portabilidade Numerica,” the service mandated by ANATEL that provides customers with the option of keeping the same telephone number when switching telephone service providers;

- “PTAX rate” are to the weighted average daily buy and sell exchange rates between the real and U.S. dollar that is calculated by the Central Bank;

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- “real,” “reais” or “R\$” are to Brazilian reais, the official currency of Brazil;
- “Speedy” are to broadband services provided by Telesp through asymmetric digital subscriber lines, or ADSL;
- “TJLP” are to Taxa de Juros de Longo Prazo, or long term interest rate; 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 110 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,” “future” or 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;
- 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;
  - the Brazilian government’s tax policy;
  - the Brazilian government’s political instability; 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, 2009 and 2008 and for the years ended December 31, 2009, 2008 and 2007 have been prepared in accordance with the accounting practices adopted in Brazil, as prescribed by Brazilian Corporate Law, or the Brazilian GAAP, which differs in certain significant respects from generally accepted accounting principles in the United States, or U.S. GAAP. Note 34 to our financial statements appearing elsewhere in this annual report describe the principal differences between the Brazilian GAAP and U.S. GAAP as they relate to us, and provide a reconciliation to U.S. GAAP of net income and shareholders' equity. These consolidated financial statements have been audited by Ernst & Young Auditores Independentes S.S. ("E&Y" or "Ernst & Young").

As a result of a change in Brazilian corporate law with respect to financial reporting (Law 11,638), certain changes in accounting criteria became effective for fiscal year 2008. A CVM rule allows companies to adopt these changes for fiscal year 2008 only, without making changes to comparative 2007 financial information, with disclosure in the notes to the financial statements explaining such accounting treatment. Based on this CVM rule, we have elected not to restate our 2007 financial statements. Any changes that would have resulted to our financial statements as of and for the year ended December 31, 2007 as a result of applying the new accounting criteria would not be material, and the application of these changes to our financial statements as of and for the year ended 2008 does not have a material effect on the comparability of our 2008 financial statements with our 2007 financial statements. However, some amounts for 2006 and 2007 presented throughout this Form 20-F have been reclassified to conform with the presentation of the 2009 amounts prepared in accordance with the new accounting criteria. Please see Note 3 and 4 to our 2009 financial statements for a qualitative and quantitative analysis of the changes resulting from this new accounting criteria.

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.

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## 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 financial statements published in Brazil, audited by Ernst & Young Auditores Independentes for the fiscal years ended December 31, 2009, 2008, 2007, 2006 and 2005. Although we adopted law 11,638 effective as of January 1, 2008 (see “Presentation of Financial Information”), certain previously reported amounts for 2005, 2006 and 2007 presented below have been reclassified to conform with the presentation of the 2008 and 2009 amounts prepared in accordance with the new accounting criteria. See Notes 3 and 4 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,				
	2009	2008	2007	2006	2005
	(in millions of reais, except for share and per share data)				
<b>Income Statement Data:</b>					
<b>Brazilian Corporate Law</b>					
Net operating revenue	15,796	15,979	14,727	14,643	14,395
Cost of goods and services	(8,956)	(8,726)	(8,029)	(7,781)	(7,717)
Gross profit	6,840	7,253	6,698	6,862	6,678
Operating expenses, net	(3,483)	(3,523)	(3,051)	(2,607)	(2,805)
Operating income before financial expense, net	3,357	3,730	3,647	4,255	3,873
Financial expense, net	(195)	(228)	(307)	(331)	(460)
Income before tax and social contribution	3,162	3,502	3,340	3,924	3,413
Income tax and social contribution	(989)	(1,082)	(977)	(1,108)	(871)
Net Income	2,173	2,420	2,363	2,816	2,542
Earnings per share in reais	4.30	4.78	4.67	5.57	5.17
<b>Cash Dividends per share in reais, net of withholding tax:</b>					
Common Shares	2.56	4.54	5.25	5.58	6.89
Preferred Shares	2.81	4.99	5.77	6.14	7.58

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U.S. GAAP

Net operating revenue	21,624	22,017	20,472	20,293	19,870
Operating income	3,305	3,803	3,635	4,305	4,026
Net income	2,185	2,500	2,370	2,930	2,638
Net income per share:					
Earnings per share—Common shares—basic	4.05	4.63	4.39	5.48	5.02
Weighted average number of common shares outstanding—basic	168,609,291	168,609,291	168,609,292	167,242,724	164,734,052
Weighted average number of common shares outstanding—diluted.....	168,744,596.....	168,638,238	168,609,292	167,242,724	164,734,052
Earnings per share—Preferred shares—basic	4.45	5.10	4.83	6.02	5.52
Weighted average number of preferred shares outstanding—basic	337,232,189	337,232,189	337,232,189	334,342,809	328,130,540
Weighted average number of preferred shares outstanding—diluted	337,469,679	337,276,489	337,232,189	334,342,809	328,130,540

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	December 31,				
	2009	2008	2007	2006	2005
	(in millions of reais, except per share data)				
Balance Sheet Data:					
Brazilian Corporate Law					
Property, plant and equipment, net	9,672	9,869	10,260	11,651	12,358
Total assets	20,461	19,992	18,950	18,146	17,760
Loans and financing—current portion	1,768	519	806	1,829	247
Loans and financing—non-current portion	1,752	3,217	2,503	510	2,151
Shareholders' equity	10,057	10,046	9,905	10,610	10,204
Capital stock	6,575	6,575	6,575	6,575	5,978
Number of shares outstanding (in thousands) (1)	505,841	505,841	505,841	505,841	492,030
U.S. GAAP					
Property, plant and equipment, net	9,673	9,909	11,280	12,018	12,726
Total assets	20,965	20,878	20,203	18,825	18,140
Loans and financing—current portion	1,768	519	808	1,828	256
Loans and financing—non-current portion	1,753	3,221	2,503	510	2,151
Shareholders' equity	11,520	10,624	10,478	10,823	10,265

(1) On May 11, 2005, the shareholders approved a reverse stock split in the proportion of 1,000 (one thousand) shares to 1 (one) share of the same class.

	December 31,				
	2009	2008	2007	2006	2005
	(in millions of reais except when indicated)				
Cash Flow Data:					
Brazilian Corporate Law					
Operating activities:					
Cash provided by operations	4,413	5,130	4,778	5,007	5,538
Investing activities:					
Net cash used in investing activities	(2,296)	(2,075)	(2,318)	(1,885)	(1,667)
Financing activities:					
Cash used in financing activities	(1,581)	(2,247)	(1,740)	(3,372)	(3,647)
Increase (decrease) in cash and cash equivalents	536	808	720	(250)	224
Cash and cash equivalents at beginning of year	1,741	933	213	463	239
Cash and cash equivalents at end of year	2,277	1,741	933	213	463

## Exchange Rates

The Brazilian Central Bank allows the real/dollar exchange rate to float freely. The real/dollar exchange rate has been established mainly by the Brazilian interbank market and has fluctuated considerably. The Brazilian Central Bank has intervened occasionally to control unstable movements in the exchange rate. However, the exchange market may continue to be volatile, and the real may depreciate or appreciate substantially in relation to the U.S. dollar in the future. It is not possible to predict whether the Brazilian Central Bank or the Brazilian government will continue to let the real float freely or will intervene in the exchange rate market.

The Brazilian government has been introducing significant changes aimed at simplifying the Brazilian foreign exchange market. Prior to March 4, 2005, there were two principal legal foreign exchange markets in Brazil:

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- the commercial rate exchange market; and
- the floating rate exchange market.

On August 4, 2006, the Brazilian National Monetary Council, through Resolution No. 3,389, relaxed the exchange coverage for exports, allowing Brazilian exporters to keep up to 30% of their income generated from exports of goods and/or services outside of Brazil. The remaining 70% of such income continued to be subject to compulsory repatriation to Brazil.

On September 27, 2006, Resolution No. 3,412 absolved existing restrictions on investments in foreign financial and derivative markets by individuals and legal entities. On October 27, 2006, Resolution No. 3,417 increased the liquidation period permitted for exchange transactions from 360 to 750 days.

Since March 17, 2008, Brazilian exporters are allowed to keep 100% of income from exports outside of Brazil. In addition, the foreign exchange mechanism was simplified to provide for the simultaneous purchase and sale of foreign currency through the same financial institution and using the same exchange rate.

Since October 2009, in accordance with Decree No. 6,983/09, the IOF tax is levied at 2% over exchange transactions for the inflow of funds to invest in the financial and capital markets. The IOF rate is zero over exchange transactions for outflow for these funds as well as over proceeds received as a result of initial public offerings. The conversion of Brazilian currency into foreign currency for purposes of paying dividends for ADS programs is currently not taxed.

The following tables set forth the exchange rate (rounded to the nearest tenth of a cent), expressed in reais per U.S. dollar (R\$/US\$) for the periods indicated, as reported by the Central Bank.

Year ended December 31,	Exchange Rate of R\$ per US\$			
	Low	High	Average(1)	Year-End
2005	2.163	2.762	2.413	2.341
2006	2.059	2.371	2.168	2.138
2007	1.732	2.156	1.929	1.771
2008	1.559	2.500	1.833	2.337
2009	1.741	2.378	1.990	1.741

Source: Central Bank of Brazil, PTAX.

(1) Represents the average of the exchange rates (PTAX) on the last day of each month during the relevant period.

Month Ended	Exchange Rate of R\$ per US\$	
	Low	High
October 31, 2009	1.703	1.784
November 30, 2009	1.702	1.756
December 31, 2009	1.709	1.788
January 31, 2010	1.722	1.874
February 28, 2010	1.804	1.877
March 2010 (through March 24th)	1.764	1.803



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Source:

Central Bank of Brazil, PTAX.

B. Capitalization and Indebtedness

Not applicable.

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C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. 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 that 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 Brazil

The Brazilian government has exercised, and continues to exercise, influence over the Brazilian economy. This influence, as well as Brazilian political and economic conditions, could adversely affect us and the trading price of our preferred shares and ADSs.

In the past, the Brazilian government has intervened in the Brazilian economy and occasionally made changes in policy and regulations. 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 things. Our business, financial condition, results of operations and the market price of our preferred shares and ADSs may be adversely affected by changes in government policies, especially those related to our sector, such as changes in telephone fees and competitive conditions, as well as general economic factors, including:

- currency fluctuations;
- exchange control policies;
- internal economic growth;
- inflation;
- energy policy;
- interest rates;
- liquidity of domestic capital and lending markets;
- tax policies (including reforms currently under discussion in the Brazilian Congress); and
- other political, diplomatic, social and economic developments in or affecting Brazil.

Uncertainty over the possibility of the Brazilian government implementing changes in policy or regulation affecting these or other factors in the future may contribute to economic uncertainty in Brazil and heightened volatility in the Brazilian securities markets and securities issued abroad by Brazilian companies. These uncertainties are heightened during presidential elections. In addition, possible political crises may affect the confidence of investors and the public in general, which may result in economic deceleration and affect the trading prices of shares issued by companies

listed on the stock exchange, such as us.

Our business may be vulnerable to the current disruptions and volatility in the global financial markets.

The global financial system has experienced difficult credit and liquidity conditions and disruptions leading to greater volatility. Since the fall of 2008, global financial markets deteriorated sharply and a number of major foreign financial institutions, including some of the largest global commercial banks, investment banks, mortgage lenders, mortgage guarantors and insurance companies, were experiencing significant difficulties including runs on their deposits and inadequate liquidity.

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In an attempt to increase liquidity in the financial markets and prevent the failure of the financial system, various governments have intervened on an unprecedented scale, but there is no assurance that these measures will successfully alleviate the current financial crisis.

Despite the extent of the above-mentioned intervention, global investor confidence remains low and credit remains relatively lacking. Hence, additional volatility in the global financial markets may occur. Continued or worsening disruption and volatility in the global financial markets could have a material adverse effect on our ability to access capital and liquidity on acceptable financial terms, and consequently on our operations. Furthermore, an economic downturn could negatively affect the financial stability of our customers, which could result in a general reduction in business activity and a consequent loss of income for us.

Political instability may have an adverse impact on the Brazilian economy and on our business.

Political crises in Brazil in the past have affected the trust of investors and the public in general, as well as the development of the economy. Political crises may have an adverse impact on the Brazilian economy, our business, financial condition and results of operations and the market price of our preferred shares and ADSs.

Inflation and government efforts to curb inflation may contribute to economic uncertainty in Brazil, adversely affecting our business and results of operations.

Brazil has historically experienced high rates of inflation. Inflation and certain of the government's measures taken in the attempt to curb inflation have had significant negative effects on the Brazilian economy. The Consumer Prices Index (Índice de Preços ao Consumidor), or the IPCA, published by the Instituto Brasileiro de Geografia e Estatística (IBGE), rose 4.3% in 2009, reaching the target fixed by the National Monetary Council. The inflation rate was 5.9 % in 2008, 4.5 % in 2007, 3.1% in 2006 and 5.7% in 2005.

Since 2006, telephone fees for fixed-line services have been indexed to the Índice de Serviços de Telecomunicações (Telecommunications Service Index or IST), reduced by a productivity factor. The IST is a basket of national indexes that reflect our industry's operating costs. As a result, this index serves to reduce the apparent incongruity between our industry's revenues and costs, and thus reduce the apparent adverse effects of inflation upon our operations. In contrast, Brazilian monetary policy has been using the IPCA as an inflation targeting system. The inflation target for 2010 is 4.5% and if inflation increases beyond this target, basic interest rates may rise, causing direct effects on the cost of debt and indirect effects on the demand for telecommunication goods and services.

Our results of operations have been negatively affected by a decrease in our customer base growth and could also be affected if our rate of customer turnover increases.

Our rate of acquisition of new customers can be negatively affected by market penetration. For example, our fixed-line customer base decreased 1.2% from December 31, 2006 to December 31, 2007, 2.5% from December 31, 2007 to December 31, 2008 and 3.5% from December 31, 2008 to December 31, 2009. The decrease was mostly due to an increase in competition in the fixed telephony industry from cable and fixed-wireless operators, and an increase in substitution of fixed lines with mobiles. This decrease in customer acquisition has negatively affected our results of operations and could continue to do so in the future. In addition, if our rate of customer turnover were to increase significantly, our results of operations and or competitive position could be adversely affected. Several factors could influence our rate of acquisition of new customers and our rate of customer turnover, including competitive pressures from mobile telecommunication service providers and other fixed-line telecommunications providers, and economic conditions in Brazil.

Fluctuations in the real/U.S. dollar exchange rate 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 currency has experienced devaluations in the past. The real was devalued against the U.S. dollar by 18.7% in 2001 and 52.3% in 2002. Over the next few years, in contrast, the real began appreciating against the U.S. dollar, increasing 18.2%, 8.1%, 11.8%, 8.7% and 17.2%, respectively, in 2003, 2004, 2005, 2006 and 2007.

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However, the real depreciated against the U.S. dollar by 31.9% in 2008. In 2009, the real appreciated against the U.S. Dollar by 25.5%. It should be noted that the IST, the current index applicable to telecommunication fees for fixed-line services, does not adequately reflect the true effect of exchange rate fluctuations as compared to the previously applicable index, the IGP-DI. Thus, since 2006, telecommunication revenues, when converted to U.S. dollars, do not adequately reflect the true effect of exchange rate fluctuations, so that our results of operations could be adversely affected. See “—Selected Financial Data—Exchange Rates” for more information on exchange rates.

As of December 31, 2009, 0.7% of our R\$3.52 billion total indebtedness was denominated in foreign currencies, primarily in U.S. dollars. As of December 31, 2008, we had currency hedges in place to cover virtually all of our foreign currency-denominated bank debt. Part of the costs relating to our network infrastructure is 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 acquire technology and goods necessary to operate our business that have their prices linked to exchange rate fluctuations. The additional costs from our debt, however, are offset by revenues from corresponding hedging transactions and the exposure of our capital expenditures is constantly monitored so that it does not reach a material amount. Nevertheless, currency fluctuations are expected to continue and they can affect our financial income and expenses.

Political, economic and social developments, and the perception of risk in other countries, especially emerging market countries, may adversely affect the Brazilian economy, our business, and the market price of Brazilian securities, including our preferred shares and ADSs.

The market for securities issued by Brazilian companies may be influenced, in varying degrees, by economic and international market conditions, especially by those in Latin American and other emerging markets. The reaction of investors to developments in other countries may have an adverse impact on the market value of securities of Brazilian companies. Crises in other emerging countries or the economic policies of other countries, in particular those of the United States, may reduce investor demand for securities of Brazilian companies, including our preferred shares. Any of the foregoing developments may adversely affect the market value of our preferred shares and hinder our ability to access the capital markets and finance our operations in the future on acceptable terms and costs, or at all.

Exchange controls and restrictions on remittances abroad may adversely affect holders of our preferred shares and ADSs.

Brazilian law allows that, whenever there is a significant imbalance in Brazil’s balance of payments or a significant possibility that such imbalance will exist, the Brazilian government may impose temporary restrictions on capital outflows. Such restrictions could hinder or prevent the holders of our preferred shares or the depositary for the ADSs from remitting dividends abroad. The Brazilian government imposed restrictions on capital outflows for a six-month period at the end of 1989. If similar restrictions are introduced in the future, they would likely have an adverse effect on the market price of our preferred shares and ADSs.

Increases in interest rates may have a material adverse effect on our business.

The Central Bank’s Monetary Policy Committee (Comitê de Política Monetária do Banco Central – COPOM), establishes the basic interest rate target for the Brazilian financial system by reference to the level of economic growth of the Brazilian economy, the level of inflation and other economic indicators. As of December 31, 2004, 2005, 2006, 2007 and 2008, the basic interest rate was 17.8%, 18.0%, 13.3%, 11.3% and 13.8%, respectively, and as of December 31, 2009, was 8.75%. Increases in interest rates may have a material adverse effect on us.



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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 fees.

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

- industry policies and regulations;
  - licensing;
  - fees and tariffs;
  - competition;
- telecommunications resource allocation;
  - service standards;
  - technical standards;
  - quality standards;
- interconnection and settlement arrangements; and
- supervision of universal service obligations.

For further information concerning specific regulations or resolutions issued by ANATEL, refer to section “Item 5.A – Operating and Financial Review and Prospects–Operating Results–Regulatory and Competitive Factors.”

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 universal service requirements and to maintain minimum quality and service standards. For example, ANATEL requires that we satisfy certain conditions with respect to, among other things, expansion of our network to provide public pay-phone 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 the number of call completions. Our ability to satisfy these terms and conditions, as well as others, may be affected by factors beyond our control. Our failure to comply with the requirements of our concession may result in the imposition of fines up to R\$50.0 million 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. Moreover, the concession agreements establish that all assets owned by the Company and which are indispensable to the provision of the services described in such agreements are considered reversible assets and are deemed to be part of the concession assets. The assets will be automatically returned to ANATEL upon expiration of the concession agreements, according to the regulation in force at that time. On December 31, 2009, the net book value of reversible assets is estimated at R\$7.0 billion, which is comprised of switching and transmission equipment and public use terminals, external network equipment, energy



equipment and system and operation support equipment.

The expiration date of the original concession agreements was December 31, 2005, but it has since been renewed as of December 22, 2005 for an additional 20-year term. The current concession agreements contain a provision allowing ANATEL to review the concession terms in 2010, 2015 and 2020. This provision permits ANATEL to update the renewed concession agreements 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. A Public Notice (consulta pública) was published on March 31, 2009 with the

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proposed revisions to the concession agreements and public meetings (audiências públicas) were held in Manaus, Salvador, São Paulo, Brasília, Florianópolis and Rio de Janeiro in May 2009.

ANATEL is currently analyzing the suggestions made to the Public Notice and it may vote on the final version of the concession agreements over 2010. The revised concession agreements will become effective as of January 1, 2011.

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

We have experienced, and expect to continue to experience, market adjustments in which providers take actions in order to compete for clients, especially corporate and premium residential clients. Such actions result in pressure on market prices and shifts in market share.

At the end of 2008, ANATEL approved a change to the General Plan of Grants or Plano Geral de Outorgas, allowing fixed-line providers to hold concession licenses within the same business group in more than one region. This change allowed for the merger between Oi and Brasil Telecom, operators in Regions I and II, respectively, thus redefining the competitive landscape in Brazil.

Number Portability was introduced in 2008. Number Portability allows clients within a limited geographic locale to relocate or change their telephone operator without the need to change their telephone number (for either a fixed or mobile line). Number Portability was introduced for certain of our clients in September of 2008 and as of December 31, 2008, approximately 18% of our clients had Number Portability rights. The year 2009 was the first full fiscal year impacted by the effects of Number Portability. Number Portability rights for all of our clients became effective in March 2009. As a result of Number Portability, we had a small increase in the churn of our fixed-line customers. Mobile operators were more impacted by the effects of Number Portability. However, despite the impact being lower than expected thus far, an attack with an aggressive positioning of GVT can accelerate the demand for portability.

Any loss of market share as a result of competition from fixed-line providers could have an adverse effect on our business, financial condition and results of operations.

We face increasing competition from cellular service providers.

Rapid growth of the cellular telecommunications industry and intense competition among cellular service providers have resulted in lower prices for cellular services. Cellular services are increasingly becoming an alternative to fixed-line services, primarily for residential customers. We expect this to negatively impact the use of fixed telecommunications services and, therefore, mobile services are still the main competitive product to our services. Certain fixed-line services operating on mobile platforms are already common in the market, wherein a user will have two numbers, a mobile number and a fixed number, the latter functioning only in the user's area of residence or "home zone." Additionally, with Oi and AEIOU now operating in the State of São Paulo beginning in the second half of 2008, competition in the mobile telecommunications market has intensified, putting further pressure on the fixed-line telecommunications market. Any loss of market share as a result of competition from cellular service providers could have an adverse effect on our business, financial condition and results of operations.

The industry in which we conduct our business is subject to rapid technological changes that 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 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. 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.

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As an example of the alternative technology, in December 2007, ANATEL auctioned frequencies for 3G services (third generation cellular telephone services) at premiums of almost 80% over minimum bid prices, for which all current operators as well as other new entrants into the market submitted bids. The 3G networks allow mobile broadband access at speeds and prices competitive with currently offered fixed broadband services, which could have an adverse effect on Speedy's growth and our results. Currently, all current mobile operators in the State of São Paulo (except AEIOU) provide 3G services at prices competitive with those of the fixed technology players in the market.

We seek to invest in new technology to remain competitive in a rapidly changing market. If we do not make sufficient investments in new technology or if our networks and technologies otherwise become outdated or obsolete, we may not be able to compete effectively against new, alternative technologies, which could have an adverse affect on our business, financial condition and results of operations.

Risks Relating to the Preferred Shares and the ADSs

Holders of our ADSs may face difficulties in serving process on or enforcing judgments against us and other persons.

We are organized under the laws of Brazil, and most of our directors and executive officers and our independent public accountants reside or are based in Brazil. Substantially all of our assets and those of these other persons are located in Brazil. As a result, it may not be possible for holders of the ADSs to effect service of process upon us or these other persons within the United States or other jurisdictions outside Brazil or to enforce against us or these other persons judgments obtained in the United States or other jurisdictions outside Brazil. Because judgments of U.S. courts for civil liabilities based upon the U.S. federal securities laws may only be enforced in Brazil if certain conditions are met, holders may face greater difficulties in protecting their interests due to actions by us, our directors or executive officers than would shareholders of a U.S. corporation.

Holders of Our Preferred Shares and ADSs generally do not have voting rights.

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

Holders of Our Preferred Shares 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.

Holders of our preferred shares 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 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—B. Memorandum and Articles of Association—Preemptive Rights."

An exchange of ADSs for preferred shares risks the loss of certain foreign currency remittance and Brazilian tax advantages.

The ADSs benefit from the certificate of foreign capital registration, which permits The Bank of New York, as depositary, to convert dividends and other distributions with respect to preferred shares into foreign currency, and to remit the proceeds abroad. Holders of ADSs who exchange their ADSs for preferred shares will then be entitled to rely on the depositary's certificate of foreign capital registration for five business days from the date of exchange. Thereafter, they will not be able to remit non-Brazilian currency abroad unless they obtain their own certificate of foreign capital registration, or unless they qualify under Resolution 2,689 of the Central Bank of Brazil, dated

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January 26, 2000 and issued by BACEN, which entitles certain investors to buy and sell shares on Brazilian stock exchanges without obtaining separate certificates of registration.

If holders of ADSs do not qualify under Resolution 2,689, they will generally be subject to less favorable tax treatment on distributions with respect to our preferred shares. There can be no assurance that the depositary's certificate of registration or any certificate of foreign capital registration obtained by holders of ADSs will not be affected by future legislative or regulatory changes, or that additional Brazilian law restrictions applicable to their investment in the ADSs may not be imposed in the future.

Holders of our preferred shares will be subject to, and holders of our ADSs could be subject to, Brazilian income tax on capital gains from sales of preferred shares or ADSs.

Brazilian Law No. 10,833 provides that gains on the disposition of assets located in Brazil by non-residents of Brazil, whether to other non-residents or to Brazilian residents, will be subject to Brazilian taxation. The preferred shares are expected to be treated as assets located in Brazil for purposes of the law, and gains on the disposition of preferred shares, even by non-residents of Brazil, are expected to be subject to Brazilian taxation. In addition, the ADSs may be treated as assets located in Brazil for purposes of the law, and therefore gains on the disposition of ADSs by non-residents of Brazil may also be subject to Brazilian taxation. Although the holders of ADSs outside Brazil may have grounds to assert that Law No. 10,833 does not apply to sales or other dispositions of ADSs, it is not possible to predict whether that understanding will ultimately prevail in the courts of Brazil, given the general and unclear scope of Law No. 10,833 and the absence of judicial court rulings in respect thereto. See "Item 10. Additional Information—E. Taxation—Brazilian Tax Considerations."

### Certain Factors Relating to Our Controlling Shareholder

Our controlling shareholder has strong influence over our business.

Telefónica Internacional S.A., or Telefónica Internacional, our principal shareholder, currently owns directly and indirectly approximately 85.57% of our voting shares and 87.95% of our total capital. See "Item 7. Major Shareholders and Related Party Transactions—A. Major Shareholders" and "Item 7. Major Shareholders and Related Party Transactions—B. Related Party Transactions." 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

Following the restructuring and privatization of Telebrás, discussed below, we were incorporated on May 22, 1998, as a corporation (sociedade anônima) organized under the laws of the Federative Republic of Brazil. We are registered with the CVM, as a publicly held company and our stock is traded on BM&FBOVESPA. We are also registered with the SEC in the United States and our ADSs are traded on the New York Stock Exchange, or the NYSE. Our headquarters are located at Rua Martiniano de Carvalho, 851, 01321-001, São Paulo, SP, Brasil. Our telephone number is 55-11-3549-7200.

As of December 31, 2009, we had 168,609,291 outstanding common shares, with no par value per share, and 337,232,189 preferred shares, with no par value per share. Our shareholders' equity was in the amount of R\$10.1 billion as presented under the Brazilian Corporate Law Method.

We provide fixed-line telecommunications services in the State of São Paulo under concession agreements granted in 1998 by the Brazilian government in connection with the restructuring and privatization of the Telebrás

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System, as described below. The concession, which was renewed in December 2005, authorizes us to provide fixed-line telecommunications services in a specific region, which includes all of the State of São Paulo except for a small area (Sector 33), where a previously existing fixed-line service provider, CTBC Telecom, which was not part of the Telebrás System, continues to operate independently.

In addition to the services we provide under the concession agreements of 1998, we also provide international and interregional long-distance services, as permitted under Act No. 23,395 of March 1, 2002, under which ANATEL also acknowledged the accomplishment of our network expansion and universal service targets as of September 30, 2001.

We also provide multimedia communication services (“serviços de comunicação multimídia” or “SCM”) such as audio, data, voice and other sounds, images, texts and other information. ANATEL granted the SCM license with Act No. 33,791 of February 14, 2003. Telesp possesses one license, for Sectors 31 (our predecessor company’s area prior to the reorganization), 32 (the area corresponding to Ceterp prior to our acquisition) and 34 (CTBC Borda’s area prior to the reorganization).

In March 14, 2007, ANATEL conceded to A.Telecom S.A., one of our wholly-owned subsidiaries, the license to offer Pay TV services through DTH (“Direct to the Home” - a special type of service that uses satellites for the direct distribution of television and audio signals for subscribers). We began offering Pay TV services on August 12, 2007.

On October 31, 2007, the board of ANATEL approved, from a regulatory perspective, the association between Grupo Abril and the Company, which involved, among other transactions, the acquisition of all of the operations of Multichannel Multipoint Distribution Service (MMDS), a special license that allows us to offer Pay TV and broadband services through our subsidiary Telefonica Sistemas de Televisão S.A. The transaction continues to be analyzed by ANATEL, solely with respect to antitrust matters, and will be finally reviewed by CADE.

In 2008, the Company pioneered the launch of internet access through fiber optic cables (“Fiber to the Home” - FTTH) for non-commercial customers. Aside from the offer of an internet connection with high-speed capacities of 8 Mbps and 30 Mbps, various bundles have also been offered, including Wi-Fi, Digital TV, 2,000 minutes of local and intra-state calls, anti-virus protection, call identification, technical assistance and specific call center assistance.

On February 16, 2009, ANATEL extended the authorization until 2024 for the use of the spectrum frequencies associated to the MMDS in the cities of São Paulo, Curitiba, Rio de Janeiro and Porto Alegre.

As of December 31, 2009, our telephone network included 11.3 million fixed lines in service, 2.6 million broadband clients and 0.5 million Pay TV clients. Of the access lines in service, approximately 72% were residential, 23% were commercial, 2% were public telephone lines and 3% were for our own use and testing.

## Historical Background

### The Restructuring and Privatization

After the incorporation of Telecomunicações Brasileiras S.A. - Telebrás in 1972, 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.

In May 1998, just prior to its privatization under the General Telecommunications Law, the Telebrás System was restructured to form, in addition to Telebrás, twelve new holding companies. Virtually all assets and liabilities of Telebrás were transferred to the new holding companies, or the “new holding companies.”



In July 1998, the federal government privatized the Telebrás System, selling substantially all its shares in the new holding companies, including TelespPar and its shares in TSP and CTBC Borda, to private sector buyers. As a result of a subsequent reorganization of SP Telecomunicações on January 10, 1999, one of its subsidiaries, SPT Participações S.A., or SPT, became the controlling shareholder of TelespPar.

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### The Reorganization of TelespPar

On November 30, 1999, the shareholders of TelespPar approved a reorganization involving a series of mergers, whereby Telespar became the telecommunications services company operating under our current name, Telecomunicações de São Paulo S.A. - Telesp.

### Ceterp's Acquisition

On December 20, 1999, we began the acquisition, 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 share capital 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.

On December 27, 2000, Ceterp was merged with and into us.

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

On August 3, 2000, the wholly-owned subsidiary Telefônica Empresas S.A. was created with the corporate goal of providing Switched Package Network services, and on January 30, 2001, the independent Brazilian corporation Telefônica Data Brasil Holding S.A. (TDBH) was created through a shareholder-approved spin-off of the data transmission operations performed by Telefônica Empresas S.A. A merger of the company and TDBH was effective July 2006. See “—The SCM Restructuring.”

### Attainment of ANATEL Targets

Telesp's business, services and tariffs have been regulated by ANATEL since June 16, 1997, in accordance with various decrees, decisions, plans and regulatory measures. We became the first operator to achieve ANATEL's service targets. As a result, ANATEL granted us a license to offer domestic and international long-distance services to our customers. Accordingly, on May 7, 2002, we began providing international long-distance services and on July 29, 2002, we began providing interregional long-distance service. See “—B. Business Overview—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies—Network Expansion and Quality of Service” for information relating to ANATEL's network expansion and universal service targets.

The Board of Directors of ANATEL, at ANATEL's meeting held on January 29, 2003, granted Telesp the authorization to use the SCM nationwide. The Company may now offer voice and data services through various points of presence composed of networks and telecommunication circuits.

On July 6, 2003, mobile telephony operators started to implement a long-distance carrier selection (CSP) that enables the client to determine the long-distance carrier for each domestic long-distance call (VP2 and VP3) or international call, in accordance with the SMP (Mobile Personal Service) rules. As a result, the Company, having acknowledged the revenues from these long distance services, started to pay the mobile telephony operators for the use of their networks.

On September 4, 2004, the rules dictated by Resolution No. 373, dated as of June 03, 2004, were implemented to carry out the reconfiguration of the local areas for the Switched Fixed Telephony Service (STFC). As a consequence, all calls previously billed at domestic long distance rates (DC level – Áreas Conurbadas) are now billed at lower rates as local calls. In São Paulo, this modification involved 53 municipalities, of which 39 are in Grande São Paulo.

### IP Network Asset Acquisition

On December 10, 2002, after receiving approval from ANATEL, our Board of Directors approved a proposal to acquire certain assets from Telefónica Data S.A. (formerly T-Empresas), one of the companies of the Telefónica group, including the following services: (i) an Internet service that allows our customers to access our network through remote dial-up connection and (ii) services that allow customers of Internet Service Providers, or ISPs, to

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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.

### Acquisition and Reorganization of Atrium

On December 30, 2004, we acquired indirect control of Atrium Telecomunicações Ltda. from Launceston Partners CV. Atrium provides various types of telecommunications services in Brazil, including internet and intranet services, telecommunications management services and the sale and rental of telecommunications systems and related equipment. 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.

On November 21, 2005, we approved the corporate reorganization of our wholly-owned companies A. Telecom S.A. (formerly Assist Telefónica S.A.), Santo Genovese Participações Ltda., or Santo Genovese and Atrium Telecomunicações Ltda., or Atrium, which was implemented and became effective on March 1, 2006.

### The SCM Restructuring

On March 9, 2006, our Board of Directors and the Boards of Directors of TDBH and Telefónica Empresas S.A., a wholly-owned subsidiary of TDBH (“T-Empresas” and together with us and TDBH, the “Companies”), approved the restructuring of the Companies’ serviços de comunicação multimídia (“SCM”), or multimedia communications services, and data transmission activities (the “SCM Restructuring”).

The terms and conditions of the SCM Restructuring are set forth in an agreement executed by the Companies on March 9, 2006. The SCM Restructuring consisted of (i) the merger of TDBH into our company (the “Merger”); and (ii) the spin-off of all T-Empresas’ assets and activities except its SCM assets and activities outside Sectors 31, 32 and 34 of Region III of Annex II of the General Concession Plan (the “Spin-off”) and assets and activities related to the data center.

Following the approval of this restructuring: (i) TDBH was dissolved; (ii) its shareholders received shares of our common or preferred stock, or ADSs, as appropriate; (iii) we succeeded TDBH in all of its rights and obligations; and (iv) T-Empresas became our wholly-owned subsidiary. The transfer to Telesp of the spun-off components of T-Empresas did not result in any increase or decrease in the net equity of Telesp, nor in the number of shares that comprise its capital stock.

With respect to TDBH’s Merger into us, certain minority shareholders tried to suspend our General Shareholders Meeting by contesting the appraisal of the share exchange ratio provided by NM Rothschild & Sons (Brasil) Ltda. by obtaining an injunction from the 14th civil chamber of the central forum of the district court of São Paulo. The injunction was lifted on July 28, 2006, and the merger became legally effective. The main action (Ação Ordinária No. 583.00.2006.156920-5) has not yet been resolved in the lower court.

On January 31, 2008, at the 22nd General Shareholders Meeting of Telefónica Empresas S.A., the only shareholder of which is Telesp, it was resolved to change the corporate name of Telefónica Empresas S.A. to Telefónica Data S.A.

### Agreement of Convergence, Purchase and Sale of Operations, Assets, Stock and Other Obligations with the Abril Group

On October 29, 2006, the Company entered into an agreement with Abril Comunicações S.A., TVA Sistema de Televisão S.A., Comercial Cabo TV São Paulo Ltda., TVA Sul Paraná Ltda., and TVA Radioenlaces Ltda. (the “Abril Group”), whereby we combined our telecommunications and broadband services with the broadband and cable services

of Tevecap S.A., or TVA, the second largest Brazilian pay TV provider with operations in the states of Paraná, Rio Grande do Sul, São Paulo and Rio de Janeiro. Through this transaction, we broadened our services to meet our users' increasing demand, combining the Abril Group's expertise in content and media production and placement with the expertise of the Telefónica Group in the telecommunications segment.

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On October 31, 2007, the board of ANATEL concluded the regulatory review of the association between Grupo Abril and the Company, approving the transaction, which involves (i) the acquisition of all of the operations of MMDS (Multichannel Multipoint Distribution Service) and broadband, and (ii) the acquisition of a significant stake, within the limit of the foreseen effective laws and regulations, in the cable television dealers controlled by Grupo Abril within and outside of the State of São Paulo. This decision was published in the Official Gazette of the Federal Executive on November 19, 2007. Antitrust clearance is still pending from the ANATEL and CADE competition authorities.

The Telesp stockholders, in the extraordinary general meeting held on November 23, 2007, ratified the entering into of the Agreement, its amendments and annexes, and approved the implementation of the deal and the signature of all documents necessary for its complete formalization.

As a result of this transaction, Navytree Participações S.A. (“Navytree”) became a wholly-owned subsidiary of Telesp, and our provision of broadband services became centralized.

On June 10, 2008, at the General Shareholders Meeting of Navytree, the corporate name of Navytree was changed to Telefônica Televisão Participações S.A. (“TTP”).

### Corporate Reorganization involving Ajato

On October 14, 2008, Telefonica Sistema de Televisão S.A. (“TST”) and TTP purchased from Abril Comunicações S.A. all shares of Mundial Voip Telecomunicações Ltda., EPP, which had its corporate name changed to Ajato Telecomunicação Ltda. (“Ajato”). Following the merger of TTP into Telesp on November 11, 2008, Ajato’s shares are held by TST and us.

### Corporate Reorganization involving DABR and TTP

On October 21, 2008, the Company’s Board of Directors and the shareholders of TTP and Telefônica Data Brasil Participações Ltda. (“DABR”) approved a corporate reorganization that consisted of the merger of TTP and DABR into us.

On November 11, 2008, the merger of TTP and DABR was approved by our Extraordinary Shareholders Meeting.

The reorganization allowed the Company to increase synergies, reduce managerial risk, simplify the corporate administrative structure and reduce costs, while also providing tax benefits expected to reduce the Company’s income tax and other taxes assessed on revenue and income, thereby improving the Company’s cash flows. The reorganization and the goodwill amortization were structured as to avoid any assumption of indebtedness by Telesp and to minimize any negative impact on the future results of the Company.

As a result of this restructuring: (i) TTP was dissolved; (ii) its shares were cancelled and Telesp’s participation in TTP was exchanged for the respective net assets, without any increase in capital stock or issuance of new shares for Telesp; (iii) Telesp assumed all rights and obligations of TTP, (iv) administrative costs were reduced, the goodwill in connection with the acquisition of TTP was transferred to Telesp, which can be amortized will result in a tax benefit of R\$288 million, based on future yield, and (v) since TTP was a wholly-owned subsidiary of Telesp, the transfer to Telesp of the net equity of TTP did not result in any increase or decrease in the net equity of Telesp nor in the number of shares that comprise its capital stock.

Moreover, following the approval of this restructuring: (i) DABR was dissolved; (ii) Telesp succeeded DABR in all of its rights and obligations; (iii) Telesp's capital stock held by DABR was directly attributed to the controlling shareholder of DABR, SP Telecomunicações Participações Ltda., in exchange for the interests it then held in DABR, and the shares retained the same rights as the shares issued by Telesp; (iv) an increase in Telesp's capital resulted, without the issuance of new shares; (v) DABR's net worth – comprising an amount equivalent to DABR's investment in Telesp and an amount corresponding to goodwill resulting from the shares received by Telesp – was transferred to Telesp, and the amortization of the goodwill resulted in a fiscal benefit to Telesp, which was accounted for in Telesp's Goodwill Special Reserve account in net equity, which shall be capitalized to the

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Company's controlling shareholder, SP Telecomunicações Participações Ltda., at which time the minority shareholders will be assured the right of first refusal to subscribe said capital increase and any amounts paid by them shall be delivered to the controlling shareholder; and (vi) the capitalization of the portion of the Goodwill Special Reserve in share capital, in the amount corresponding to the fiscal benefit, will be realized at the end of each fiscal year to the extent that this benefit represents an effective decrease in the taxes paid by Telesp.

Recent Developments

Corporate Restructuring involving A.TELECOM S.A.

On December 9, 2009, the Company's Board of Directors approved the submission to a shareholder vote of the corporate reorganization proposal consisting of the partial spin-off of A.TELECOM S.A. ("A.TELECOM"), and the subsequent merger into Telesp of the spun-off part of A.TELECOM.

On December 30, 2009, A.TELECOM's shareholders approved the spin-off of part of A.TELECOM and the subsequent merger of the spun off part into Telesp. On the same date, Telesp's shareholders approved the merger of the spun-off part into us.

This corporate restructuring created synergies for us and A.TELECOM providing both of us with better administrative, operating and regulatory efficiencies regarding telecommunication integrated services, thus benefiting both of us and our respective shareholders.

The transaction can be summarized as follows: (1) a partial spin-off of A.TELECOM and the subsequent merger into Telesp of the spun-off part (including the assets, rights and liabilities) was approved pursuant to Article 229 of Brazilian Corporate Law; (2) as a result of the spin-off, the capital of A.TELECOM was reduced in the proportion of the spun-off part valued at R\$99,292,785.24 and the corresponding shares held by Telesp were cancelled; (3) A.TELECOM's spun-off part was merged into Telesp. There was no capital increase for Telesp as a result of the merger because A.TELECOM is a wholly-owned subsidiary of Telesp. Telesp incurred a reduction in its investment accounted in its fixed assets. All assets and liabilities existing on the spin-off special balance sheet were transferred to Telesp, with no changes to its equity; (4) any changes to A.TELECOM's equity between the date of the appraisal report and the shareholders' meeting that approved the merger were absorbed by A.TELECOM; (5) Telesp became liable only for the liabilities that were expressly transferred to it as a result of the merger as memorialized in the Protocol of Merger and the spin-off special balance sheet, with no joint liability with A.TELECOM. There are no material contingencies or off-balance sheet liabilities transferred to Telesp as result of the merger of the spun-off part of A.TELECOM.



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## Corporate Structure and Ownership

Our general corporate and shareholder structure is as follows:

## Capital Expenditures

We are permitted to determine our own capital expenditure budget, subject to compliance with certain obligations to expand service under the concession. With this in mind, we were focused in voice services in order to comply with ANATEL's targets and to provide quality service for clients. Also, in order to achieve a consolidated position in the broadband and Pay TV market, during 2009 the focus of our capital expenditure has been, and continues to be, expanding, modernizing and upgrading our ADSL network, increasing the base of Pay TV and improving our systems and processes of customers relations, marketing and sales.

The following table sets forth our capital expenditures for each year in the three-year period ended December 31, 2009.

	Year ended December 31,		
	2009	2008	2007
	(in millions of reais)		
Switching equipment	73.5	61.1	54.7
Transmission equipment	266.7	226.6	264.5
Infrastructure	121.9	56.0	45.6
External network	463.2	433.4	356.0
Data transmission	426.2	559.8	444.7
Line support equipment	378.3	471.8	380.2
Administration (general)	430.9	459.2	368.5
Other	60.3	74.6	78.3
Total capital expenditures	2,221.0	2,342.5	1,992.5

In addition to the consolidation of our broadband market position, 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 “—B. Business Overview—Regulation of the Brazilian Telecommunications Industry—Obligations of Telecommunications Companies.”

We anticipate that our capital expenditures for 2010 will be approximately R\$2.3 billion. We expect to fund these expenditures with funds internally generated from our operations and through debt.

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### 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 40.6 million, representing 21.6% of Brazil's total population. Based on the most recent data available, the gross domestic product, or GDP, of the State of São Paulo in 2007 was an estimated R\$902.8 billion, or approximately US\$509.9 billion, representing approximately 34% of Brazil's GDP for the year. The State of São Paulo's annual per capita income during 2007 was an estimated R\$22.7 thousand, or approximately US\$12.6 thousand.

The concessions granted by the Brazilian government in 1998 and renewed in 2006 allow 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 represents approximately 1.5% of total lines in service and 2.2% 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 40.6 million. Of the municipalities in Region III, 72 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 Borda do Campo 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. According to the Presidential Decree regarding the new General Plan of Grants, published in the Diário Oficial da União on November 21, 2008, we were given a period of 18 months for the unification of the three sectors for which we act as a concessionaire (sectors 31, 32 and 34).

On May 7, 2002, we began offering international long distance service and on July 29, 2002, we started offering interregional service. The conditions for the provision of 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" that permits our callers to originate calls using our services even though they are outside our concession area. All interregional and international cellular calls, whether in our concession area or that of another provider, need to dial a carrier selection code using Personal Mobile Service—SMP, through which mobile services users choose the provider for interregional and international long-distance calls, and which requires dialing our code "15" in order to use our services. See "—Services—Network Services."

#### Services

##### Overview

Our services consist of:

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

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- intraregional, interregional and international long-distance services;
  - data services, including broadband and other data link services;
- Pay TV services through DTH (direct to home) satellite technology and land based wireless technology MMDS (multichannel multipoint distribution service);
- network services, including interconnection and rental of facilities, as well as other services.

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In March 2002, ANATEL certified our compliance with the 2003 universal service targets and authorized us in April 2002 to start providing 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 A. Telecom S.A. (formerly Assist Telefônica S.A.), our wholly-owned subsidiary. Until January 2001, we provided data transmission services, but spun off our data transmission operations into TDBH. In March 2006, we began the restructuring of our multimedia communications services (serviços de comunicação multimídia) and data transmission activities. See “—A. History and Development of the Company—Historical Background—The SCM Restructuring.”

The monthly and usage fees for our services (local and long-distance) were initially determined in our concession agreements. From March 2007 until July 31, 2007, the billing system was converted to a minute basis and the former measurement based on pulses was discontinued for all customers. Our concession agreements also set forth criteria for annual fee adjustments. We derive a substantial portion of our revenues from services subject to this price adjustment. The method of price adjustment is essentially a price cap. ANATEL annually applies a price index correction that reflects the inflation index of the period and a productivity factor to our local and long-distance fees. Since 2006, the inflation index has been replaced by the IST, which reflects variations in telecommunications companies’ costs and expenses. ANATEL has complied with the fee range set by the concession agreements.

The following table sets forth our operating revenue for the years indicated. Our fees 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,		
	2009	2008	2007
	(in millions of reais)		
Local service	8,138	8,609	9,125
Intraregional service	2,672	2,644	2,006
Interregional long-distance service	1,199	1,165	1,215
International long-distance service	113	140	134
Data transmission	4,176	3,760	2,996
Fixed-to-mobile services	4,102	4,372	4,064
Network usage services	488	466	405
Network Access	509	384	319
TV service	600	379	54
Other	1,158	1,102	866
Total	23,155	23,021	21,184
Taxes and discounts	(7,360)	(7,042)	(6,456)
Net operating revenue.	15,795	15,979	14,728

## Local Service

Local service includes activation, 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.” 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

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December 1999. Embratel, Br Telecom and Telemar also provide local services in our concession region. 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. In May 2004, we began providing local telephone services in seven other states in Brazil, including those in the capitals of Pará, Roraima, Amapá, Rondônia, Maranhão, Tocantins and Acre. In May 2005, we also began to provide local telephone services in the capitals of the following states: Ceará, Amazonas, Pernambuco, Rio de Janeiro, Bahia, Mato Grosso do Sul and Mato Grosso. Since May 2006, we have also been providing local telephone services in Brasília (Distrito Federal) and Goiânia, the capital of the State of Goiás. We have not had any activations since 2007.

### 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. Embratel, Br Telecom and Telemar also provide long-distance services in our concession region. 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 Fixed Telephone Commuted Service (STFC) and granted us a concession to develop interregional long-distance services in Region III and an authorization to develop services in the local, intraregional, interregional and international markets throughout Brazil.

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 in Brazil and a point outside Brazil.

### Network Services

Brazil is divided into four regions in relation to telecommunication services with the following incumbent service providers: (i) Region I, that encompasses the North and Northeast regions of Brazil and in which concessions are granted to Oi (Telemar) and CTBC Telecom; (ii) Region II, that encompasses the South and Center-West regions of Brazil and in which concessions are granted to Oi (Brasil Telecom), CTBC Telecom, and Sercomtel; (iii) Region III, that encompasses the State of São Paulo and in which concessions are granted to Telefônica and CTBC Telecom; and (iv) Region IV, that encompasses the whole country and in which the concession for long distance calls is granted to Embratel.

In 2005, after meeting the targets imposed in the concession agreement two years before the target date, Telefônica started to operate in Regions I and II, expanding its long-distance network to the main Brazilian cities, providing services in the main markets with infrastructure based on new generation platforms.

By the end of 2009, we were present in the main cities of Regions I and II, namely: Porto Alegre, Curitiba, Brasília, Rio de Janeiro, Vitória, Belo Horizonte, Salvador, Florianópolis, Fortaleza, Recife and Goiânia.

Telesp has continuously adapted and expanded its network topology and services aiming to develop new business opportunities in the State of São Paulo through offering services to other telecommunications companies. The result was a significant increase in the number of providers that use Telefônica's wholesale services.

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Other important adaptations have been implemented in the network topology in order to meet the regulatory requirements and to integrate several calling areas of the State of São Paulo, thus allowing customers to make local calls in situations that had previously been categorized as long-distance calls. The integration of new cities into local areas is annually determined by ANATEL and Telefônica is fully complying with ANATEL's determinations.

In 2007, we developed network solutions and invested significant funds to adapt its network to ANATEL's Number Portability requirements. The implementation of Number Portability in the State of São Paulo was effectively initiated in September 2008 and fully implemented in March 2009. Systems and processes adjustments are still in progress in order to improve support to Number Portability requirements.

Competition for long-distance service has increased and by the end of 2009 there were a total of 34 different operators available through the Service Provider Selection Code (Código de Seleção de Prestadora - CSP). A new pre-paid attendant service for long-distance call forwarding has been implemented, as well as satellite services for providing circuits in remote areas for wholesale and large customers.

### 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.

As a result of our acquisition of certain assets from Telefónica Data S.A. in 2002, we also started providing the following services: (i) an Internet service that allows our customers to access our network through remote dial-up connection and (ii) services that allow customers of Internet Service Providers, or ISPs, to have access to broadband Internet.

### Interconnection

In July 2005, ANATEL published new rules regarding interconnection systems that substantially changed the interconnection model. These changes include: (i) an obligation to have an interconnection public offer for all types of interconnection services, in addition to the interconnection between fixed-line service providers and mobile service providers; (ii) an offer of interconnections for Internet Service Providers (ISPs); (iii) the establishment of criteria for the treatment of fraudulent calls; and (iv) the reduction of time in which new interconnection solicitations are answered. These reforms have facilitated market entry for new operators.

The interconnection public offer (OPI) had been amended following negotiations with providers and changes in the services rendered and regulatory requirements. Telesp has adopted procedures to reduce the time necessary to answer customers' interconnection requests, as well as to monitor and comply with quality levels set by ANATEL for interconnection services with a current availability level of 99.8%.

Telesp has also completed the implementation of the interconnection with mobile service providers in the most intensive traffic areas, assuring the proper billing for such calls and reducing interconnection costs.

In 2007, ANATEL published the new version of the Regulation of Fixed Network Compensation Rates, which primarily modified the rules for interconnection rates and calculation methods. Local and long-distance tariffs that were flat at all times became variable according to the rules for public service tariffs. A 20% increase was applied to tariffs of non incumbents in their regions.



In addition to the necessary adaptations in its network concerning the Number Portability, Telesp, in conjunction with other operators, implemented a systematic solution including several interoperative processes, which allows the correct forwarding of calls.

According to the Personal Mobile Service (SMP) regulation, the Mobile Network Interconnection Fee (VUM) price is subject to free negotiation between parties and once an agreement is reached it should be homologated by ANATEL to take effect. The agreement currently in effect was executed in 2008.

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Starting in November 2009, the licenses of each mobile operator were consolidated by region, resulting in the consolidation of tariffs and in the reduction from two to one VUM in the fees owed for on-net network traffic.

At the end of 2009, Telefônica was party to 187 local and long-distance interconnection agreements and 91 traffic and transport agreements.

### I-Telefônica

I-Telefônica is a free Internet access service provider launched in September 2002 by our subsidiary A. Telecom S.A. (formerly Assist Telefônica). The product is available in 622 cities in the State of São Paulo and over 1,500 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 supply 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. Traffic imbalance (sumidouro) occurs when a certain telecommunications operator has a higher volume of incoming than outgoing traffic (with another operator). When the incoming/outgoing traffic relationship falls outside the 45%-55% range, the operator with higher outgoing traffic must pay to the other the interconnection fees corresponding to the traffic that exceeds the range. Telecommunications operators that house internet service providers tend to have more incoming than outgoing traffic, and thus receive interconnection revenues from other operators. I-Telefônica helps us keep our dial-up traffic on our own network, and thus reduce unfavorable traffic imbalance, thereby lowering our interconnection expenses.

### Authorization to Provide Multimedia Services

On January 29, 2003, ANATEL granted our SCM license nationwide, allowing A. Telecom S.A. (formerly Assist Telefônica), our wholly-owned subsidiary, to provide voice and data services through points-of-presence (POPs), which are comprised of private telecommunications networks and circuits. In addition to A. Telecom S.A., ANATEL granted SCM licenses to T-Data (formerly T-Empresas) and Emergia.

### Authorizations for pay TV via satellite

On March 14, 2007 ANATEL granted A. Telecom S.A. authorization to provide services of paid TV via satellite (Direct to Home – DTH). DTH is one of the special types of subscription TV services that utilize satellites for the direct distribution of television and audio signals for subscribers. The launching of the commercial transaction occurred on August 12, 2007.

### Authorization for Multichannel Multipoint Distribution Service (MMDS)

On October 31, 2007, the board of ANATEL concluded its regulatory review of the association between Grupo Abril and the Company, approving the transaction from a regulatory perspective, which involved, among other transactions, the acquisition of all of the operations of Multichannel Multipoint Distribution Service (MMDS).

This decision was published in the Official Gazette of the Federal Executive on November 19, 2007. The transaction continues to be analyzed by ANATEL, solely with respect to antitrust matters, and will be ultimately also reviewed by CADE (Conselho Administrativo de Defesa Econômica), the Competition Authority.

On February 16, 2009, ANATEL extended the authorization until 2024 for the use of the spectrum frequencies associated to the Multichannel Multipoint Distribution Service (MMDS) in São Paulo, Curitiba, Rio de Janeiro and

Porto Alegre. ANATEL is currently analyzing the price to be paid for the spectrum usage.

The STFC Concession Agreement

As mentioned above, we are a concessionaire of STFC to render local and domestic long-distance call services originated in Region III, which comprises the State of São Paulo, in Sectors 31, 32 and 34, established in the General Concession Plan (PGO).

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The current concession agreement, dated December 22, 2005, was renewed on January 1, 2006, and will be valid until December 31, 2025. However, the agreement can be reviewed by ANATEL on December 31, 2010, 2015 and 2020. Based on such review, ANATEL may establish new requirements and targets for universal and high quality telecommunication services, according to the conditions present at the time of review.

The concession agreement establishes that all assets owned by the Company and which are indispensable to the provision of the services described in such agreement are considered reversible assets and are deemed to be part of the concession assets. These assets will be automatically returned to ANATEL upon expiration of the concession agreement.

Every two years, during the agreement's new 20-year period, publicly held companies will have to pay a renewal fee which will correspond to 2% of its prior-year SFTC revenue, net of taxes and social contributions. The first payment of this biennial fee occurred on April 30, 2007, based on the 2006 STFC net revenues, and the second payment occurred on April 30, 2009, based on the 2008 STFC net revenues. The next payment is scheduled for April 30, 2011 based on the 2010 net revenues. See Note 20 to our Consolidated Financial Statements.

On April 8, 2008, Telesp signed an additive term to the concession contracts to substitute the obligation to install telecommunications service posts with an obligation to roll out broadband network infrastructure throughout the municipalities serviced by such concessionaires.

### Corporate Customer Services

We offer our corporate clients comprehensive telecommunications solutions and IT support designed to address specific needs and requirements of companies operating in a number of different market segments such as manufacturing, services, financial institutions and government.

Our clients are assisted by our highly qualified professionals who offer specialized telecommunication and IT support tailored to meet the specific needs of each company by delivering corporate Internet access, voice and data solutions, and by consistently striving for greater service efficiency to preserve our competitiveness in our market.

### 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 and other additional services.

Rates for telecommunications services are subject to comprehensive regulation by ANATEL. See “—Regulation of the Brazilian Telecommunications Industry.” Since the relative stabilization of the Brazilian economy in mid-1994, two major changes in rates for local and long-distance services have occurred: in 1996 to compensate for accumulated effects of inflation and in 1997 to eliminate the cross-subsidy between local and long-distance services.

Concession agreements, which were valid from 1998 until December 31, 2005, and subsequently renewed for an additional 20 years until 2025 (all of our relevant concession agreements were renewed), establish a price cap for annual rate adjustments.

As of January 2006, with the renewal of our concession agreements until December 31, 2025, new readjustment rules for fees became effective. The current contract may be reviewed and modified by ANATEL on December 31, 2010, 2015 and 2020 to set forth new terms that account for conditions existing at the time of that future review.

According to the new contract, we readjust charges based on a service basket of fees, as follows:

- local services, where rates are established pursuant to a service basket of fees that includes rates for the measured traffic and subscription fees. In the case of a price adjustment, each one of the items within the

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local fee basket has a different weight and, as long as the total local fee price adjustment does not exceed the rate of increase in the Telecommunication General Price Index, or IST, minus a productivity factor as established in the concession agreements, each individual fee within the basket can exceed the IST variation by up to 5%;

- installation of residential and commercial lines and public telephone services, with adjustments limited to the rate of increase in the IST minus a productivity factor as established in the concession agreements; and
- 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, and taking into account time and distance. For these categories, each fee may individually exceed the rate of increase in the IST by up to 5%; however, the total adjustments in the basket of fees cannot exceed the rate of increase in the IST minus a productivity factor as established in the concession agreements. See “—Regulation of the Brazilian Telecommunications Industry.”

Our rates for international services are not subject to regulation and are not required to follow the price cap for annual rate adjustment described above for other services. Therefore, we are free to negotiate our fees for international calls based on the international telecommunications market, where our main competitor is Embratel.

### Local Rates

As of March 2007, the billing system for local calls was converted to a per-minute system and the previous pulse system was discontinued. The conversion of pulses to minutes occurred gradually, between the months of March and July of 2007. As of August 1, 2007, all of the customers of the Company had their local calls billed in minutes.

Our revenue from local service consists principally of activation charges, monthly subscription charges, measured traffic charges and public telephone charges. Users of measured traffic, both residential and non-residential, paid for local calls depending on usage, which until July was measured in pulses and from then on has been measured in minutes. The first minute is accounted for at the moment a call is connected to its destination.

Under current ANATEL regulations, residential customers who sign up for the basic plan monthly fee receive an allowance of 200 minutes per month.

Our local concession contracts set forth two mandatory plans for local fixed service, and allow for the concession company to design other alternative pricing plans of its own. Customers will have a choice between the two mandatory plans, any other alternative plan or a combination of basic and alternative plans. The main differences between the two main mandatory plans are as follows:

- Local Basic Plan: for clients that make mostly short duration calls (up to three minutes), during regular hours; and
- Mandatory Alternative Plan (PASOO): for clients that make mostly longer duration calls (above three minutes), during regular hours and/or that use the line for dial-up service to the Internet.

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The following table outlines the basic billing requirements and rates for the local Basic Plan and the Mandatory Alternative Plan:

CHARACTERISTICS OF PLAN	BASIC PLAN	MANDATORY ALTERNATIVE PLAN
Monthly Basic Assignment		
Allowance (minutes included in the Residential Assignment)	200 minutes	400 minutes
Commercial Assignment		
Allowance (minutes included in the Commercial Assignment)	150 minutes	360 minutes
Local Call Charges		
Regular Hours		
Completing the call (minutes deducted from the allotment)	-	4 minutes
Completing the call after the terms of the allotment		
Sector 31	-	R\$0.15596
Sector 34	-	R\$0.15192
Sector 32	-	R\$0.16365
Local Minutes - charges in excess use of the allotment		
Sector 31	R\$0.10158	R\$0.03899
Sector 34	R\$0.10158	R\$0.03798
Sector 32	R\$0.10158	R\$0.04091
Minimum time billing	30 seconds	-
Reduced Hours		
Charge per answered call (minutes deducted from allotment)	2 minutes	4 minutes
Charge per answered call after the allotted duration		
Sector 31	R\$0.20316	R\$0.15596
Sector 34	R\$0.20316	R\$0.15192
Sector 32	R\$0.20316	R\$0.16365

The fees for Local Basic Plan Service were approved by ANATEL's Act No. 5,180 of September 11, 2009. The Alternative Plan under Mandatory Service Provisions (Oferta Obrigatória) (PASOO) was approved by Resolution No. 450, on December 7, 2006, being that the readjustment of the tariffs follows the same rule established for the local basic plan.

Besides the Basic Service Plans, Telesp may offer alternative plans with any pricing design it chooses. However, ANATEL must be notified of these alternative plans prior to publishing and implementing of any such plan.

On September 11, 2009, ANATEL's Act No. 5,180 approved new local tariffs for our areas of concession, to take effect as of September 16, 2009. The average readjustment in the local service basket was 0.9767%. The tariffs were applied to customers as demonstrated below:

- Residential customers were charged a monthly subscription fee for the provision of service of R\$40.35;
- Commercial clients and non-residential customers (PBX) were charged a monthly subscription fee for the provision of service of R\$69.22 in Sector 31, R\$67.38 in Sector 34 and R\$64.30 in Sector 32;
  - Local minute tariffs were charged R\$0.10158 per minute to Sectors 31, 32 and 34; and
- Activation fees were charged R\$113.53 in Sector 31, R\$93.44 in Sector 34 and R\$60.63 in Sector 32.



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### 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 license 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, as a concessionaire, 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 (Brazil Telecom's concession region). However, our authorization 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 in Region III and authorization 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 have developed alternative rate plans for our residential and corporate customers.

### 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. 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 fee below the price cap, it must offer the same fee to any other requesting party on a non-discriminatory basis. If the parties cannot reach an agreement on the terms of interconnection, including the interconnection fee, 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 fees:

- Fee 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

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charge local service providers a fee for traffic that exceeds 55% of the total local traffic between the two service providers.

- Fee for the use of our long-distance network—We charge the service providers a network usage charge on a per-minute basis only when the interconnection access to our long-distance network is in use.
- Fee for the rental of certain transmission facilities used by another service provider in order to place a call.

Beginning in 2006, with the 20-year renewal of the concession contracts, the rules in respect of local network fees, or TU-RL, were changed. Beginning on January 1, 2008, local network fees were supposed to be calculated based on a long-term cost model (LRIC—Long Run Incremental Costs).

Through Resolution No. 464, published on April 27, 2007, ANATEL postponed the adoption of the LRIC model to April 30, 2009. Nevertheless, ANATEL is still working on the necessary studies to implement this cost model, as this model is part of its General Plan for Updating the Telecommunications Regulations in Brazil, published on November 12, 2008.

On February 8, 2007, ANATEL published Resolution No. 458, that approved the regulation of payment for interconnection for STFC. Through this regulation, ANATEL established, as the transition rule until the LRIC model becomes effective, that the value TU-RL stays limited to 40% of the local minute value.

In the same way, Resolution No. 458 established that the transition rule for the inter-city network tariff TU-RIU will remain in effect until the LRIC model becomes effective, and further determined that the value of TU-RIU is limited to 30% of the long distance minute value of Class 4, which is the class of calls of the longest distance established by ANATEL.

Cellular telecommunications services in Brazil, unlike those in the United States, are 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 mobiles outside the registration area, but within the mobile authorization area, are charged at a higher rate, “VC2.” Calls to mobiles outside the mobile authorization area are billed at the highest rate, “VC3.” When a fixed-line service customer calls a mobile subscriber, we charge the fixed-line service customer 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.

## Data Transmission Rates

We receive revenues from charges for data transmission, which include “Speedy,” the rental of dedicated analog and digital lines for privately leased circuits to corporations and others that were provided by Telesp and Telefonica Data. See “—A. History and Development of the Company—Historical Background—The Spin-off of Certain Data Transmission

Operations” and “—A. History and Development of the Company—Historical Background—The SCM Restructuring.”

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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 3.65% to 9.25% (on a non-cumulative basis). However, revenues related to, among other things, equity, dividends and fixed asset sales, are not subject to PIS and COFINS, except for revenues relating to 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. Contributions to FUST by all telecommunications services companies began in January 2001, at the rate of 1% of net operating telecommunications services revenue (except for interconnection revenues), 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. Contributions to FUNTTEL by all telecommunications services companies began in March 2001, at the rate of 0.5% of net operating telecommunications services revenue (except interconnection revenues), and it may not be passed on to customers.

We must also pay a contribution to the Fund for Telecommunications Regulation—“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 charge, 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

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 16 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

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various banks and other collection agencies (including lottery-playing facilities, drugstores and supermarkets) either by debiting the customer's checking account, by direct payment to a bank or through the Internet.

In accordance with the Brazilian telecommunications regulations, we use a billing method called "co-billing." This method allows billing from other phone service providers to be included within our own invoice. Our customers can receive and subsequently pay all of their bills (including the fees for the use of services of another telephone service provider) by using one invoice. To allow for this method of billing, we provide billing and collection services to other telephone service companies and have developed a special system for such bills. We have co-billing agreements ("co-billing in") with Intelig, Embratel, Telemar/TNL, GVT, CTBC Telecom, IP Corp, Brasil Telecom and Convergia, each of which provides fixed-line services, and with TIM, which provides mobile services. Similarly, we use the same method of co-billing to bill charges for our services on the invoices of other telephone service providers. We have co-billing agreements of this nature ("co-billing out") with Telemar, CTBC Telecom, Brasil Telecom, Sercomtel, GVT and Embratel, each of which provides fixed-line services, and with Oi, Tim, Sercomtel Celular, CTBC Celular, Brasil Telecom Celular, VIVO and Claro, each of which provides mobile services.

ANATEL regulations allow us to prevent a customer from making outgoing calls after a receivable has been outstanding for 30 days—a partial block—or prevent 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. During 2009, the monthly average of partial blocks was 884,750 telephone lines and the monthly average of total blocks was 156,009 telephone lines. On December 31, 2009, 10.2% of all receivables had been outstanding between 30 and 90 days, and 40.3% 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."

We continue working on improving the system to control the revenue chain. This control is important for continual improvements in our billing and collections processes, as well as for the assurance of the non occurrence of losses in the implementation of new systems and in roll-outs. The actions are followed closely by our Revenue Assurance Team, which measures every risk of loss of revenue detected along the billing and collection chain. These risks are managed to minimize revenue losses.

### Network and Facilities

Our network consists of an access layer, that connects our clients to our central switching voice and data hubs, and a network transport layer for managing client concentration, which also connects our clients to our central hubs. These central hubs are interconnected locally or remotely through transmission equipment, which forms a layer of network services that interconnect with other operators. Local transmission is provided through fiber-optic and metallic trunk lines. Intraregional long-distance transmission is provided by fiber-optic cable or by a microwave network. Our network strategy is to develop a broadband integrated network that is compatible with several types of telecommunications services and multimedia applications.

As a telecommunication service provider, we do not manufacture equipment for the construction of our networks and facilities. We buy the equipment from qualified suppliers and through this equipment we mount our networks and facilities through which we supply our services. The following table sets forth selected information about our network in aggregate, at the dates and for the years indicated:

	At and for Year ended December 31,				
	2009	2008	2007	2006	2005
Installed access lines (millions)	14.5	14.7	14.6	14.4	14.3
Access lines in service (millions) (1)	11.3	11.7	12.0	12.1	12.3
Average access lines in service (millions)	11.5	11.8	12.0	12.3	12.4

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Access lines in service per 100 inhabitants	27.1	28.7	29.1	29.9	30.9
Percentage of installed access lines connected to digital switches	100.0	100.0	100.0	100.0	100.0
Employees per 1,000 access lines installed	0.5	0.6	0.5	0.6	0.5
Number of public telephones (thousands)	250.5	250.3	250.3	250.3	331.5
Registered local call minutes (billions)	51.5	51.8	54.5	n.a.	n.a.



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	At and for Year ended December 31,				
	2009	2008	2007	2006	2005
Domestic long-distance call billed minutes (billions)	10.7	11.8	11.9	13.0	14.1
International call billed minutes (millions)	63.8	84.7	88.1	94.7	104.9
Broadband services (ADSL) (millions)	2.6	2.5	2.0	1.6	1.2

(1) Data includes public telephone lines.

### Technology

In order to offer a greater quantity of integrated services, we have incorporated a series of new technologies in our voice and data networks, the most prominent being IP/MPLS Multiservices networks supported by the IP/MPLS platform.

The IP/MPLS platform allows us to offer internet connection solutions to business clients at speeds that vary from 64Kbps to 10Gbps, as well as to forward the traffic of all Speedy clients.

This platform is directly connected to the main Brazilian internet providers and telecommunication companies through the network of Telefonica International Wholesale Services, or TIWS, via redundancy connections made by sub-sea cables. These characteristics provide our clients with high quality services and short delays in their internet connections.

Additionally, we have name solution centers (DNS — Domain Name System) strategically positioned in the platform, which guarantee a quick name solution to our internet services clients. These centers transform the internet addresses typed by residential and business clients into IP addresses guaranteeing the correct transmission of data to the internet.

We provide the IP/MPLS network to our business clients offering advanced connection solutions to small, medium and large companies (Private Virtual Networks — VPN). This network has mechanisms of quality assurance for all applications (Qos – Quality of Service) as well as applications for voice, video and data convergence. We also offer connectivity solutions to business clients through a network based on Frame-Relay and ATM technologies.

In the telephonic segment we have created a network of the latest generation that allows for transportation of multiple media over IP Protocol that supports a diversified portfolio of products and services for clients.

Other top technologies in the segments of access (fiber-optic cables running to the client's home, Wi-Fi), transmittal (Metroethernet) and service platforms (flexible billing plans, prepaid) are being implemented which will allow Telesp to offer, in the short term, voice, video and data services in an integrated form, encompassing all the segments of the market. This convergent network will allow for increased offerings for our clients and a reduction in operational costs centralizing information into fewer elements.

In the residential segment, since 1999, we have been heavily investing in offering broadband access through an asymmetric digital subscriber line, or ADSL, technology under the brand "Speedy." This technology provides high-speed Internet access through regular telephone lines. In 2007, we initiated the implementation of the FTTx network (available through fiber-optic cables running to the subscriber's home – GPON technology) with a coverage of 371K Home Passed, offered within a range of different speeds up to 30 Mbps, and IPTV high definition service (HDTV). In December 2009, we surpassed the mark of 2,553 million broadband clients connected in service, 65% of which had speeds equal to or greater than 2Mbps. To reach this number of clients, we constantly search for market

differentials such as new integrated services, speed upgrades and servicing of new localities, among others.

We offer the IPTV service through a partnership with TVA through the FTTx network and Telesp Plataform. In 2010, we will improve Telesp Plataform aiming to increase its competition in the market. This platform consists of pay TV with video broadcast offered through the use of the IP protocol. The offering of such technologically advanced services is only made possible due to our partnership with TVA, a recognized provider of pay TV

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services. Additional services, such as pay-per-view and “video on demand” (“VOD”), are also available. Furthermore Telefônica’s network contains space for the recording of programs or local recordings in the Set Top Box (“STB”), and in the future, third-party content providers will be able to offer games and connectivity services.

We also offer digital television service via satellite (DTH) to the subscribers in the State of São Paulo (and in the future, all of Brazil) that receive broadcast/PPV content through a Ku band antenna and Set Top Box (with Smart Card). As of December 31, 2009, we surpassed the mark of 300,000 subscribers in service. In 2010, we foresee the expansion of coverage of local channels with high penetration in their geographical markets. We will also improve the content protection system in 2010, aiming to reduce the possibility of undesired access to the distributed content.

Our development plan contemplates the use of the most advanced technology available, focusing on integration with the Internet and an increase in the number of multimedia transmission services, with emphasis beyond ADSL investments in FTTx (GPON), NGN, DWDM and re-transmittal technologies of TV over IP protocol (IPTV) and satellite (DTH).

Currently, 100% of our network is digital.

## Competition

We currently face strong competition in the corporate and premium residential segments in respect of 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 customer migration and the need for greater discounts to maximize client retention.

Our main competitors in the corporate segment are Oi (formerly Telemar), Intelig, Teléfonos de México, S.A. de C.V. (“Telmex”) through Embratel and GVT a “mirror” operator (operators with certain restrictions set forth by ANATEL during the privatization process) in Region II, which has been acquired by Vivendi in November 2009. Our competitors employ varying strategies in an effort to gain market share. For example, Embratel has sought to expand its presence by consolidating a large portfolio of companies, making direct sales and improving customer service. New market entrants Oi and GVT have focused their emphasis on larger corporate clients. Our market strategy in this sector is based on offering bundled products (voice, broadband and hardware) and on improving our customer service.

In the high-income residential service segment, we compete in fixed voice and long-distance services with Telmex (Embratel) and in broadband and pay TV services with the pay TV provider NET Serviços de Comunicação S.A. 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 in-network mobile-to-mobile calls. Such competition increases our advertising and marketing costs. We are taking several steps to defend ourselves from increasing competition. In this customer segment we are focused on improving our voice, broadband and pay TV offerings by developing our products toward specifically defined market segments to remain competitive with new products offered by our competitors.

There are five mobile service operators in our region, two of which began operating in São Paulo in the second half of 2008. In March, 2007, ANATEL granted UniceL a license to offer mobile telephone services in São Paulo. Beginning in August 2008, UniceL began offering mobile telephone services in the city of São Paulo and in 63 of the municipalities of the State of São Paulo under the brand AEIOU. In September 2007, Oi obtained a SMP authorization from ANATEL through a public bidding process. In November 2008, Oi began offering mobile telephone services in the State of São Paulo. We expect that the entry of AEIOU and Oi in the mobile telecommunications market in São Paulo will increase downward pressure on the prices for mobile telephone services in the state, contributing to further migration of users from fixed-line to mobile telephone service.

The five mobile service operators in the State of São Paulo include:

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- Vivo (formerly Telesp Celular), which was the incumbent mobile telephone provider in the State of São Paulo 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 service 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 subsidiary Telmex;
  - TIM, controlled by Telecom Italia, which began operations in October 2002;
- Oi (formerly Telemar), which was the incumbent fixed-line telephone operator in Region I under the General Plan of Grants and which entered the São Paulo mobile telecommunications market following the acquisition of a 3G license in September 2007; and
- AEIOU (formerly Unicef), which obtained a mobile telephone services license in March 2007 to operate in the city of São Paulo and 63 other municipalities in the region and began operating in August 2008, focusing primarily on providing services to a younger demographic, offering lower rates, pre-paid service and distinguishing itself by the absence of physical stores (all sales are made through the Internet).

In 2009, we continued to see a slight decline in the number of fixed-line customers, in part as a result of increased competition. In an effort to maintain the attractiveness of fixed-line telecommunications service, we have created product offerings customized to different customer segments. For example, in the low-income, local fixed telecommunications segment, we face less direct competition due to the low profitability of this market. However, we do face more significant competition from prepaid cellular telecommunications providers in this segment. Such services are relatively profitable because of the high fees generated through the interconnection of fixed and cellular networks. To address indirect competition from prepaid cellular telecommunications providers in the low-income customer segment, we offer low-cost, pre-paid fixed-line service, which we believe helps prevent migration of these customers from fixed-line service to mobile service.

We have also sought to protect our voice services offerings by increasing our offerings of “Minute Packages” and by including bundling offers with Speedy and pay TV. We have enhanced the attractiveness of our voice services through the increase of packages, mainly through the offer of flat rates in the “Fale e Navegue a Vontade” voice plan, that allows unlimited on-net local calling and internet dialing.

In addition to traditional telephone services, we continue to develop our product offerings by expanding our offerings in related market sectors, particularly those with greater potential for future growth, such as broadband Internet services, pay TV, and information technology services.

With respect to our broadband Internet offerings, in spite of increased competition in the broadband Internet market, Speedy has maintained its position as a market leader, with more than 2,6 million customers as of December 31, 2009. In addition to the voice and data bundling services previously mentioned, we have been actively pursuing additional market strategies to maintain this position, including the launch of high speed broadband services (up to 30 Mbps) in addition to expanding our offering of 2 Mbps services to the majority of our customer base.

We believe we made substantial advances in the pay TV market in 2009 by expanding our range of available programming, leading to increased subscription, with over 487 thousand clients as of December 31, 2009.

At the end of 2009, there were approximately 43 million mobile phones in the State of São Paulo (out of approximately 170 million in Brazil). Operators such as the subsidiaries of America Móvil operating under the brand name Claro and Embratel, controlled by Carso Telecom Group, launched combination offerings in 2006 involving fixed-line and mobile services. Other integrated groups, such as Oi (formerly Telemar) and Brasil Telecom and its cellular company “BrT GSM,” have also launched offers incorporating the use of fixed telephones and mobile phones, though such offerings have not yet been launched in the São Paulo market despite the pressure of Oi in the

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mobile market. We are also offering combinations of services for our customers with “Vivo,” one of the mobile companies affiliated with the Telefônica group.

In 2009, we continued strengthening our position in the corporate market as a provider of complete information technology infrastructure solutions customized to individual clients from which we receive monthly rental payments. As part of this new product offering, we provide “work stations” to our large business clients and “information stations” for small and medium business clients, packaging hardware, voice, data, internet, and network servicing solutions in one convenient bundle.

Additionally, we launched the “At Home” service, a residential automation service, which is a solution that provides integration and digital control to residences (lighting, entertainment, security, conditioning and communication) and Orby (smartphone with touch screen that allows Internet access and use of VoIP).

Finally, we believe our relationships with our customers are the foundation upon which our business is built, and in 2009 we made important advancements in improving our customer relations. We launched the “Telefônica em Ação” program in order to make structural changes in the services we offer. The program directed investments in infrastructure improvements focusing on increased quality standards.

In addition, we restructured our call centers and adapted our internal customer relations procedures with the goal of offering a higher level of customer service at all points of communication with our customers. The results of the program were excellent as reflected in the higher levels of customers satisfaction.

### Sales, Marketing and Customer Service

#### Sales

We employ the following different approaches to deliver our solutions to customers:

- Person-to-person sales: our business management team offers customized sales services to preserve customer loyalty, customized consulting telecommunication and IT services and technical and commercial support;
  - Telesales: sales through telemarketing call centers employing highly trained sales associates;
- Indirect channels: outsourced sales—by certified companies in the telecommunications and data processing segments—to provide an adequately sized network for our products and services;
- Internet: “Portal Telefônica,” with on-line information on our products and services specifically targeted toward our corporate clients; in 2009, we started to sell some of our “Portal Telefônica” services and products through chat, employing highly trained partners; and
- Door-to-Door: in order to approach more Telefônica corporate clients, in March 2006, we launched door-to-door sales of services by consultants in the State of São Paulo.

#### Marketing

We continuously monitor market trends in an effort to develop new products and services that may address future needs and tendencies of our customers.

We increased the number of developed packaged products customized to meet the market needs, bundling voice and data services, digital telephone, minutes packages, information systems and improved connectivity in response to a growing demand from our clients. We believe that the trend toward bundled offers will continue to grow, and developing such offers will be important to maintain our competitiveness in the market.

We employ a different approach to marketing whereby we use a mix of human and technological resources (a specialized team and business intelligence tools, respectively), in addition to specific studies that allow us to target each market segment according to the relevant customer's specific needs.



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We believe that the brand strength of Telefónica (the brand under which we offer our services) and its customer service, marketing and communication efforts will produce new business opportunities and attain and preserve customer loyalty.

## Customer Service

Our principles of corporate operations state that we must always offer our clients innovative and trustworthy products and services of high quality and at reasonable prices. We continually improve the quality of our products and services through the modernization of our telecommunications platform and its management systems, as well as its operational support management systems, and an organizational structure with as few levels as possible, bringing the company closer to the customers. The following table sets forth information on service quality for the periods indicated.

	Year ended December 31,		
	2009	2008	2007
Repair requests of traditional telephones (% requests for repairs of traditional lines/lines in service)	1.4	1.3	1.4
Repair requests of public telephones (% requests for repairs of public lines/lines in service)	4.8	5.0	6.2
Call completion local rate during the peak night period (% local calls attempted and completed/total local calls attempted)	74.6	75.0	75.3
Call completion national long-distance rate during the peak night period (% long-distance calls attempted and completed/total long distance calls attempted)	71.3	71.1	71.1
Billing complaints (complaints per 1,000 bills)	1.7	1.8	2.6

Under Brazilian telecommunications regulations, our concession and authorization contracts for providing services (fixed commuted, communication and multimedia telephone and pay TV) contain required targets that must be reached with respect to the quality of services that apply to access times for special service codes, response times for requested information for access codes, national and international call completions, repair requests, fulfillment of repair requests, fulfillment of address change requests and the quality of billing documents.

In June 2009, ANATEL suspended sales of our broadband service Speedy due to certain problems with the quality of the services provided. Sales resumed in August, as authorized by ANATEL after our implementation of a remediation and stabilization plan.

Service quality improvements were focused on investments in our broadband network and in rebuilding our commercial and operating practices. The key measures in the stabilization and growth of broadband network capacity were as follows:

- Doubled the resolution capacity of DNS servers, increasing redundancy and contingency by increasing the DNS centers;
- Increased the capacity of international internet access (toll-gate) and the adoption of a third access to increase redundancy;
- Increased the interconnection protocol for sub-networks (IP) platform.

We also rebuilt our customers services center, aiming to meet our targets to continuously improve services to our clients and comply with two new features in our business, namely the Number Portability and the “Lei do SAC”. In order to achieve this goal we invested in:

- Customer service team training, in an effort to train more than 4,000 people;
- Investments in new equipments and technology.

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The results were favorable as our customer service improved its capacity to help clients within just one call and the total number of calls to customers service decreased by 52.3% between the first quarter of 2009 and the last quarter of 2009.

We also implemented changes in the sales strategy. We now audit all sales of broadband services and ensure that clients are aware of the characteristics of the services purchased, such as speed, installation terms and technical requirements for installation.

In order to continue improving the quality of our services, we have undertaken several measures to guarantee customer satisfaction, including:

- Increased emphasis by the management on product and service quality and on customer satisfaction with weekly meetings attended by our senior officers;
- Broadening the scope of customer satisfaction surveys conducted each month for each customer segment among residential, small business and corporate (large companies). In addition to customer satisfaction, the surveys evaluate customer loyalty and our corporate image;
- Analyses of satisfaction surveys: identification of the critical factors for customers and main points for improvement and analysis of the correlation of the results of the satisfaction surveys with the operational indicators of the company;
- Maintaining an increased emphasis on programs and projects focused on customer satisfaction, oriented toward and prioritized on customer satisfaction survey results together with internal evaluation and evaluation by outside consultants to help focus on action items of primary importance to customers;
- Reviewing customers support processes, aiming to increase the support capacity and solve issues raised by clients;
- Broad review of the broadband technical assistance processes in order to decrease the repair period and increase the level of successful solutions;
- Implementation of processes aimed at reducing billing errors and technical problems for fixed-line and broadband service;
- Maintenance and review of quality controls and objectives designed from the customer's perspective, which establish internal service levels among business areas and support areas (network and system facilities).

## 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. Our companies that operate under a concession are authorized to provide specified services and have 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 in October 1997. ANATEL is administratively and financially independent of 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.

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Concessions and Authorizations

Concessions are licenses to provide telecommunications services that are granted under the public regime, while authorizations are licenses to provide telecommunications services granted under the private regime.

Companies that provide services under the public regime, known as the concessionary 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 authorized companies, are generally not subject to the same requirements regarding continuity or universality of service; however, they may be 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, Oi, CTBC Telecom and Sercomtel. 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 agreements for the local, intraregional and interregional long-distance services, were extended on December 22, 2005, for an additional period of 20 years.

The current concession agreements contain a provision allowing for ANATEL to review the concession terms in 2010, 2015 and 2020. This provision permits ANATEL to update the renewed concession agreements 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. A Public Notice (consulta pública) was published on March 31, 2009 with the proposed revisions to the concession contracts. Related public meetings (audiências públicas) were held in Manaus, Salvador, São Paulo, Brasília, Florianópolis and Rio de Janeiro in May 2009.

ANATEL is currently analyzing the suggestions received to the Public Notice and it may vote on the final version of the concession agreements during 2010. The revised concession agreements will become effective as of January 1, 2011.

Under the renewed concession agreements and during the 20-year renewal period, we are required to pay a biennial 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 current concession agreements, as well as current obligations under the existing concession agreements, may impact our business plan and results of operations.

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.”

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Since 2002 we 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.

### Obligations of Telecommunications Companies

We and other telecommunications service providers are subject to obligations concerning quality of service, network expansion and modernization. The concession telecommunication 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.

In 2008, the presidential decree published with the General Plan of Grants increased the flexibility of telecommunications provider groups as STFC concessionaires by allowing such providers to provide services in up to two General Plan of Grants regions. Prior to this decree, telecommunications provider groups holding STFC concessions could offer STFC services in only one region under the public regime.

### Public Regime Service Restrictions

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 shares in any other public regime company, unless previously approved by ANATEL, according to ANATEL's Resolution 101/99;
- a prohibition on public regime companies to provide similar services through related companies; and
- various restrictions on the offering of cable television by concessionary companies.

### Network Expansion and Quality of Service

We are subject to the General Plan for Universal Service Targets (Plano Geral de Metas para a Universalização) and the General Plan for Quality Targets (Plano Geral de Metas de Qualidade), 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.

The decree altering the General Plan for Universal Service Targets rescinded in 2008 the obligation of telecommunications concessionaires to install telecommunications service centers (providing calling and data access to walk-in customers) and substituted such obligation with an obligation to roll out broadband network infrastructure throughout the municipalities serviced by such concessionaires. According to this decree, all municipalities in Brazil are expected to have the necessary infrastructure for broadband networking by 2010. This obligation will require us to roll out network infrastructure to 257 of the 622 municipalities in our concession region. Going forward, this regulation will require us to expand our network throughout substantially all of our concession region. As of December 31, 2009, we have installed network infrastructure in 226 out of the 257 cities in which we are required to make these installations.

Moreover, we have, as have other telecommunications concessionaires, committed to provide free internet access to public schools during the term of our concession grant (until 2025). This will require us to connect approximately 9,200 schools in our concession region by the end of 2010, besides roughly 3,000 other schools that were included according to the new school census of INEP/MEC.

If a public regime company does not fulfill its obligations under the General Plan for Universal Services and the General Plan for Quality Targets, there are various monetary penalties that may be imposed by ANATEL. A company may lose its license if ANATEL considers it incapable of providing basic services under the two General Plans.



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### Interconnection

In compliance with resolution 458 of February 2007, new rules for interconnection fees were introduced. The interconnection fee for off-peak hours was reduced by 30% and it was indicated that the use of the LRIC long-term cost-based model for determining interconnection fee values will be implemented after 2009.

### C. Organizational Structure

On December 31, 2009, our voting shares were controlled by two major shareholders: SP Telecomunicações Participações Ltda. with 50.71% and Telefônica Internacional S/A with 34.87%. Telefônica Internacional is the controlling shareholder of SP Telecomunicações and, consequently, holds directly and indirectly 85.57% of our common shares and 89.13% of our preferred shares. Telefônica Internacional is a wholly-owned subsidiary of Telefônica, S.A. of Spain.

### Subsidiaries

A. Telecom S.A. (formerly Assist Telefônica) is our wholly-owned subsidiary. A. Telecom was incorporated in Brazil on October 29, 1999, and it is engaged primarily in providing telecommunications and data services and internal telephone network maintenance for customers. The principal services are as follows: (i) digital condominium which is a value-added service for commercial buildings, integrated solution for equipments and services for voice transmission, data and images on commercial buildings under a Building Local Exchange Carrier (“BLEC”) model; (ii) installation, maintenance, exchange and extension of new points of internal telephony wire in companies and dwellings under a basic plan of maintenance (BPM) and (iii) provision of 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 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. On March 1, 2006 then-subsiary Santo Genovese Participações Ltda., having merged into its subsidiary Atrium Telecomunicações Ltda., was acquired by A. Telecom S.A. and ceased to exist. A. Telecom remained a wholly-owned subsidiary of Telesp, and began carrying out the activities formerly performed by Atrium. See “—B. Business Overview—Services.”

From the second half of 2006, A. Telecom began providing pay TV services, fully focusing on the development of this new product line. In February 2008, A. Telecom became an owned subsidiary of Telefônica Televisão Participações S.A. (TTP). In November 2008, TTP was merged into Telesp and A. Telecom became a wholly owned subsidiary of Telesp. See “—A. History and Development of the Company—Historical Background—Corporate Reorganization involving DABR and TTP.”

Telefônica Data S.A.’s business purpose is to render telecommunications services such as the development, implementation and installation of projects related to integrated business solutions and telecommunications consulting, as well as activities related to the rendering of technical assistance and equipment and telecommunications network maintenance services. Telefônica Empresas, currently (“Telefônica Data”), became a wholly-owned subsidiary of the Company after the corporate reorganization that was carried out in July 2006. See “—A. History and Development of the Company—Historical Background—The SCM Restructuring.” In July 2008, Telefônica Data became a wholly owned subsidiary of TTP. In November 2008, TTP was merged into Telesp and Telefônica Data became a wholly owned subsidiary of Telesp. See “—A. History and Development of the Company—Historical Background—Corporate Reorganization involving DABR and TTP.”

Telefônica Sistema de Televisão S.A. (“TST”) is a company that provides pay television services through the Multipoint Multichannel Distribution Services (“MMDS”) modality.

#### Associated Companies

Since June 30, 2000, we have consolidated, under the Brazilian 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, 2009, we held a 50% share ownership and Telefónica S.A. held the remaining 50%.

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Furthermore, since December 31, 2003, we have also consolidated, under the Brazilian Corporate Law Method, our investment under proportional consolidation in Companhia AIX de Participações, or AIX. At December 31, 2009, 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 fiber-optic. See Note 1 to the consolidated financial statements included in this Annual Report starting at page F-1. We also consolidate, as required under the Brazilian Corporate Law Method, Companhia ACT de Participações, in which we hold a 50% interest.

### D. Property, Plants and Equipment

Our main physical properties for providing the Company's services involve the segments of switching (public switching telephone network-PSTN), transmission (optic and wireless systems), data communication (multiplex devices, IP network), infrastructure (Energy systems and air conditioned) and external Network (fiber-optic and metallic cables), which are distributed in many buildings in the State of São Paulo and in the main cities out of the State of São Paulo. Some of these buildings are also used in administrative and commercial areas.

Our properties are located throughout the State of São Paulo. At December 31, 2009, we used 2,105 properties in our operations, 1,438 of which we own, and we have entered 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.

As of December 31, 2009, property related to construction in progress represented 5.9% of the net book value of our total fixed assets, automatic switching equipment represented 24.7%, transmission and other equipment represented 33.5%, underground and marine cables, poles and towers represented 2.2%, subscriber and public booth equipment represented 4.6%, electronic data process equipment represented 1.3%, buildings and underground equipment represented 25.0%, land represented 2.3%, and other assets represented 0.5% of total fixed assets. As of December 31, 2009, the net book value of our property, plant and equipment was R\$9.7 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. Financial Information—A. Consolidated Statements and Other Financial Information—Legal Proceedings."

### ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

### 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 information included under "Item 3. Key Information—A. Selected Financial Data." Except as otherwise indicated, all financial information in this annual report has been prepared in accordance with the Brazilian Corporate Law 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 Brazilian Corporate Law.

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 has experienced moderate growth this decade. According to the IBGE which uses the new methodology of national accounts, Brazil's GDP expanded 5.7% in 2004, 3.2% in 2005, 4.0% in 2006, 5.7% in 2007, and 5.1% in 2008. In 2009, Brazil's GDP decreased 0.2%.

Consumer prices, as measured by the Consumer Price Index, or the IPCA, published by the IBGE, registered a variation of 4.3% in 2009. Accordingly, growth in consumer prices was below the inflation target established by the Central Bank of 4.5%. In 2006, 2007 and 2008, the variation had been of 3.1%, 4.5% and 5.9%, respectively. Inflation, as measured by the General Price Index, or the IGP-DI, calculated by the Fundação Getúlio Vargas, which includes wholesale, retail and home-building prices, decreased 1.43% in 2009, compared to increases of 9.1% in 2008, 7.9% in 2007 and 3.8% in 2006.

As a result of the deceleration of increasing inflation and of the economic activity, the Central Bank decreased interest rates during 2009, and as a result, the Selic rate decreased from 13.75% to 8.75%, which is the lowest level since the creation of the inflation target system in 1999.

Brazil finished 2009 with a trade balance surplus of US\$25.3 billion, compared to US\$24.8 billion in 2008. Exports went down by 22.7% to US\$153.0 billion, while imports decreased by 26.3% to US\$127.6 billion. Financial inflows into the country decreased significantly, with foreign direct investments of US\$25.9 billion, compared to US\$45.1 billion in 2008. Portfolio investments increased by US\$46.7 billion in 2009, in comparison to the increase of US\$6.3 billion in 2008. The good performance of external accounts allowed international reserves to increase by US\$32.2 billion to the record level of US\$239.1 billion.

The economic downturn and the reduction of taxes resulted in lower tax revenues which affected public finances and efforts to meet the target for primary surplus established at 3.8% of GDP. The target was revised to 2.5% during 2009. In addition, the Federal Government realized that the expenditures with the Growth Acceleration Program (Programa de Aceleração do Crescimento), or PAC, and the Investment Pilot Program (Programa Piloto de Investimento), or PPI, had not been included in the calculation of the primary surplus, resulting in an increase of expenses of 1.6% of the GDP. Considering the primary surplus of 2.1% of the GDP plus the expenditures with the PAC and the PPI programs, the revised target has been met. Net public debt, as a proportion of GDP, increased in 2009 to approximately 43.0% from 37.3% in 2008. The appreciation of the real in 2009 helped to increase the public debt. This was due, in part, to a higher level of international reserves accumulated by the country that was greater than the public debt, and Brazil's becoming an international creditor, rather than a debtor. Despite the increase in the public debt, Brazil's sovereign debt received investment grade rating from Moody's, reflecting the country's performance over the past years and its recovery from the global economic crisis.

The improvement in domestic economic data, such as inflation, external accounts, and interest rates, along with increased liquidity in the international capital markets led to a decrease in country risk in 2009. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI + Brazil), which tracks total returns for traded external debt instruments in the emerging markets, decreased to 197 basis points by the end of 2009 from 428 basis points at the end of 2008.

As a result, the real appreciated against the U.S. dollar by 25.9% in 2009. The exchange rate on December 31, 2009 was R\$1.74/US\$1.00. After the crisis in 2008, when the exchange rate reached R\$2.3/US\$1.00, the appreciation trend observed since 2004 arose as a consequence of the decrease in country risk. In the previous years, the exchange rate was R\$1.77 to US\$1.00 as of December 31, 2007 compared to R\$2.14 to US\$1.00 as of December 31, 2006 and R\$2.34 to US\$1.00 as of December 31, 2005. 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 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.

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## Impact of Inflation on Our Results of Operations

Prior to 2006, the fees we charged our customers were periodically adjusted by ANATEL based on the inflation rates measured by the General Price Index (IGP-DI).

Starting in 2006, telephone fees were indexed to the IST, which is a basket of national indexes that reflect the telecommunications sector's operating costs. Such indexing will thus reduce inconsistencies between revenues and costs in our industry and therefore reduce the adverse effects of inflation on our business. The IST for the last 12 months is 4.2% according to the last data published by ANATEL in June 2009.

The table below shows the Brazilian general price inflation (according to the IGP-DI, IPCA and the IST) for the years ended December 31, 2004 through 2009:

	Inflation Rate (%) as Measured by IGP-DI (1)	Inflation Rate (%) as Measured by IPCA (2)	Inflation Rate (%) as Measured by IST (3)
December 31, 2009	(1.4)	4.3	2.1
December 31, 2008	9.1	5.9	6.6
December 31, 2007	7.9	4.5	3.2
December 31, 2006	3.8	3.1	3.2
December 31, 2005	1.2	5.7	

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

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

(3) Source: IST, as published by the Agência Nacional de Telecomunicações.

## 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 adjustment;
- the granting of licenses to new competitors in our region; and
- the introduction of new or stricter requirements for our operating concession.

A series of new regulations became effective in 2009. The most important among these regulations were:

- Resolution No. 527, which approved the Rule for the Use of Broadband Radiofrequency through Electric Energy Networks;
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Resolution No. 529, which approved the Rule for Telecommunication Equipments Certification concerning Electric Safety Aspects;

- Resolution No. 532, which approved the Amendment to the IST Calculation Rule, applied in the Adjustment of the Fees Related to Telecommunication Services, revoking Resolution No. 420;
  - Resolution No. 534, which amended Annexes I and II of the Rule of Local Areas of the STFC;
  - Resolution No. 535, which approved the Rules for the Methodology to be Used in the WACC Calculation.

We expect the following issues to become effective as new regulations or to be subject of one or more Public Notices in 2010, with an exact timeline yet to be determined by ANATEL.



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- Proposals for new conditions and goals for quality and universal access to be included in the revision of concession contracts of STFC operators;
  - Creation of a General Quality Targets Plan for the SCM;
  - Proposals for the assignment of the 2.5 GHz bandwidth;
  - Announcement for bidding of licenses on the 3.5 GHz bandwidth;
- Development of a General Competition Plan that would regulate standards for service providers with significant market power.

Number portability came into effect in Brazil in September 2008. Number portability allows clients within a limited geographic locale to relocate or change their telephone operator without the need to change their telephone number (for either a fixed or mobile line). Number Portability rights for all of our clients became effective in March 2009.

In addition to regulatory considerations, our business is affected by competition from other telecommunications providers. We began to face competition in our region in July 1999, and we 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.

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 and corporate stakes in foreign companies.

On December 31, 2009, 0.7% of our R\$3.52 billion of indebtedness was denominated in foreign currencies, primarily in U.S. dollars. See Note 14 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 and corporate stakes in foreign companies.

We use derivative instruments to limit our exposure to exchange rate risk. Since September 1999, we have hedged virtually all of our foreign currency-denominated bank debt; using swaps. However, we remain exposed to market risk resulting 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 variable interest rates. On December 31, 2009, R\$1.99 billion of our indebtedness was subject to TJLP (a long term interest rate with a very low variation), R\$0.02 billion was subject to variation of the U.S. dollar and the balance was subject to variations in 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, 2009, we had swap transactions—CDI against fixed rates which totaled R\$1.51 billion 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 33 to the Consolidated Financial Statements and “Item 11—Quantitative and Qualitative Disclosures about Market Risk.”

Since we have foreign currency derivatives with notional amounts substantially equivalent to our borrowings denominated in foreign currency, we do not have material exchange rate exposure with respect to these contracts.

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However, we could still continue to have exchange rate exposure with respect to our planned capital expenditures, approximately 31% of which are made in foreign currencies (mostly U.S. dollars). We systematically monitor the amounts and time of exposure to exchange rate fluctuations and may contract for hedging positions, when appropriate, at our discretion.

### Discussion of Critical Accounting Estimates and Policies

The preparation of financial statements in accordance with Brazilian Corporate Law 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 presentation 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 methods used in the preparation of those statements and Note 4 includes a summary of the significant accounting policies. In order to provide an understanding of how we form the foregoing judgments and estimates, we have summarized certain critical accounting policies below.

### 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 assets are acquired and are based on historical experience with similar assets, as well as taking into account technological changes and public telecommunications service regulations. 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 an impairment loss to reflect the write-down in value of the assets. We review our goodwill and other indefinite lived intangibles for impairment losses annually, or together with other intangible assets and property, plant and equipment that have finite lives and are depreciated when events or circumstances indicate that the carrying amount may not be recoverable over the remaining lives of the assets. In assessing impairment losses, we employ the cash flow method, which takes into account management's estimates of future operations. See Notes 12 and 13 to the Consolidated Financial Statements.

As of December 31, 2009, we had R\$11.1 billion recorded as property, plant and equipment and intangible assets under the Brazilian Corporate Law, accounting for approximately 54.4% of our total assets.

### Goodwill Impairment

Under Brazilian Corporate Law, the amount of goodwill impairment, if any, is measured based on projections of our future operating cash flows. Under U.S. GAAP, goodwill is subject to a yearly impairment test. In performing the yearly impairment test, we identify our reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets. We then determine the fair value of each reporting unit and compare it to the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds the fair value of the reporting unit, we would be required to perform the second step of the impairment test that involves the determination of the implicit fair value of the goodwill in the reporting unit by performing a hypothetical purchase accounting calculation. If the implicated value of the goodwill exceeds its book value, an impairment is recognized.

A determination of the fair value and the undiscounted future operating cash flows of our business requires management to make certain assumptions and estimates with respect to projected cash inflows and outflows related to

future revenues, expenditures and expenses. These assumptions and estimates can be influenced by different external and internal factors, such as economic tendencies, industry trends, and interest rates, changes in our business strategies and changes in the type of services we offer to the market. The use of different assumptions and estimates could significantly change our financial statements. If assumptions and estimates about the expected future net cash flows change in the future, we may have to recognize impairment charges on goodwill, which would decrease our results of operations and shareholders' equity.

#### Revenue Recognition and Accounts Receivable

Under Brazilian Corporate Law 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 Brazilian Corporate Law and U.S. GAAP, revenues from public telephones are recognized at the time the prepaid phone card is used. For the year ended December 31, 2009, we had R\$386.6 million recorded as revenues from public telephone services under Brazilian Corporate Law. See Note 22 to our Consolidated Financial Statements. Deferred revenues are determined based on estimates of outstanding credits of prepaid phone cards that were sold but have not been used as of the date of each balance sheet. Under the Brazilian Corporate Law, 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 the estimated expected service period of the customer of 4.74 years.

In light of increasing competition in the telecommunications industry, we are increasingly offering bundled products and services to our customers. This practice does not allow for the exercise of judgments and estimates in determining the value of bundled products with respect to the various components of the bundled products in order to recognize revenue under US GAAP.

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

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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 Brazilian Corporate Law.

### 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. We also reassess whether we should recognize future revenue from such customers when collection is assured. 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. We recognized provisions for doubtful accounts of R\$565 million, R\$539 million, and R\$653 million for the years ended December 31, 2009, 2008 and 2007, respectively.

### 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 and we are able to reasonably estimate the expected loss. We have recorded no provisions for a number of significant tax disputes with the Brazilian tax authorities because we do not believe it is probable we will incur losses in connection therewith. Our required reserves for contingencies may change in the future based on 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 recognizing our net deferred tax assets, we imply that we will generate sufficient future taxable income in certain tax jurisdictions, based on estimates and assumptions to realize the benefits of such assets, 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 recognize 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, 2009, we did not believe an additional provision to offset our net deferred tax assets was required

beyond those recognized in the financial statements.

#### 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 Brazilian Corporate Law, as of January 1, 2009, foreign currency swap agreements are recorded at fair value. For the year ended December 31, 2009, we recognized net gains of R\$58.2 million (net losses

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of R\$153.4 million in 2008) on our derivative transactions, assets of R\$0.6 million and liabilities of R\$31.7 million as of December 31, 2009 (assets of R\$95.8 and liabilities of R\$37.3 million as of December 31, 2008) in order to recognize existing temporary gains or losses. The gains or losses on hedge transactions were calculated based on the fair value of the derivative financial instruments.

We apply ASC 815, "Derivatives and Hedging," under U.S. GAAP. According to ASC 815, 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 or losses. Portions of changes in the fair value related to ineffective cash flow hedges are immediately recognized in earnings of the period.

On December 31, 2009, we had US\$8.5 million of notional value swap contracts designated as fair value hedges of a portion of our foreign currency-denominated bank debt. Under U.S. GAAP, we had no hedge accounting derivative instrument which resulted in an increase of R\$0.73 million in our indebtedness as of December 31, 2009 (compared to a decrease of R\$2.5 million for the period ended December 31, 2008). Under U.S. GAAP, we recognized a gain of R\$11.0 million for the period ending December 31, 2009 for such transactions (compared to R\$3.5 million for the period ended December 31, 2008).

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 operating 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.

### Adoption of IFRS in Brazil

The Brazilian securities regulator, the Comissão de Valores Mobiliários (locally CVM) has determined that IFRS, as issued by IASB, should be used for consolidated financial statements of public companies from 2010 onwards. The local standards are issued by Comitê de Pronunciamentos Contábeis (locally CPC), a Brazilian accounting standard setter. Both public and non-public are currently required to prepare their financial statements in accordance with local standards which are similar to IFRS.

Furthermore, for the year to be ended December 31, 2010, we will present our consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB). As permitted by the US SEC rules, starting in 2010 we will no longer present reconciliation to US GAAP of our consolidated financial statements.

### Sources of Revenue

Our revenues are derived primarily from the following:

- local service charges, which include monthly subscription charges, measured service charges, activation fees, and charges for use of public telephones (including prepaid cards); for calls to both fixed and mobile numbers, either within or outside our network;
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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;
- charges for data transmission, which include Speedy (broadband service) and management and data transmission to corporate segment since the merger of Telefónica Empresas in July 2006;
- fixed-to-mobile charges, which include fees paid by our customers for fixed-mobile calls;
- interconnection fees paid by other telecommunications service providers on a per-call basis for their calls that terminate in our network;
- infrastructure rental fees paid by other telecommunications service providers on a contractual basis for the use of parts of our network; and
- charges for other services, which include miscellaneous revenues from other services (call waiting, call forwarding, voice and fax mailboxes, speed dialing, and caller ID).

Our gross operating revenues include value-added and other indirect taxes and discounts to customers in accordance with Brazilian GAAP. The composition of operating revenues by category of service is presented in our



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Consolidated Financial Statements and discussed below. We have not calculated net operating revenues for each category of revenue.

## Results of Operations

The following table sets forth certain components of our net income for each of the years in the three-year period ended December 31, 2009, as well as the percentage change of each component.

	Year ended December 31,			% Change	
	2009	2008	2007	2009 - 2008	2008 - 2007
	(in millions of reais, except percentages)				
Net operating revenue	15,796	15,979	14,727	(1.1)	8.5
Cost of goods and services	(8,956)	(8,726)	(8,029)	2.6	8.7
Gross profit	6,840	7,253	6,698	(5.7)	8.3
Operating expenses:					
Selling expense	(2,568)	(2,601)	(2,462)	(1.3)	5.6
General and administrative expense	(868)	(755)	(839)	15.0	(10.0)
Other net operating income (expense)	(47)	(167)	250	(71.9)	(166.8)
Operating expenses, net	(3,483)	(3,523)	(3,051)	(1.1)	15.5
Operating income before financial expense, net	3,357	3,730	3,647	(10.0)	2.2
Financial expense, net	(195)	(228)	(307)	(14.5)	(25.7)
Income before taxes and social contribution	3,162	3,502	3,340	(9.7)	4.9
Income tax and social contribution	(989)	(1,082)	(977)	(8.6)	10.7
Net income	2,173	2,420	2,363	(10.2)	2.4

## Results of Operations for the Year Ended December 31, 2009 Compared to the Year Ended December 31, 2008

## Net Operating Revenue

Net operating revenue decreased by 1.1% reaching R\$15.8 billion in 2009 from R\$16.0 billion in 2008. The decrease in net operating revenue is primarily a result of a decrease in revenues from local service monthly subscription charges and a decrease in revenues in connection with the traffic of fixed-to-mobile calls and in fixed-to-mobile subscriptions. These reductions were partially offset by an increase in the revenues from data transmission services, pay-tv and voice infrastructure services.

The following table sets forth certain components of our operating revenues for 2009 and 2008, as well as the percentage change of each component.

	Year ended December 31,		% Change
	2009	2008	2009 - 2008
	(in millions of reais, except percentages)		
Gross operating revenue:			
Local services:			
Monthly subscription charges	5,226	5,487	(4.8)
Activation fees	109	114	(4.8)

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Measured service charges	2,417	2,563	(5.7)
Public telephones	387	445	(13.1)
Total	8,139	8,609	(5.5)

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	Year ended December 31,		% Change
	2009	2008	2009 - 2008
	(in millions of reais, except percentages)		
Long-distance services:			
Intra-regional	2,672	2,644	1.1
Inter-regional and international	1,311	1,305	0.5
Total	3,983	3,949	0.9
Data transmission	4,176	3,760	11.1
Fixed-to-mobile services	4,102	4,372	(6.2)
Network usage services	488	466	4.7
Infrastructure rental service	509	384	32.5
TV services	600	379	58.4
Other services	1,158	1,102	5.1
Total gross operating revenue	23,155	23,021	0.6
Value added and other indirect taxes	(5,778)	(5,979)	(3.3)
Discounts	(1,581)	(1,063)	48.8
Net operating revenue	15,796	15,979	(1.2)

## Local Services

Revenues from local services decreased by 5.5% to R\$8.1 billion in 2009 from R\$8.6 billion in 2008. The decrease was due primarily to a decrease in subscriptions and a decrease in traffic revenues as a result of a flat tariff imposed on local calls. These reductions were partially offset by an increase in revenues related to the residential alternative basic plan.

Monthly subscription charges. Revenues from monthly subscriptions decreased by 4.8% to R\$5.2 billion in 2009 compared to R\$5.5 billion in 2008. The decrease in 2009 was primarily due to a decrease in revenues received from residential subscriptions in an amount of R\$248.8 million and in non-residential subscriptions in an amount of R\$83.7 million. The decrease was partially offset by an increase in revenues received from DDR Access digital subscriptions in an amount of R\$100.9 million and from basic package residential plans in an amount of R\$50.3 million.

Activation fees. Revenues from monthly activation fees decreased by 4.8% to R\$108.8 million in 2009 from R\$114.3 million in 2008. The decrease was mainly due to a decrease of R\$36.1 million in revenues in relation to control line activation fees, which was partially offset by an increase in revenues from the following activation fees: "Linha Econômica" in an amount of R\$15.5 million; "Linha Jovem" in an amount of R\$13.5 million and "Linha Lazer" in an amount of R\$1.1 million.

Measured service charges. Revenues from measured service charges decreased by 5.7% to R\$2.4 billion in 2009 from R\$2.6 billion in 2008. The decrease in 2009 was due primarily to decreases in traffic revenues with respect to: the basic fixed-fixed plan in an amount of R\$147.9 million as a result of a decrease in the customers' used minutes; the "0300" fixed-fixed plan in an amount of R\$125.6 million due to a decrease in marketing advertisements on TV and radio. This decrease was partially offset by an increase in revenues from alternative plans traffic and by adjustments in tariffs charged of 0.98% effective since September 2009.

Public telephones. Revenues from charges for the use of public telephones decreased by 13.1% to R\$386.6 million in 2009 from R\$444.9 million in 2008. The decrease in 2009 was due to a decrease in sales of pre-paid cards by R\$58.3 million.



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### Long-Distance Services

Revenues from long distance services increased by 0.9% to R\$4.0 billion in 2009 from R\$3.9 billion in 2008, due primarily to an increase in revenues from SME traffic using our network, which was partially offset by a decrease in the traffic originating from fixed calls.

### Data Transmission

Revenues from data transmission services increased by 11.1% to R\$4.2 billion in 2009 from R\$3.8 billion in 2008. The increase in 2009 was primarily due to an increase in revenues in relation to the Speedy plan in the amount of R\$257.1 million, in relation to the interconnection protocol (IP) in the amount of R\$191.5 million, to maintenance (voice infrastructure) in the amount of R\$37.4 million, to voice/desktop infrastructure management in the amount of R\$15.3 million, to commuting data transmission service in the amount of R\$5.7 million and to outsourcing of voice infrastructure in the amount of R\$5.1 million. The increase was partially offset by a decrease in frame-relay services in the amount of R\$37.7 million, host services in the amount of R\$27.3 million, dial provider and outsourcing monthly fees in the amount of R\$14.1 million, consulting services in the amount of R\$8.2 million, installation of frame-relay and voice infrastructure in the amount of R\$6.8 million and rental fees of frame-relay and voice infrastructure in the amount of R\$1.5 million.

### Fixed-to-Mobile Services

Revenues from fixed-mobile services decreased by 6.2% to R\$4.1 billion in 2009 from R\$4.4 billion in 2008, due primarily to a decrease in revenues from fixed-mobile traffic (VC1/VC2/VC3) in the amount of R\$267.7 million and from collect calls (VC1/Intra) in the amount of R\$70.4 million. These effects were partially offset by an increase in pre-paid traffic (VC1/VC2/VC3) in the amount of R\$29.8 million, fixed-radio traffic in the amount of R\$5.7 million, fixed-mobile traffic in the amount of R\$3.5 million, and traffic of "0800" calls in the amount of R\$28.6 million.

### Network Usage Services

Revenues from network usage services increased by 4.7% to R\$487.8 million in 2009 from R\$465.8 million in 2008, due to an increase in revenues from local network use in the amount of R\$27.1 million and an increase in traffic originating from mobile calls. The increase was partially offset by a decrease in intraregional network use revenues in the amount of R\$21.9 and international network use revenues in the amount of R\$3.3 million.

### Infrastructure Rental Services

The revenues derived from network access increased by 32.5% to R\$509.3 million in 2009 from R\$384.3 million in 2008, due primarily to an increase in revenues from dedicated lines rented to other carriers (EILD) in the amount of R\$124.9 million resulting from the growth of the telecommunications market and the demand for a higher volume of band for data transmission.

### TV Services

Revenues from TV services increased by 58.4% to R\$600.3 million in 2009 from R\$379.0 million in 2008. The increase is mainly due to the increase in packages ("duo" and "trio") offered by the Company and its subsidiary Telefônica Sistemas de Televisão, and also to an increase of 3.0% in the customer base up to 486,614 customers in 2009 as compared to 472,222 customers in 2008.

Other Services

Revenues from other services increased by 5.1% to R\$1.2 billion in 2009 from R\$1.1 billion in 2008. These effects were caused primarily by an increase in revenues from providing maintenance services in the amount of R\$46.3 million, from providing information services in the amount of R\$36.0 million, from equipment resales in connection with the supply of equipment to the corporate customer segment carried out by T.Data in the amount of R\$32.0 million, from the implementation and operation of an underground fiber-optic network by Cia Aix in the

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amount of R\$9.3 million, from advertising fees earned by our subsidiary Telefônica Sistemas de Televisão in the amount of R\$4.8 million and from providing general support services in the amount of R\$4.3 million. The increase was partially offset by a decrease in value added services in the amount of R\$34.7 million, a decrease in tariffs (related to line migration) in the amount of R\$27.3 million, a decrease in voice infrastructure installation fees in the amount of R\$10.8 million and a decrease in sales of call blocker services in the amount of R\$4.0 million.

## Value Added and Other Indirect Taxes

Value added and other indirect taxes decreased by 3.3% to R\$5.7 billion in 2009 from R\$6 billion in 2008, as a result of the decrease in revenues from fixed-line services.

## Discounts

Discounts increased by 48.8% to R\$1.5 billion in 2009 from R\$1.1 billion in 2008. The increase was due primarily to an increase in discounts related to national long-distance calls in the amount of R\$164.9 million, to subscription fees in the amount of R\$148.4 million, to the Speedy program in the amount of R\$118.4 million, to TV-related programs and content in the amount of R\$47.8 million, to monthly DDR fees in the amount of R\$23.5 million, to the interconnection protocol for sub-networks (IP) in the amount of R\$21.2 million, to special clients in the amount of R\$13.6 million, to dedicated lines rented to other carriers (EILD) in the amount of R\$2.9 million, to the 0020 “Detecta” (caller identification) service in the amount of R\$2.5 million and to leasing fees in the amount of R\$2.0 million. The increase was partially offset by a decrease in discounts in DDR services in the amount of R\$21.8 million, sale of telephone pre-paid cards in the amount of R\$5.8 million and in the “0800” call service in the amount of R\$2.3 million.

## Cost of Goods and Services

Cost of goods and services primarily includes depreciation and amortization expenses, interconnection services, personnel expenses and costs of services provided by third parties. Cost of goods and services increased by 2.6% to R\$8.9 billion in 2009 from R\$8.7 billion in 2008, mainly due to an increase in expenses related to maintenance of network access terminals, purchase of TV content, increase in fixed-mobile expenses, increase in expenses relating to the purchase of goods in connection with the “Posto de Trabalho Informático” product and a decrease in the useful life of certain equipment.

The following table sets forth certain components of our cost of goods and services, as well as the percentage change of each component from the prior year, for 2009 and 2008.

	Year ended December 31,		% Change 2009 - 2008
	2009	2008	
	(in millions of reais, except percentages)		
Cost of goods and services:			
Depreciation and amortization	2,255	2,391	(5.7)
Outsourced services	1,910	1,525	25.2
Interconnection services	3,803	3,855	(1.3)
Operational personnel	187	199	(6.0)
Organizational Restructuring Program	—	21	(100)
Materials	180	132	36.4
Other costs	621	603	3.0
Total cost of goods and services	8,956	8,726	2.6

Depreciation and amortization

Depreciation and amortization expenses decreased by 5.7% to R\$2.3 billion in 2009 from R\$2.4 billion in 2008, due primarily to a decrease in depreciation in the amount of R\$181.4 million resulting from an increase in assets that have been fully depreciated. The decrease was partially offset by an increase in the provision for outdated modems of R\$24.4 million.



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### Outsourced Services

Expenses relating to services from third parties increased by 25.2% to R\$1.9 billion in 2009 from R\$1.5 billion in 2008, due primarily to expenses related to maintenance of network access terminals, purchase of TV content, and data processing expenses.

### Interconnection Services

Expenses related to interconnection services decreased by 1.3% to R\$3.8 billion in 2009 from R\$3.9 billion in 2008, principally due to a decrease in expenses related to the use of the fixed-mobile network in the amount of R\$39.2 million, a decrease in fixed termination (average tariff) expenses in the amount of R\$10.9 million, a decrease in expenses related to the intraregional use of the fixed-fixed communication network in the amount of R\$7.3 million, a decrease in expenses related to outgoing mobile traffic in the amount of R\$6.3 million and incoming mobile traffic in the amount of R\$6.2 million. The decrease was partially offset by an increase in expenses related to use of the local network of fixed-fixed communication in the amount of R\$15.4 million and the incoming traffic of fixed communication in the amount of R\$2.0 million.

### Operational Personnel

Such costs include expenses relating to salaries, bonuses and other benefits of employees that directly operate and maintain our businesses. Employee expenses decreased by 6.0% to R\$187 million in 2009 from R\$199 million in 2008, mainly due to lower expenses in connection with salaries, contributions to pension plans and other payroll expenses relating to the organizational restructuring program we implemented in 2008. The decrease was partially offset by an increase in bonus and FGTS (retirement) payments.

### Materials

The costs of materials increased by 36.40% to R\$180 million in 2009 from R\$132 million in 2008, mainly due to an increase in the costs of goods sold in the amount of R\$25.4 million related to the resale of infrastructure equipment. The increase was partially offset by a decrease in the cost of goods in the amount of R\$15.3 million relating to the resale of equipment related to the “Posto Informático” product by A.Telecom.

### Other Costs

Other costs include costs associated with the rental of certain infrastructure equipment, poles and underground cables used to operate our telephone lines and costs associated with our concession contracts. Other costs increased by 3.0% to R\$621 million in 2009 from R\$603 million in 2008, due primarily to an increase in infrastructure rental costs relating to last mile traffic and rental of pipes.

### Operating Expenses, Net

Net operating expenses decreased by 1.1% to R\$3.4 billion in 2009 from R\$3.5 billion in 2008, mainly due to a reduction in the amortization of goodwill that is no longer being amortized since January 1, 2009, and a reduction in losses on permanent asset disposals. This decrease was partially offset by an increase in general and administrative expenses.

### Selling Expenses

Selling expenses decreased 1.3% to R\$2.5 billion in 2009 from R\$2.6 billion in 2008, mainly due to a decrease in expenses related to outsourced services, especially regarding agency and intermediation services.

#### General and Administrative Expenses

General and administrative expenses increased by 15.0% to R\$868 million in 2009 from R\$755 million in 2008, mainly due to an increase in social contribution expenses, marketing services expenses and insurance expenses. The increase was partially offset by a decrease in outsourced expenses relating to communication and transport.

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## Other Operating Income (Expenses), Net

Other net operating results include a variety of revenues and costs. In 2009, we had a total expense of R\$47 million compared to an expense of R\$167 million in 2008. This decrease in 2009 was primarily due to a reduction in the amortization of goodwill that is no longer amortized since January 1, 2009, as well as a reduction in losses on permanent asset disposals, partially offset by reversal of provisions

## Financial Expense, Net

We recorded a net financial expense of R\$194.6 million in 2009 compared to a net financial expense of R\$227.9 million in 2008. This reduction is mainly due to higher gains in financial investments and lower net debt.

## Income Tax and Social Contribution

Our income tax and social contribution expenses decreased by 8.6% to R\$1.0 billion in 2009 from R\$1.1 billion in 2008. This decrease was due primarily to a decrease in the income before tax and social contribution. Our effective income tax and social contribution increased slightly to 31.3% in 2009 from 30.9% in 2008. See note 29 to our financial statements for a recognition to our combined statutory rate of 34% in both years.

## Net Income

As a result of the foregoing factors, net income decreased by 10.2% to R\$2.2 billion in 2009 from R\$2.4 billion in 2008.

## Results of Operations for the Year Ended December 31, 2008 Compared to the Year Ended December 31, 2007

## Net Operating Revenue

Net operating revenue increased by 8.5% reaching R\$15.9 billion in 2008 from R\$14.7 billion in 2007. The increase in net operating revenue is primarily a result of increased revenues from cable TV services and data transmission services (Speedy), and from increased revenues in our national long distance services and interconnection services, both of which were motivated by the increase in the number of mobile customers resulting from a higher number of mobile operators. This increase in net operating revenue is also attributed to increases in revenues from such sources as Posto Informático (PDTI), digital network services, and a tariff readjustment that took effect as of July 2008 that increased service charges to our customers by a weighted average of 3.01%. These increases were partially offset by a reduction of revenues from local services, from activation fees and from public telephone services, the latter due to an increase in competition from mobile telephony companies.

The following table sets forth certain components of our operating revenues for 2008 and 2007, as well as the percentage change of each component.

	Year ended December 31,		% Change
	2008	2007	2008 - 2007
	(in millions of reais, except percentages)		
Gross operating revenue:			
Local services:			
Monthly subscription charges	5,487	5,646	(2.8)
Activation fees	114	120	(5.0)

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Measured service charges	2,563	2,808	(8.7)
Public telephones	445	551	(19.2)
Total	8,609	9,125	(5.7)
Long-distance services:			
Intraregional	2,644	2,006	31.8
Interregional and international	1,305	1,349	(3.3)
Total	3,949	3,355	17.7
Data transmission	3,760	2,996	25.5

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	Year ended December 31,		% Change
	2008	2007	2008 - 2007
	(in millions of reais, except percentages)		
Fixed-to-mobile services	4,372	4,064	7.6
Network usage services	466	405	15.1
Network access	384	319	20.5
TV services	379	54	594.6
Other services	1,102	866	27.3
Total gross operating revenue	23,021	21,184	8.7
Value added and other indirect taxes	(5,979)	(5,576)	7.2
Discounts	(1,063)	(881)	20.7
Net operating revenue	15,979	14,727	8.5

## Local Services

Revenues from local services decreased 5.7% to R\$8.6 billion in 2008, from R\$9.1 billion in 2007. The decrease was due primarily to lower revenues from subscriptions to basic residential packages, basic fixed-fixed call traffic plans and basic plan activation fees, as well as lower revenues from VC1, VC2, VC3, Intra, Inter, Local and International traffic. These decreases were partially offset by an increase in the alternative basic residential plan subscriptions, alternative fixed-fixed call traffic plans and prepaid traffic.

Monthly subscription charges. Revenues from monthly subscriptions decreased 2.8% to R\$5.5 billion in 2008 compared to R\$5.6 billion in 2007. The decrease in 2008 was primarily due to a decrease in the average lines in service, an increase in customer use of new alternative plans to fixed telephony, including our Linha Control (Line Control) calling plans (offering packages of fixed-to-fixed minutes of calling time for set monthly fees) and our DUO and TRIO bundles, which have a lower subscription fee, and an accounting reclassification of DDR revenues (related to call transfers) in accordance with new requirements established by ANATEL. These effects were partially offset by the tariff readjustment of 3.01% that took effect on July 2008.

Activation fees. Revenues from monthly activation fees decreased by 5.0% to R\$114 million in 2008 from R\$120 million in 2007. The decrease was mainly due to a program we instituted promoting the exemption from activation fees for non-residential customers that acquire two or more business lines as of July 2008. These effects were partially offset by the tariff readjustment of 3.01% that took effect as of July 2008.

Measured service charges. Revenues from measured service charges decreased 8.7% to R\$ 2.6 billion in 2008 from R\$2.8 billion in 2007. The decrease in 2008 was due primarily to the sale of DUO and TRIO traffic packages offering unlimited local calling for a flat fee, that resulted in the reduction of traffic revenues despite higher calling traffic. These effects were partially offset by a significant increase in the sale of such DUO and TRIO traffic packages, and by the tariff readjustment of 3.01% that took effect as of July 2008.

Public telephones. Revenues from charges for the use of public telephones decreased by 19.2% to R\$445 million in 2008 from R\$551 million in 2007. The decrease in 2008 was due to increased competition from the mobile telephony market. This effect was partially offset by the tariff readjustment of 3.01% that took effect as of July 2008.

## Long-Distance Services

Revenues from long distance services increased by 17.7% to R\$3.9 billion in 2008 from R\$3.4 billion in 2007, due primarily to an increase in revenues from our mobile SMP (Personal Mobile Service) services using CSP “15” (code of personal services), resulting mainly from the expansion of the mobile telephony market. Revenues from long distance services also increased as a result of the tariff readjustment of 3.01% that took effect as of July 2008.

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### Data Transmission

Revenues from data transmission services increased 25.5 % to R\$3.8 billion in 2008 from R\$3.0 billion in 2007. The increase in 2008 was primarily due to an increase in the use of such services by our residential customers due to the offer of the “Speedy” and “Ajato” Internet services, as well as an increase in the use of data transmission services by corporate customers.

### Fixed-to-mobile Services

Revenues from fixed-to-mobile services increased by 7.6% to R\$4.4 billion in 2008 from R\$4.1 billion in 2007, due primarily to a significant increase in the number of mobile operators, that positively impacted VC1, VC2 and VC3 traffic, and also due to the tariff readjustment of 3.01% that took effect as of July 2008.

### Network Usage Services

Revenues from network usage services increased by 15.1% to R\$466 million in 2008 from R\$405 million in 2007, due to increased traffic between operators and use of our networks by other operators as a consequence of the growth of the telecommunications market, and also due to the tariff readjustment of 3.01% that took effect as of July 2008.

### Network Access

The revenues derived from network access increased 20.5% to R\$384 million in 2008 from R\$319 million in 2007, due primarily to an increase in revenues from fees in connection with leasing dedicated lines to other carriers (EILD), and by an increase in the volume of data usage by our clients.

### TV Services

Revenues from TV services increased 594.6% to R\$379.0 million in 2008 from R\$54.0 million in 2007, due to the acquisition of Telefônica Sistema de Televisão S.A. in the fourth quarter of 2007.

### Other Services

Revenues from other services increased 27.3% to R\$1.1 billion in 2008 from R\$866 million in 2007. These effects were caused principally by the growth in demand for PDTI (Posto Informático), and by increases in monthly fees for DDR (transfer of calls).

### Value Added and Other Indirect Taxes

Value added and other indirect taxes increased 7.2% to R\$6 billion in 2008 from R\$5.6 billion in 2007, as a result of the increase in operating revenues.

### Discounts

Discounts increased 20.7% to R\$1.1 billion in 2008 from R\$881 million in 2007. The increase was due primarily to discounts granted to the interconnection protocol for sub-networks (IP) and TV services, discounts in connection with subscriptions (such as providing two phone lines for the price of only one subscription instead of the customary two), discounts in connection with call services (such as providing lower call rates during certain hours), and discounts related to our Speedy services.

### Cost of Goods and Services

Cost of goods and services primarily includes depreciation and amortization expenses, interconnection services, personnel expenses and costs of services provided by third parties. Cost of goods and services increased 8.7% to R\$8.7 billion in 2008 compared to R\$8.0 billion in 2007, mainly due to increased expenses related to our terminals and network access maintenance, purchase of TV content (such as more channels) from Telefônica Televisão Digital, increased fixed-mobile network expenditures arising from the use of the network, higher wages and



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compensation expenses as a result of the Organizational Restructuring Program, increased expenses related to the purchase of goods in connection with the Posto Informático product, and a decrease in the estimated useful life for certain of our equipment (modems).

The following table sets forth certain components of our cost of goods and services, as well as the percentage change of each component from the prior year, for 2008 and 2007.

	Year ended December 31,		% Change 2008 - 2007
	2008	2007	
(in millions of reais, except percentages)			
Cost of goods and services:			
Depreciation and amortization	2,391	2,348	1.8
Outsourced services	1,525	1,240	23
Interconnection services	3,855	3,617	6.6
Operational personnel	199	225	(11.6)
Organizational Restructuring Program	21	63	(66.7)
Materials	132	32	312.5
Other costs	603	504	19.6
Total cost of goods and services	8,726	8,029	8.7

#### Depreciation and amortization

Depreciation and amortization expenses increased 1.8% to R\$2.4 billion in 2008 from R\$2.3 billion in 2007, due primarily to a decrease in the estimated useful life for certain of our equipment as a result of our acquisition of new modems.

#### Outsourced Services

Expenses relating to services from third parties increased 23% to R\$1.5 billion in 2008 from R\$1.2 billion in 2007, due primarily to an increase in TV content, along with increased network access and network maintenance expenses.

#### Interconnection Services

Expenses related to interconnection services increased 6.6% to R\$3.8 billion in 2008 from R\$3.6 billion in 2007, principally due to an increase in expenses related to fixed-mobile traffic related to the increasing number of calls terminating on other providers' networks.

#### Operational Personnel

Such costs include expenses relating to salaries, bonuses and other benefits of employees that directly operate and maintain our businesses. Employee expenses decreased 11.6% to R\$199 million in 2008 from R\$225 million in 2007, mainly due to lower expenses related to wages, pension plan payments and other payroll expenses resulting from the Organizational Restructuring Program carried out in 2007, and lower expenses related to wages paid to mandatory officers due to a reduction of such officers in 2008 to 4 from 15 in 2007. This decrease was partially offset by an increase in bonus payments to senior officers and sales executives, as well as payments of indemnification for termination of employment contracts.

#### Organizational Restructuring Program

Expenses relating to the Organizational Restructuring Program decreased by 66.7% to R\$21 million in 2008 from R\$63 million in 2007. This decrease was due to lower expenditure requirements under this program.

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Materials

The costs of materials increased 312.5% to R\$132 million in 2008 from R\$32 million in 2007, mainly due to the application of the new accounting classification criteria under Law 11,638/07 for the calculation of the cost of equipment for the Posto Informático product, which until fiscal 2008 had been recorded as a depreciation expense.

Other Costs

Other costs include costs associated with the lease of certain infrastructure equipment, poles and underground cables used to operate our telephone lines and costs associated with our concession contracts. Other costs increased 19.6% to R\$603 million in 2008 from R\$504 million in 2007, due primarily to an increase in infrastructure lease expenses for last-mile traffic termination and duct rental.

Operating Expenses, Net

Operating expenses increased 15.5% to R\$3.5 billion in 2008 from R\$3.1 billion in 2007, mainly due to an increase in expenses for third party services, increases in wage and wage-related payments for our sales associates, higher expenses in connection with technical and administrative services, and increase in depreciation of fixed assets related to sales.

Selling Expenses

Selling expenses increased 5.6% to R\$2.6 billion in 2008 from R\$2.5 billion in 2007, mainly due to an increase in wage and wage-related payments for our sales associates, higher expenses in connection with technical and administrative services (especially with the print-on-demand service and with our call center), increases in telesales services, higher costs in connection with the provision of customer service, increases in customer redemption services, and depreciation of fixed assets related to sales.

General and Administrative Expenses

General and administrative expenses decreased by 10.0% to R\$755 million in 2008 from R\$839 million in 2007, mainly due to lower expenses resulting from the Organizational Restructuring Program in 2007 and lower depreciation expenses for plant and equipment in service. This decrease was partially offset by an increase in expenses for third-party services related to purchases of TV content.

Other Net Operating Income (Expenses)

Other net operating results include a variety of revenues and costs. In 2008, we had total expenses of R\$167.0 million compared to an income of R\$250.1 million in 2007. The 2007 income recorded was due primarily to the partial reversal of the INSS provision in the amount of R\$105.7 million corresponding to the Bresser, Verão and SAT plans due to a favorable court decision, reduction in scrap iron revenues, increased in labor, tax and civil provisions and goodwill amortization.

Financial Expense, Net

We recorded a net financial expense of R\$228.0 million in 2008 compared to a net financial expense of R\$307 million in 2007. This reduction is mainly due to lower net debt and a decrease in funding costs.

Non-Operating Income, Net

The “non-operating income, net” line item that was reported in our income statement for prior periods no longer exists due to a change in Brazilian law. Upon adoption of Law 11,638/07, components of the non-operating result account were reclassified into other accounts in the income statement and for fiscal year 2008 and beyond (and for prior periods presented in this annual report) will no longer appear as an independent line item.

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### Income Tax and Social Contribution

Our income tax and social contribution expenses increased by 10.7% to R\$1.1 billion in 2008 from R\$977 million in 2007. This increase was due primarily to a decrease in tax credits attributable to our subsidiaries A. Telecom and Telefónica Data S/A and decreased tax benefits as a result of a decrease in the value of interest on shareholders' equity. The increase in income tax and social contributions was also due in part to higher income before taxes and social contributions.

### Net Income

As a result of the foregoing factors, net income increased 2.4% to R\$2.419 million in 2008 from R\$2.173 million in 2007.

## 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. As of December 31, 2009, we had R\$2.3 billion 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\$4.4 billion in 2009 compared to R\$5.1 billion in 2008. The decrease in cash flow from operating activities of 14.0% in 2009 compared to 2008 was due primarily to a decrease in our net income and a decrease in non-cash expenses in 2009 as compared to 2008 related to goodwill amortization and monetary and exchange variations, among others.

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 our base of customers and installed network.

### Uses of Funds

Our cash flow used in investing activities was R\$2.3 billion in 2009 compared to R\$2.1 billion in 2008. The increase in the cash flow used in investing activities in 2009 compared to 2008 was primarily due to a larger investment in the telecommunications plant. These amounts refer to payments actually made. Economic investments, which are accounted on an accrual basis, totaled R\$2.2 billion and R\$2.3 billion in 2009 and 2008, respectively.

Our cash flow used in financing activities was R\$1.6 billion in 2009 compared to R\$2.2 billion in 2008, primarily due to higher dividends paid in 2008 (R\$2.2 billion) as compared to 2009 (R\$1.5 billion).



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Indebtedness

As of December 31, 2009, our total debt was as follows:

Debt	Currency	Annual interest rate payable
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