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B. Capitalization and Indebtedness

Not applicable.

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 which we do not presently consider material, or of which we are not currently aware, may also affect us. Our business, results of operations or financial condition could be impacted if any of these risks materializes and, as a result, the market price of our preferred shares and our ADSs could be affected.

Risks Relating to Brazil

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

In the past, the Brazilian government has intervened in the Brazilian economy and occasionally made drastic changes in policy. The Brazilian government's actions to control inflation and affect other policies have often involved wage and price controls, currency devaluations, capital controls, and limits on imports, among other 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, as well as general economic factors, including:

- currency fluctuations;
- exchange control policies;
- internal economic growth;
- inflation;
- price instability;
- 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 as to future government policies may contribute to an increase in the volatility of the Brazilian securities markets and securities issued abroad by Brazilian companies. The Brazilian economy grew 2.3% in 2005, 4.9% in 2004 and 0.5% in 2003. Due to the limited economic growth in recent years, it is not certain whether the current economic policy will succeed. We can not predict whether Brazil's monetary, tax, social security and other policies will cause an adverse impact to the economy, to our business and results of operations or to the market price of our preferred shares and ADSs.

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

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.

Additionally, the Brazilian presidential election is scheduled to occur in October 2006. Considering that the Brazilian President has great powers to determine and change the governmental policies, including the economic ones, the result of the presidential run up may result in the implementation of new policies which might have an adverse impact in the transactions and results of operations of Brazilian companies, including our company. It is impossible to foresee the future development of the Brazilian economy and if it will or not affect us, our business, 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. Since 1994, and after enactment of the Real Plan, Brazil's inflation rate has been substantially reduced than in previous periods. The Consumer Prices Index (*Índice de Preços ao Consumidor*), or the IPCA, published by the *Instituto Brasileiro de Geografia e Estatística*, rose 5.7% in 2005, the lowest rate of inflation in five years, helped by the exchange rate appreciation. This index had presented variations of 7.6% in 2004, 9.3% in 2003 and 12.5% in 2002. The General Prices Index (*Índice Geral de Preços*), or IGP-DI, as published by *Fundação Getúlio Vargas*, which is more influenced by exchange rates variations due to the inclusion of producer prices, registered inflation rates of 1.2% in 2005, 12.1% in 2004, 7.7% in 2003 and 26.4% in 2002.

Starting in 2006, at ANATEL's direction, telephone fees will be indexed to the IST, which is a basket of national indexes that reflect our sector's operating costs, which could reduce the inconsistencies between our industry's revenues and costs and thus reduce the adverse effects of inflation on us. However, Brazilian monetary policy will continue to call for the IPCA as an inflation targeting system. This means that upon rises in inflation beyond the Brazilian Central Bank's 4.5% 2006 target, basic interest rates may rise, the indirect effects of which could be damage on demand for telecommunication goods and services.

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

The Brazilian currencies have experienced devaluations in the past. The *real* devalued against the U.S. dollar by 18.7% in 2001 and 52.3% in 2002. In contrast, the *real* appreciated in 2003, 2004 and 2005 against the U.S. dollar by 18.2%, 8.1% and 11.8%, respectively. See "Item 3.A-Selected Financial Data-Exchange Rates" for more information on exchange rates.

It should be noted that the IST, the new index applicable to telecommunication fees from 2006 onward, reflects exchange fluctuation to a lesser degree than the previously applicable index, the IGP-DI. This means that from 2006 onward, telecommunication revenues, when converted to U.S. dollars, might also reflect exchange fluctuations to a lesser degree, which would weaken the results of our operations during periods of devaluation.

As of December 31, 2005, 36.5 percent of our R\$2.40 billion total indebtedness was denominated in foreign currencies and primarily in U.S. dollars and Japanese yen. As of December 31, 2005, we had currency hedges in place to cover virtually all of our foreign currency denominated debt. See "Item 11(a)-Quantitative and Qualitative Disclosures about Market Risk-Exchange rate risk." 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 the exchange rate fluctuation. Certain additional costs, however, are offset by revenues from corresponding hedging transactions. Nevertheless, currency fluctuations are expected to continue to affect our financial income and expense.

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 is influenced, in varying degrees, by global economic and market conditions, and especially by those of Latin American countries 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 provides 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 the remittance to foreign investors of the proceeds of their investment in Brazil (as it did for approximately six months in 1989 and early 1990) and on the conversion of *reais* into foreign currencies. Any such restrictions could hinder or prevent the holders of our preferred shares or the depositary for the ADSs from converting dividends, distributions or the proceeds from any sale of such securities into U.S. dollars and remitting such U.S. dollars abroad. The imposition of these restrictions would also likely have a material adverse effect on the market price of our preferred shares and the ADSs.

Risks Relating to the Brazilian Telecommunications Industry and Us

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

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

The initial monthly and usage fees for our services (local and long-distance) were initially determined in our concession agreement, which also sets the annual price adjustment. We derive a substantial portion of our revenues from services subject to this

price adjustment. The method of price adjustment is basically a price cap. ANATEL applies annually a price index correction that reflects the inflation index of the period (in accordance with the concession contract) and a productivity factor (in accordance with the concession contract) to our local and long-distance fees. ANATEL has complied with the fee range set by the concession agreement. We are currently involved in litigation relating to the inflation index used to calculate the price adjustment of our fees that may negatively impact our financial results. See "Item 4B-Local Rates" and "Item 8A-Regulatory and Antitrust Litigation" for additional information on these claims.

In July 2005, ANATEL published new rules regarding interconnection systems which substantially changed the interconnection model. These changes include: (i) an obligation to offer the public all types of interconnection services, in addition to interconnections between fixed line service providers and mobile service providers; (ii) an offer of interconnections for Class III and Class V services; (iii) the establishment of criteria for the treatment of fraudulent calls; and (iv) the reduction of terms for the availability of interconnections. As a result of these reforms, new operators may enter the market and increase the competition we currently face.

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 services 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 telephone service for all areas with populations in excess of 100, expansion of our network to provide private individual telephone service for all areas with populations in excess of 300 and, with respect to quality of service, targets for call completion rates. Our ability to satisfy these terms and conditions, as well as others, may be affected by factors beyond our control. There is no guarantee that, going forward, we will be able to comply with all of the requirements imposed on us by ANATEL or the Brazilian government. Our failure to comply with the requirements of our concession may result in the imposition of fines or other government actions, including the termination of our concession. Any partial or total revocation of our concession would have a material adverse effect on our financial condition and results of operations.

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

The expiration date of the original Concession Agreement was December 31, 2005, but it has been renewed as of December 22, 2005 for an additional 20-year term.

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

The satisfaction of ANATEL's universal service targets by several fixed telecommunications services providers opened our region to the provision of local and long-distance telecommunications services by other providers. We have experienced, and expect to continue to experience, market adjustments in which providers take actions in order to compete for clients, especially corporate and premium residential clients. Such actions tend to result in lower prices and impacts market share. The Brazilian telecommunications market continues to reorganize and the profile of our competitors remains subject to change. This move towards reorganization and consolidation during 2005 is well illustrated by Carso Group's acquisition of a significant corporate stake in the biggest Brazilian cable company Net Comunicações S.A. through Telefônos de Mexico S.A. - Telmex. Such consolidation could allow our competitors to threaten our market share by providing bundled services or by making increased investments or offering more discounts as a result of greater financial viability.

We face increasing competition from cellular service providers.

Rapid growth of the cellular telecommunications industry and intense competition among cellular services providers have resulted in lower prices for cellular services. Cellular services are increasingly becoming an alternative to fixed-line services for residential customers. 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. See "Item 4-Information on the Company-Competition." In 2004,

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the number of cellular phones surpassed the number of fixed phones in the State of São Paulo. While some of the negative impact from the migration to cellular services is mitigated by the interconnection fees we receive from cellular to fixed-line calls, we cannot assure you that this will continue or that the continued growth of cellular services, and possible combination packages of services between fixed-line and mobile services, will not ultimately have an adverse impact on our business. In 2005, the mobile network interconnection fees paid by fixed operators to mobile operators should have begun running based on free negotiation among the operators, whereby each operator would negotiate the mobile interconnection fee directly with each other operator. However, the operators failed to reach an agreement and so ANATEL intervened in their negotiations and arbitrarily set the terms thereof, extending the then current fixed mobile interconnection conditions for at least one year. In respect of the interconnection fees paid to fixed operators, the extension of the Concession Contract, which began on January 1, 2006, set new conditions for the calculations of the fees. Now, the local network interconnection fee is defined as 50% of the price of one minute of local traffic and the long distance interconnection fee is defined based on the price of long distance traffic. As a result, the fees were significantly reduced (by between 30% and 40%). Further, there is uncertainty regarding this issue due to a postponing of the conversion of the fees from per pulse to per minute. This situation increases the chances of legal claims related to the conversion process, which could in turn affect the defined values for the interconnection fees.

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, in part, on our ability to anticipate and adapt in a timely manner to technological changes. We expect that new products and technologies will emerge and that existing products and technologies will be further developed.

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

Risks Relating to the Preferred Shares and the ADSs

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

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

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

You will not be able to exercise the preemptive rights relating to the preferred shares underlying your ADSs unless a registration statement under the U.S. Securities Act of 1933, as amended, or the Securities Act, is effective with respect to those rights, or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement. Unless we file a registration statement or an exemption from registration applies, you may receive only the net proceeds from the sale of your preemptive rights by the depositary, or if the preemptive rights cannot be sold, they will lapse and you will not receive any value for them. For more information on the exercise of your rights, see "Item 10-Additional Information-Memorandum and Articles of Association-Preemptive Rights."