

C. Capitalization and Indebtedness

Not applicable.

D. Reasons for the Offer and Use of Proceeds

Not applicable.

E. Risk Factors

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

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

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

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

- currency fluctuations;
- inflation;
- price instability;
- energy policy;
- interest rates;
- tax policy; and
- other political, diplomatic, social and economic developments in or affecting Brazil.

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

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

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

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

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

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

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

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

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

Risks Relating to the Brazilian Telecommunications Industry and Us

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

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

- regulations;
- licensing;

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

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

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

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

Our current Concession Agreement expires December 31, 2005, and, subject to satisfactory completion of certain network expansion, modernization and service quality obligations, contemplates a full renewal for an additional 20 years or revocation. In accordance with the notice provisions of the current Concession Agreement, we formally notified Anatel of our intention to renew such Concession Agreement on June 30, 2003. While the basic form of the renewed Concession Agreement has been finalized by Anatel and subject to extensive public comment, certain regulatory terms and conditions that will, or may be incorporated, into the renewed Concession Agreement remain pending. Such regulatory additions to the renewed Concession Agreement pertain to, among other things, price index, general competitive practices, corporate and consumer accounting and productivity measures. See "Item 4B-Business Overview-Regulation of the Brazilian Telecommunications Industry-Concessions and Authorizations." Subject to our satisfaction of the network expansion, modernization and service quality obligations set forth in the current Concession Agreement through December 2005, the renewed Concession Agreement will become effective on January 1, 2006.

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

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

We face increasing competition from cellular service providers.

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

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

The telecommunications industry is subject to rapid and significant technological changes. Our future success depends, in part, on our ability to anticipate and adapt in a timely manner to technological changes. We expect that new products and technologies will emerge and that existing products and technologies will be further developed.

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

Risks Relating to the Preferred Shares and the ADSs

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

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

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

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