

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, significant 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 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 over whether the reelected Brazilian government will implement 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. 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.

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.

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 an 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 from that 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 3.1% in 2006, the lowest rate of inflation in eight years, helped by the exchange rate appreciation. This index had presented variations of 5.7% in 2005, 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 rate variations due to the inclusion of producer prices, registered inflation rates of 3.8% in 2006, 1.2% in 2005, 12.1% in 2004, 7.7% in 2003 and 26.4% in 2002.

Since 2006, telephone fees have been indexed to the *Índice de Serviços de Telecomunicações* (Telecommunications Service Index - 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. The inflation target for 2007 is 4.5%. This means that upon increases in inflation beyond the Brazilian Central Bank's 4.5% 2006 target, basic interest rates may rise, the indirect effects of which could be a decrease in 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 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. In contrast, the *real* appreciated in 2003, 2004, 2005 and 2006 against the U.S. dollar by 18.2%, 8.1%, 11.8% and 8.7%, 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 since 2006, reflects exchange fluctuations to a lesser degree than the previously applicable index, the IGP-DI. This means that since 2006, telecommunication revenues, when converted to U.S. dollars, reflect exchange fluctuations to a lesser degree, which would weaken the results of our operations in the event of currency devaluation.

As of December 31, 2006, 35.2% of our R\$2.34 billion total indebtedness was denominated in foreign currencies, primarily in U.S. dollars and Japanese yen. As of December 31, 2006, 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 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 to 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 is influenced, in varying degrees, by global economic and market conditions, and especially by those in 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 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 an adverse effect on the market price of our 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 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 agreements. From March 2007 until July 31, 2007, the billing system will be converted to a minute basis, and the former measurement based on pulses will be discontinued. Our local concession contract sets forth the Local Basic Plan (PBL) and ANATEL's right to impose an Obligatory Offer Alternative Plans (PAS00s) for local call charges. On December 7, 2006, ANATEL published Resolution 450 imposing an obligation on the concessionaires to offer a specific PAS00 and establish its fees. Customers have the right to choose between the two plans, the PBL and the PAS00. One plan will benefit customers who make mostly short calls, and the second will benefit customers who make mostly longer calls (and/or those who use dial-up internet access). 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.

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 call completion rates. 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, 2006, the net book value of reversible assets is estimated at R\$8,027,464, which is comprised of switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment.

On December 1, 2005, we sent ANATEL the necessary evidence that we had reached our network expansion and 2005 universal service targets established by the *Serviço Telefônico Fixo Comutado* (STFC). 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; however, it has not indicated when it will issue the certificate.

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.

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 service providers opened our region to 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 downward price and market share pressures. The Brazilian telecommunications market continues to reorganize, and the profile of our competitors remains subject to change. This move towards reorganization and consolidation is well illustrated by Carso Group's acquisition of a significant corporate stake in Brazil's largest cable company, Net Comunicações S.A., through Telefônios de Mexico S.A. - Telmex. In October 2006, Net Comunicações S.A. acquired Vivax, S.A., the second largest cable provider in the State of Sao Paulo (although this transaction is still awaiting authorization from Brazilian authorities). 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 service 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 our services. See "Item 4-Information on the Company-Competition." For example, in 2006 the mobile operator TIM launched the "TIM Casa" product, a minutes package for fixed telephone lines at a lower price that can only be used from a restricted location pre-registered as a "TIM Casa." Services of this nature may eventually encourage substitution of fixed lines with the use of cellular telephones in residences.

Currently the number of mobile telephone lines is already more than double the number of fixed telephone lines in the State of São Paulo. The negative impact from the migration to cellular services is mitigated by the interconnection fees we receive from cellular to fixed-line calls; however, the recent calculation method for such fees has been causing significant reductions in those fees. Currently, 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 fees as opposed to traffic, the prior criteria. As a result, the fees were significantly reduced. We cannot assure you that such fees will continue in the future 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 effect on our business.

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. 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 that are 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 depository, 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."

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.A—Major Shareholders" and "Item 7.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.