

TELESP PARTICIPACOES SA  
Form 20-F  
April 15, 2005  
Table of Contents

As filed with the Securities and Exchange Commission on April 15, 2005

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## SECURITIES AND EXCHANGE COMMISSION

### FORM 20-F

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

OR

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

OR

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

Commission file number 001-14475

## TELECOMUNICAÇÕES DE SÃO PAULO S.A. TELESP

(Exact name of registrant as specified in its charter)

## Telecommunications of São Paulo Telesp

(Translation of registrant's name into English)

Federative Republic of Brazil

(Jurisdiction of incorporation or organization)

Rua Martiniano de Carvalho, 851 21º andar

01321-001 São Paulo, SP, Brasil

(Address of principal executive offices)

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

**Title of each class:**

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

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

New York Stock Exchange\*  
New York Stock Exchange

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

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

None

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**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:**

None

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The number of outstanding shares of each class of stock of Telecomunicações de São Paulo S.A. Telesp as of December 31, 2004.

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

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

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

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Yes  No

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

Item 17  Item 18

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**Table of Contents**

**TABLE OF CONTENTS**

	<u>Page</u>
<b>PART I</b>	
ITEM 1. <u>IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS</u>	1
ITEM 2. <u>OFFER STATISTICS AND EXPECTED TIMETABLE</u>	1
ITEM 3. <u>KEY INFORMATION</u>	1
ITEM 4. <u>INFORMATION ON THE COMPANY</u>	9
ITEM 5. <u>OPERATING AND FINANCIAL REVIEW AND PROSPECTS</u>	29
ITEM 6. <u>DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES</u>	48
ITEM 7. <u>MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS</u>	59
ITEM 8. <u>FINANCIAL INFORMATION</u>	60
ITEM 9. <u>THE OFFER AND LISTING</u>	68
ITEM 10. <u>ADDITIONAL INFORMATION</u>	73
ITEM 11. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	83
ITEM 12. <u>DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES</u>	86
<b>PART II</b>	
ITEM 13. <u>DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES</u>	86
ITEM 14. <u>MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS</u>	86
ITEM 15. <u>CONTROLS AND PROCEDURES</u>	86
ITEM 16. <u>[RESERVED]</u>	86
<b>PART III</b>	
ITEM 17. <u>FINANCIAL STATEMENTS</u>	89
ITEM 18. <u>FINANCIAL STATEMENTS</u>	89
ITEM 19. <u>EXHIBITS</u>	89
<u>GLOSSARY OF TELECOMMUNICATIONS TERMS</u>	90

**Table of Contents**

**INTRODUCTION**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

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

statements concerning our operations and prospects;

the size of the Brazilian telecommunications market;

estimated demand forecasts;

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

our strategic initiatives and plans for business growth;

industry conditions;

our funding needs and financing sources;

network completion and product development schedules;

expected characteristics of competing networks, products and services; and

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

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

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

the cost and availability of financing;

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

inflation and exchange rate risks;

the Brazilian government's telecommunications policy; and

the adverse determination of disputes under litigation.

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



**Table of Contents**

**PRESENTATION OF FINANCIAL INFORMATION**

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

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

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

Not applicable.

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

Not applicable.

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

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

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

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

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

**Table of Contents**

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

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

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

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

**Table of Contents**

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

**Table of Contents****B. Exchange Rates**

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

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

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

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

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

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

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

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

Source: Central Bank.

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

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

Source: Central Bank.

**Table of Contents**

**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.

## **Table of Contents**

*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;

**Table of Contents**

tariffs;

competition;

telecommunications resource allocation;

service standards;

technical standards;

quality standards;

interconnection and settlement arrangements; and

supervision of universal service obligations.

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

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

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

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

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

## **Table of Contents**

### ***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

## **Table of Contents**

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 on Increase in Preferred Share Capital.

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

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

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

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

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

#### **General**

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

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

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



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

### **Historical Background**

#### *The Restructuring and Privatization*

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

## **Table of Contents**

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

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

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

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

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

### ***The Reorganization***

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

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

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

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

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

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

## **Table of Contents**

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

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

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

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

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

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

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

### **Corporate Structure and Ownership**

Our general corporate and shareholder structure is as follows:

### **Capital Expenditures**

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

**Table of Contents**

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

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

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

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

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

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

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

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

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

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

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

## **Table of Contents**

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

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

## **Services**

### ***Overview***

Our services consist of:

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

intraregional, interregional and international long-distance services;

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

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

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

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



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

## **Table of Contents**

### ***Local Service***

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

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

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

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

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

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

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

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

*Network Services*

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

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

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

**Table of Contents**

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

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

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

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

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

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

***Other Services***

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

***Interconnection***

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

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

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

### *I-Telefônica*

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

### *IP Network Asset Acquisition*

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

## **Table of Contents**

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

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

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

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

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

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

### **Corporate Customer Services**

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

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

### **Rates and Taxes**

**Rates**

*Overview*

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

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

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## **Table of Contents**

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

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

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

### ***Local Rates***

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

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

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



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

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

## **Table of Contents**

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

The tariffs were applied to consumers as follows:

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

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

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

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

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

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

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

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

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

***International Long-Distance Rates***

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

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

## Table of Contents

### *Network Usage Charges*

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

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

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

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

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

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

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

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

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

***Data Transmission Rates***

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

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## **Table of Contents**

### **Taxes**

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

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

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

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

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

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

### **Billing and Collection**

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

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

## Table of Contents

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

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

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

## **Network and Facilities**

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

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

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



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

(1) Data includes public telephone lines.

## **Table of Contents**

### **Technology**

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

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

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

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

### **Competition**

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

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

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

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

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

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

## Table of Contents

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

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

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

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

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

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

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

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

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

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

## **Table of Contents**

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

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

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

### ***Sales***

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

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

Telesales: sales through telemarketing;

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

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

### ***Marketing***

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

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

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

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

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

(1) Local calls.

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

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

bi-annual customer satisfaction surveys;

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

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

establishment of various programs and projects focused on customer satisfaction;

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

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



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

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

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

### **Seasonality**

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

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

#### ***General***

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

## **Table of Contents**

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

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

## ***Concessions and Authorizations***

Concessions and licenses to provide telecommunications services are granted under the public regime, while authorizations are granted under the private regime. Companies that provide services under the public regime, known as the public regime companies, are subject to certain obligations as to quality of service, continuity of service, universality of service, network expansion and modernization. Companies that provide services under the private regime, known as the private regime companies, are generally not subject to the same requirements regarding continuity or universality of service, however they are subject to certain network expansion and quality of service obligations set forth in their authorizations. Companies that operate under the public regime include us, Embratel, Telemar, Brasil Telecom and other local providers. The primary public regime companies provide fixed-line telecommunications services in Brazil that include local, intraregional, interregional and international long-distance services. All other telecommunications service providers, including the other companies authorized to provide fixed-line services in our concession region, operate under the private regime.

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

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

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

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

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

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

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

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

**Table of Contents**

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

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

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

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

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

In addition, the renewed Concession Agreement contemplates possible changes to its terms by Anatel in 2010, 2015 and 2020. This provision permits Anatel to update the renewed Concession Agreement with respect to network expansion, modernization and quality of service targets in response to changes in technology, competition in the marketplace and domestic and international economic conditions.

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

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

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

*Fixed-line Services - Private Regime.* The Brazilian telecommunications regulations provide for the introduction of competition in telecommunications services by requiring Anatel to authorize private regime companies to provide local and intraregional long-distance service in each of the three fixed-line regions and to provide intraregional, interregional and international long-distance services throughout Brazil. Anatel has already granted authorizations to private regime operators to operate in Region III, our concession region. Anatel also granted other private regime companies authorizations to operate in other fixed-line regions and authorizations to provide intraregional, interregional and international long-distance services throughout Brazil in competition with Embratel. Several companies have already applied for the authorization and Anatel may authorize additional private regime companies to provide intraregional, interregional and international

long-distance services. See Competition.

***Obligations of Telecommunications Companies***

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

## **Table of Contents**

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

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

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

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

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

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

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

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

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

## **C. Organizational Structure**

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

### **Subsidiaries**

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

## **Table of Contents**

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

## **Associated Companies**

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

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

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

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

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

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

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

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



**A. Operating Results**

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

**Overview**

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

## **Table of Contents**

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

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

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

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

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

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

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

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

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

*Impact of Inflation on Our Results of Operations*

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

**Table of Contents**

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

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

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

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

**Regulatory and Competitive Factors**

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

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

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

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

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

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

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

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

In addition to evolving regulatory considerations, our business is affected by competition from other telecommunications providers. We began to face competition in our region in July 1999 and anticipate that competition will contribute to declining prices for fixed-line telecommunications services and increasing pressure on operating margins. Our future growth and results of operations will depend significantly on a variety of factors, including:

Brazil's economic growth and its impact on the greater demand for services;

the costs and availability of financing; and

the exchange rate between the *real* and other currencies.

## **Table of Contents**

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

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

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

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

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

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

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

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

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

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

## **Table of Contents**

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

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

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

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

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

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

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

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



*Provision for contingencies*

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

## **Table of Contents**

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

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

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

### ***Deferred Taxes***

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

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

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

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

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

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

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

**Table of Contents**

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

**Results of Operations**

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

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

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

Our revenues are derived primarily from the following:

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

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

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

charges for data transmission;

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

**Table of Contents**

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

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

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

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

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

**Net Operating Revenue**

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

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

***Local Services***

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

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

## **Table of Contents**

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

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

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

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

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

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

### ***Data Transmission***

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

### ***Network Services***

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



***Goods Sold***

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

***Other Services***

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

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

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

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

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

**Depreciation and amortization**

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

**Outsourced Services**

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

**Interconnection Services**

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

### *Operational Personnel*

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

### *Materials*

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

## **Table of Contents**

### ***Goods Sold***

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

### ***Other Costs***

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

### ***Operating Expenses***

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

### ***Selling Expenses***

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

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

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

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

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

***Financial Expense, Net***

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

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

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

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

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

***Net Income***

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

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

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

	<b>Year ended December 31,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	<b>2003-2002</b>
	<b>(in millions of reais, except percentages)</b>		
Gross operating revenue:			
Local services:			