

BRASIL TELECOM SA  
Form 20-F  
May 09, 2007

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**SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

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**FORM 20-F**

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**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006**

Commission file number: 1-15256

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**BRASIL TELECOM S.A.**  
(F/K/A TELECOMUNICAÇÕES DO PARANÁ S.A. - TELEPAR)

(Exact Name of Registrant as Specified in Its Charter)

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**Brazil Telecom Company**  
(Translation of Registrant's Name into English)

**The Federative Republic of Brazil**  
(Jurisdiction of Incorporation or Organization)

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**SIA/Sul, ASP, Lote D, Bloco B**  
**71215-000 Setor de Indústria, Brasília, DF, Brazil**

(Address of Principal Executive Offices)

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

<b>Title of Each Class</b>	<b>Name of Each Exchange On Which Registered</b>
Preferred Shares, without par value, represented by American Depositary Shares*	New York Stock Exchange

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\* American Depositary Shares issuable upon deposit of Preferred Shares were registered under a separate registration statement on Form F-6.

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

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

**Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by this Annual Report:**

At December 31, 2006 there were outstanding:  
249,597,049,542 Common Shares, without par value  
297,675,140,857 Preferred Shares, without par value

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

Yes      No

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

Yes      No

Indicate by check mark whether the registrant is a large accelerated, an accelerated filer, or a non-accelerated filer.

See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer      Accelerated Filer      Non-Accelerated Filer

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

Item 17      Item 18

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## PRESENTATION OF FINANCIAL INFORMATION

In this Annual Report, Brasil Telecom S.A., a corporation organized under the laws of the Federative Republic of Brazil and its subsidiaries are referred to collectively as Brasil Telecom, our company, we, us or the Registrant. References to our company's businesses and operations are references to the businesses and operations of our company on a consolidated basis for the years 2004, 2005 and 2006.

References to (i) the *real*, *reais* or R\$ are to Brazilian *reais* (plural) and the Brazilian *real* (singular) and (ii) *dolla* or US\$ are to United States dollars. All amounts in Brazilian currencies that existed prior to the adoption of the *real* as the Brazilian currency on July 1, 1994 have been restated in *reais*. On March 30, 2007, the Commercial Market selling rate (as defined in Item 3 Key Information Selected Financial Data Exchange Rates ) was R\$2.0504 to US\$1.00 as published by the Brazilian Central Bank. The exchange rate information in this Annual Report should not be construed as a representation that any such amounts have been, would have been or could be converted at this or any other exchange rate.

Our audited consolidated financial statements were prepared in conformity with generally accepted accounting principles in Brazil ( Brazilian GAAP ) which are similar to the Brazilian Corporate Law (Law 6.404/76, as amended by Law 10.303/01), except for the effects of the recognition of inflationary effects from January 1, 1996 to December 31, 2000, and are consistent with the rules and regulations of the Brazilian Securities and Exchange Commission (CVM *Comissão de Valores Mobiliários*), and the accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil* or IBRACON ). Investors should note that financial statements prepared in accordance with Brazilian GAAP differ from financial statements prepared in accordance with Brazilian Corporate Law in the methodology used for the recognition of inflation, among other things. Since all assets impacted by the recognition of inflationary effects from January 1, 1996 to December 31, 2000 were fully depreciated at December 31, 2004, this difference ceased to exist subsequent to December 31, 2004. See Notes 2a and 2b to our audited consolidated financial statements for (i) a summary of the principal differences between Brazilian GAAP and Brazilian Corporate Law as they relate to us and (ii) a reconciliation from Brazilian Corporate Law to Brazilian GAAP of shareholders' equity as of December 31, 2004 and net income for the year ended December 31, 2004. Brazilian GAAP when applied to us differs in certain important respects from generally accepted accounting principles in the United States ( US GAAP ). See Note 35 to our audited consolidated financial statements for (i) a summary of the principal differences between Brazilian GAAP and US GAAP as they relate to us and (ii) a reconciliation to US GAAP of shareholders' equity as of December 31, 2005 and 2006 and net income (loss) for each of the years ended December 31, 2004, 2005 and 2006. These audited consolidated financial statements are referred to herein as the Financial Statements.

Our audited annual consolidated financial statements as of December 31, 2004 and 2005, and for each of the two years ended December 31, 2004 and 2005 prepared in accordance with Brazilian GAAP with reconciliation of shareholders' equity and net income (loss) to US GAAP, included in this Annual Report, have been audited by KPMG Auditores Independentes, in accordance with the standards of the Public Company Accounting Oversight Board as stated in their report appearing in this Annual Report on Form 20-F ( Annual Report ).

Our audited annual consolidated financial statements as of December 31, 2006, and for the year ended December 31, 2006 prepared in accordance with Brazilian GAAP with reconciliation of shareholders' equity and net income (loss) to US GAAP, included in this Annual Report, have been audited by Deloitte Touche Tohmatsu Auditores Independentes, in accordance with the standards of the Public Company Accounting Oversight Board as stated in their report appearing in this Annual Report.

The Index of Defined Terms that begins on page 177 lists the page where each defined term is defined within this document. Technical terms are defined in the Technical Glossary on page 179.

Certain figures included in this Annual Report have been subject to rounding adjustments. Accordingly, figures shown as totals in certain tables may not be an arithmetic aggregation of the figures that precede them.

## **FORWARD-LOOKING INFORMATION CONTAINED IN THIS ANNUAL REPORT**

This Annual Report contains forward-looking statements. We may also make forward-looking statements in press releases and oral statements. Forward-looking statements are not statements of historical fact and involve known and unknown risks and uncertainties. The words anticipates, believes, estimates, expects, forecasts, intends, plans, predicts, projects, targets and similar words are intended to identify these forward-looking statements.

In this Annual Report, we have made forward-looking statements with respect to, but not limited to:

- our marketing strategy;
- our ability to meet our network expansion, service quality and modernization obligations;
- our market share in general and the growth in our Internet service offerings in particular;
- our compliance with radiation standards;
- the reduction of our labor force;
- the payment of our debt;
- the material adverse financial effect of any labor, civil or tax claims arising out of acts committed by Telebrás prior to the effective date of the breakup of Telebrás;
- the retroactive application of state value-added taxes to certain services, including installation services, rendered during the five years preceding June 30, 1998;
- the growth in the customer base and products offered by cable television services providers in our region;
- our projected capital expenditures; and
- our liquidity.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Our future results and shareholder values may differ materially from those expressed in or suggested by these forward-looking statements. Many of the factors that will determine these results and values are beyond our ability to control or predict.

Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. These factors include:

- the performance of the Brazilian economy generally;
- the levels of exchange rates between Brazilian and foreign currencies;
- the telecommunications policy of Brazil's federal government;

- the growth of the Brazilian telecommunications industry as a whole;
- the introduction of competition to the Brazilian telecommunications industry in general and in our region in particular;
- the receipt of additional, and/or the revocation of our existing, governmental approvals and licenses;



- the availability of financing;
- the resolution of disputes among certain of our controlling shareholders;
- changes in the rates that we may charge under government regulations;
- the emergence of new technologies and the response of our customer base to those technologies;
- our ability to grow our business, in particular our mobile telephone business;
- acquisitions by us of other companies; and
- other factors discussed under Item 3. Key Information Risk Factors.

The reader should not place undue reliance on any forward-looking statement. Forward-looking statements speak only as of the date they are made, and we do not undertake any obligation to update them in light of new information or future developments. Neither our independent auditors, nor any other independent accountants, have compiled, examined, or performed any procedures, with respect to the prospective financial information contained herein, nor have they expressed any opinion or any other form of assurance on such information or its achievability, and assume no responsibility for, and disclaim any association with the prospective financial information.

Information included in this Annual Report concerning Brazil, Telecom Italia International N.V. ( TII ), Techold Participações S.A. ( Techold ) and Timepart Participações Ltda. ( Timepart ) and other direct and indirect shareholders has been included herein based on public filings or other sources we assume to be correct but we have not independently verified such information.

**PART I****ITEM 3. KEY INFORMATION****Selected Financial Data*****Background***

The selected financial information presented herein should be read in conjunction with our Financial Statements and notes, which appear elsewhere in this Annual Report. Our selected financial information is presented on a consolidated basis for all years presented.

In the selected financial information, amounts are presented in Brazilian reais, except where noted, and all amounts are in thousands, except number of shares and per share amounts.

The following paragraphs discuss some important features of the presentation of the selected financial information and our Financial Statements. These features should be considered when evaluating the selected financial information and our Financial Statements and Notes.

***Brazilian GAAP and US GAAP***

The consolidated financial statements have been prepared in accordance with Brazilian GAAP, which differs in certain significant respects from US GAAP.

See Note 35 to our Financial Statements for (i) a summary of the principal differences between Brazilian GAAP and US GAAP as they relate to us, and (ii) a reconciliation to US GAAP of shareholders' equity as of December 31, 2005 and 2006 and net income (loss) for each of the years ended December 31, 2004, 2005 and 2006.

***Difference from Financial Statements Published in Brazil***

Our statutory financial statements prepared in accordance with the Brazilian Corporate Law (the Statutory Financial Statements ) are the basis for dividend and tax determinations. See Notes 2a and 2b to our Financial Statements for (i) a summary of the principal differences between Brazilian GAAP and Brazilian Corporate Law as they relate to us and (ii) a reconciliation from Brazilian Corporate Law to Brazilian GAAP of shareholders' equity as of December 31, 2004 and net income (loss) for the year ended December 31, 2004. Our Statutory Financial Statements also differ from our Financial Statements in respect of certain reclassifications, and presentation of comparative information.

**Selected Financial Information**

<b>Income Statement Data:</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b><i>Brazilian GAAP:</i></b>					
Net operating revenue	7,071,368	7,915,194	9,064,855	10,138,684	10,296,659
Cost of services	(5,180,182)	(5,472,465)	(6,158,836)	(6,525,898)	(6,466,463)
Gross profit	1,891,186	2,442,729	2,906,019	3,612,786	3,830,196
Operating expenses:					
Selling expenses	(776,573)	(821,753)	(1,105,628)	(1,656,242)	(1,470,642)
General and administrative expenses	(672,928)	(847,730)	(1,017,502)	(1,264,741)	(1,314,119)
Other net operating income (expenses)	118,496	(214,953)	(61,198)	(626,306)	(262,134)
Operating income before net financial expenses	560,181	558,293	721,691	65,497	783,301
Net financial expenses	(618,899)	(844,802)	(579,514)	(596,239)	(289,662)
Operating income (loss)	(58,718)	(286,509)	142,177	(530,742)	493,639
Net non-operating income (expenses)	(64,497)	(541,691)	(112,073)	(149,024)	30,865
Income (loss) before taxes and minority interests	(123,215)	(828,200)	30,104	(679,766)	524,504
Income and social contribution tax benefits	111,596	320,751	75,012	389,066	(95,035)
Income (loss) before minority interests	(11,619)	(507,449)	105,116	(290,700)	429,469
Minority interests	-	14	(6,276)	(12,971)	2,922
Net income (loss)	(11,619)	(507,435)	98,840	(303,671)	432,391
Number of Common Shares (millions) <sup>(1)</sup>	243,564	249,597	249,597	249,597	249,597
Number of Preferred Shares millions) <sup>(1)</sup>	292,020,330	289,850,319	292,011,413	292,021,849	297,675,141
Net income (loss) per thousand Common Shares ( <i>reais</i> ) <sup>(1)</sup>	(0.05)	(2.03)	0.40	(1.22)	1.73
Dividends per thousand Common Shares ( <i>reais</i> ) <sup>(1)</sup>	0.51	0.39	0.70	0.98	0.65
Dividends per thousand Common Shares (dollars) <sup>(1)(2)</sup>	0.15	0.13	0.26	0.42	0.31
Dividends per thousand Preferred Shares ( <i>reais</i> ) <sup>(1)</sup>	0.51	0.39	0.70	0.98	0.65
Dividends per thousand Preferred Shares (dollars) <sup>(1)(2)</sup>	0.15	0.13	0.26	0.42	0.31

(1) See Note 3t to our Financial Statements. Outstanding shares at the balance sheet date.

- (2) Dividends per thousand shares were converted into dollars at the Commercial Market selling rate, of R\$3.5333 per dollar on December 31, 2002, of R\$2.8892 per dollar on December 31, 2003, of R\$2.6544 per dollar on December 31, 2004, R\$2.3407 per dollar on December 31, 2005, and of R\$2.1380 per dollar on December 31, 2006, respectively.

**Selected Financial Information (continued)**

<b>Income Statement Data (continued)</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>US GAAP:</b>					
Net income (loss)	317,280	(287,739)	284,907	168,790	687,299
Net income (loss) per thousand shares ( <i>reais</i> ) <sup>(1)</sup> :					
Common Shares Basic	0.59	(0.54)	0.53	0.31	1.26
Common Shares Diluted	0.59	(0.54)	0.53	0.31	1.26
Preferred Shares Basic	0.59	(0.54)	0.53	0.31	1.26
Preferred Shares Diluted	0.59	(0.54)	0.53	0.31	1.26

- (1) In accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, or SFAS 128, basic and diluted earnings per share have been calculated, for US GAAP purposes, using the two class method. See Note 35.e to our Consolidated Financial Statements.

	<b>At December 31</b>				
	2002	2003	2004	2005	2006
	(Thousands of <i>reais</i> )				
<b>Balance Sheet Data:</b>					
<b>Brazilian GAAP:</b>					
Cash and cash equivalents	1,422,899	1,465,765	2,397,810	1,730,083	2,541,608
Short term investments	-	-	-	-	89,424
Intangibles <sup>(1)</sup>	647,431	812,021	1,138,970	1,219,986	1,163,392
Property, plant and equipment, net	9,782,902	8,538,472	8,299,604	7,592,574	6,535,225
Deferred Charges	446,870	340,605	387,711	194,444	138,468
<b>Total assets</b>	<b>16,432,198</b>	<b>15,622,803</b>	<b>17,402,504</b>	<b>16,107,453</b>	<b>15,997,784</b>
Loans and financing current portion	702,614	1,966,686	1,079,284	1,431,939	993,188
Swaps related to loans and financing current portion	(19,338)	23,588	23,849	57,445	116,376
Loans and financing non-current portion	4,398,531	2,614,447	4,076,046	3,127,187	3,961,397
Swaps related to loans and financing non-current portion	-	31,116	102,319	291,654	304,229
<b>Total liabilities (including funds for capitalization and minority interests)</b>	<b>8,808,408</b>	<b>8,781,841</b>	<b>10,921,141</b>	<b>10,610,846</b>	<b>10,469,483</b>
<b>Shareholders' equity</b>	<b>7,623,790</b>	<b>6,840,962</b>	<b>6,481,363</b>	<b>5,496,607</b>	<b>5,528,301</b>
<b>US GAAP:</b>					
Cash and cash equivalents	1,005,059	605,108	491,686	355,868	401,543
Short term investments	417,840	860,657	1,906,124	1,374,215	2,229,489
Intangibles <sup>(2)</sup>	1,352,120	1,537,664	2,021,469	1,990,419	1,971,140
Property, plant and equipment, net	12,004,568	10,087,601	9,819,160	9,104,552	8,103,302
<b>Total assets</b>	<b>19,371,265</b>	<b>17,786,575</b>	<b>19,393,944</b>	<b>18,059,313</b>	<b>18,131,914</b>
Loans and financing current portion	509,504	1,755,410	830,680	1,148,361	794,739
Swaps related to loans and financing current portion	(28,838)	3,518	16,806	54,068	115,326
Loans and financing non-current portion	4,252,220	2,424,781	3,888,052	2,962,968	3,917,350
Swaps related to loans and financing non-current portion	-	4,641	72,099	274,513	301,483
<b>Total liabilities (including funds for capitalization and minority interests)</b>	<b>11,559,241</b>	<b>10,530,135</b>	<b>12,321,824</b>	<b>11,501,127</b>	<b>11,077,331</b>

Shareholders' equity	7,812,024	7,256,440	7,072,120	6,558,186	7,054,583
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- (1) Includes the goodwill from our acquisition of a controlling stake in Companhia Riograndense de Telecomunicações ( CRT ), which was calculated based on book value.
- (2) Intangibles under US GAAP include the goodwill from our merger with Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre and CTMR and our merger with CRT at December 31, 2002, 2003, 2004, 2005 and 2006, and amounts relating to our personal communication system ( PCS ) licenses at December 31, 2003, 2004, 2005 and 2006. See Note 35.o to our Consolidated Financial Statements.

Cash Flows	2004	2005	2006
<b>BRGAAP</b>			
Operating activities	3,471,730	2,460,809	2,525,697
Increase (reduction) in cash and cash equivalents	932,045	(667,727)	811,525
<b>USGAAP<sup>1</sup></b>			
Operating activities	2,426,262	2,992,719	1,759,847
Increase (reduction) in cash and cash	(113,423)	(135,817)	45,675

- (1) As described in Note 35.u, under US GAAP, cash equivalents are defined as short-term, highly liquid investments, which are both readily convertible to known amounts of cash and original maturities of 90 days or less. The Company holds certain highly liquid, low risk financial investments, comprised principally of high quality government debt, which are classified as cash equivalents under BR GAAP. Although the investments have high level of liquidity and present insignificant risks of changes in value, under US GAAP, since these investments have original maturities of over 90 days, such investments do not qualify as cash equivalents. This change in definition had no impact on either shareholders' equity or net income for the periods presented.

#### Exchange Rates

Until March 14, 2005, there were two principal foreign exchange markets in Brazil: the commercial rate exchange market (the Commercial Market) and the floating rate exchange market (the Floating Market). Most foreign trade and financial foreign currency exchange transactions were carried out on the Commercial Market. Purchases of foreign exchange in the Commercial Market could be carried out only through a financial institution authorized to buy and sell currency in that market. The Floating Market rate generally applies to specific transactions for which the approval of the Brazilian Central Bank (or the Central Bank) was not required.

On March 4, 2005, the National Monetary Council (CMN) enacted new rules with respect to the foreign exchange market in Brazil. Resolution 3.265 unified the Commercial Market and the Floating Market in a single market (the Foreign Exchange Market). The new rules also eliminated previous restrictions thereby allowing more flexibility for the purchase and sale of foreign currency. The unified Foreign Exchange Market is intended to simplify both inbound and out bound exchange transactions by permitting exchange contracts to be executed by the local institutions authorized to deal in foreign exchange. Foreign currencies may only be purchased through a Brazilian financial institution authorized to operate in the market. Furthermore, under the Foreign Exchange Market, Brazilian entities and individuals may purchase and sell foreign currency in transactions of any nature and without any limitations on the amounts involved, subject to the legality of the transaction and in accordance with the economic basis of the transactions and obligations set forth in the respective documentation. Rates are freely negotiated but the Central Bank may, in limited circumstances, intervene in the Foreign Exchange Market to curb excessive volatility.

Under the *Real Plan* (Real Plan), adopted on July 1, 1994, the *real* was introduced as the official unit of Brazilian currency, with each *real* having an exchange rate of R\$1.00 to US\$1.00. The issuance of *reais* was initially subject to quantitative limits backed by a corresponding amount of dollars in reserves, but the government subsequently expanded those quantitative limits and allowed the *real* to float, with parity between the *real*/dollar (R\$1.00 to US\$1.00) as a ceiling.

Since January 15, 1999, the *real* has been allowed to float freely. In 2000, the *real* devalued by 9.3% against the dollar to R\$1.9554. Further deterioration in the political and economic environment in 2001, in addition to the

Brazilian energy crisis, resulted in the *real* devaluing by 18.7% against the dollar in that year. In 2002, as a reaction to political and economic uncertainties, the global economic downturn, the crisis in Argentina and the Brazilian presidential elections, the dollar appreciated by 52.3% against the *real* to R\$3.5333 per US\$1.00 at December 31, 2002. The *real* recovered in 2003, appreciating by 18.2% to R\$2.8892 per US\$1.00, at December 31, 2003. In 2004, the *real* appreciated by 8.1% against the dollar, quoted at R\$2.6544 per US\$1.00 on December 31, 2004. In 2005, the real appreciated by 13.4% against the dollar, quoted at R\$2.3407 per US\$1.00 on December 31, 2005. In 2006, the real appreciated by 9.5% against the dollar, quoted at R\$2.1380 per US\$1.00 on December 31,



2006. We cannot guarantee that the *real* will not substantially devalue again in the future. See Risk Factors Risks Relating to Brazil.

### ***Selling Rate for Dollars***

As of March 30, 2007, the selling rate published by the Brazilian Central Bank was R\$2.0504 per US\$1.00. The following table sets forth the reported high and low selling rates for dollars for the months indicated.

	<b>High</b>	<b>Low</b>
October 2006	2.1676	2.1331
November 2006	2.1870	2.1353
December 2006	2.1693	2.1380
January 2007	2.1556	2.1247
February 2007	2.1182	2.0766
March 2007	2.1388	2.0504

Source: Brazilian Central Bank

The following table sets forth the reported high and low, average and period-end selling rates for dollars for the annual periods indicated. The average selling rates represent the average of the month-end commercial market selling rates (R\$/US\$) during the relevant period.

<b>For the Year Ended December 31,</b>	<b>High</b>	<b>Low</b>	<b>Average</b>	<b><u>Period End</u></b>
2002	3.955	2.271	2.915	3.533
2003	3.662	2.822	3.060	2.889
2004	3.205	2.654	2.926	2.654
2005	2.762	2.163	2.434	2.340
2006	2.3711	2.0586	2.1771	2.1380

Source: Brazilian Central Bank

Brazilian law provides that whenever there is a serious imbalance in Brazil's balance of payments or reliable information to foresee such an imbalance temporary restrictions may be imposed on remittances of foreign capital abroad. We cannot guarantee that these restrictive measures will not be taken by the Brazilian government in the future. See Risk Factors Risks Related to Operations In Brazil.

## RISK FACTORS

The following are risk factors that relate materially to our company and to an investment in our Preferred Shares or American Depositary Shares ( ADSs ). Our business, results of operations or financial condition could be harmed if any of these risks materialize and, as a result, the trading price of our Preferred Shares or ADSs could decline and a holder of those securities could lose a substantial portion or all of his investment.

### *Risks Related to Our Business*

***Regulatory developments could affect our services, including placing restrictions on the rates we charge for our services, which could adversely impact our business.***

Our main activities, wireline phone services, as well as the main activities of our competitors, are subject to regulation and inspection by the Agência Nacional de Telecomunicações ( Anatel ). The regulations enacted by Anatel and applicable to our activities include provisions regarding charges, fees, universalization, quality of services, consumer s rights, net expansion, licenses, competition, changes in our corporate control (including participation by foreign investors), interconnection and other operational issues related to the functioning of our telecommunications net.

Any changes in the laws, regulations or governmental policies applicable to the telecommunications sector or in the interpretation of such laws and regulations may have material adverse effects on our financial condition and results of operations.

Although there are some indications expressed by Anatel and by the Ministry of Communications at the end of each year, it is not possible to predict which policies for the telecommunications sector will be adopted by the government in the future or the consequences of such policies to our business and the business of our competitors.

The new concession contracts contain sections regarding the new General Plan for Quality Targets (*Plano Geral de Metas de Qualidade*; the PGMQ ) and the new General Plan for Universalization Targets (*Plano Geral de Metas de Universalização*; the PGMU ) related to (i) new targets for the universalization of services; (ii) change in the criteria for the charging of local calls, substituting pulses for minutes in the calculation of charges, that what shall be in effect until July 2007; (iii) new parameters for the adjustment of rates (the Telecommunications Industry Index ( IST ) became the official index to measure the sector inflation and adjust rates, although private-regime companies that compete with us do not require Anatel s approval when setting their rates and may unilaterally determine the prices they charge for their services) and interconnection rates; and (iv) portability of fixed line telephone numbers. There is a risk that Anatel may change the values of network usage ( VUM ) as agreed to by BrT and BrT GSM.

Anatel, has already provided an agenda for 2007, highlighting some topics that will develop this year, including a Plan for Competition Target (*Plano Geral de Metas de Competição*), a review of the general mobile regulations, the Plan for Authorization Targets (*Plano Geral de Metas de Autorização*) (for mobile telecommunications) and the regulation of multimedia services.

These changes, some of them yet to be implemented, may affect the financial balance of our concession contract and adversely affect our business and financial conditions. We are still discussing certain terms of the new concession contract with Anatel, which we renewed in December 2005, to reconcile the fact that such terms do not contemplate investments made by us to reach the previous targets determined by our old concession contract, the fact that we are to bear the costs associated with the new universalization targets and the fact that the IST may not accurately reflect inflation in a given period, or the variation of the IGP-DI, the inflation index used before the IST. We cannot assure you that we will be able to successfully challenge such provisions. Since the IST was greater than actual inflation in

2006, 3.22% to 3.14%, respectively, the loss in comparison to the IGP-DI, the previously used index which would have amounted to 3.74%, must be considered.

***Our Concession Contracts could be terminated under several scenarios, each of which would adversely affect our financial condition.***

According to the General Telecommunications Law, as well as according to the concession contracts, the concessions are revocable in the following situations:

- non-renewal upon the expiration of the concessions;
- an extraordinary situation in which the public interest is in jeopardy, during which time Brazilian government may operate our company. In such cases, the Brazilian government must legislatively authorized to terminate the concession and our company must be indemnified;
- contractual, legal or free-will termination by us when an act or omission of the Brazilian government makes rendering services excessively burdensome to us, or:
- the occurrence of:
  - (a) a split-up, spin-off, amalgamation, merger, capital reduction or transfer of our corporate power without Anatel's authorization;
  - (b) the transfer of the concessions without Anatel's authorization;
  - (c) our dissolution or bankruptcy;
  - (d) an extraordinary situation where Brazilian government intervention, although legally possible, is not undertaken since such intervention would prove to be inconvenient, unnecessary or would result in unfair benefits for us; or
  - (e) our failure to comply with the universalization targets.
- The benefits we obtain from the concession contracts are a primary component of our financial performance. The loss of any or all of those contracts would materially affect our ability to continue operations.

***A proposed bill of law terminating monthly subscription fees may adversely affect our business and financial condition.***

On May 12, 2004, the Consumer Defense Committee of the House of Representatives approved a bill of law proposing the termination of the monthly subscription fees charged for fixed-line services by Brazilian telephone concessionaires, including our company. The bill is still under consideration before the House of Representatives, where a special committee was created on June 3, 2005, to discuss and to make a report regarding the bill. To date, there have been no further developments. The bill will be subject to the approval of the House of Representatives, the Senate and the President. In 2006 our revenue of monthly subscription fees charged for fixed-line was R\$3.5 billion. Should this bill be approved, it may have an impact on our current rate structure and, as a result, our operations and competitive position could be adversely affected.

***The procedure to establish the rules for the portability of fixed-line telephone numbers was initiated in 2006 and, when finally implemented, could result in a significant loss of our fixed-line customers.***

At the end of the year 2006, the procedure to establish the rules for the portability of fixed-line and mobile telephone numbers was initiated. Portability allows customers to change from one telecommunications services concessionary/authorized company to another without having to change their fixed-line or mobile telephone numbers (access code). The forecasted date for the complete implementation of the regulations and procedures is 2009. According to Anatel's expectations, it will be possible for customers to change their operators in the same area code as well as their addresses in the same area code without changing their telephone numbers. Anatel's objective in

introducing the telephone number portability is to increase the competition among the operators.

Two important components of the portability plan that may adversely affect our business are: (i) the customers do not need to contact us to change to another operator, so we will only be notified of the change without any opportunity to influence the customers' decisions; and (ii) the costs of portability will be paid for by the operators, not by the customers.

Portability was recently approved by Anatel pursuant to a specific regulation in this regard (Resolution 460). According to this regulation, portability shall be totally implemented by the first quarter of 2009.

***We are subject to financial covenants and other contractual provisions under our existing indebtedness. Failure to comply with these provisions could adversely affect our business and financial condition.***

The agreements that govern our debt, including our credit facilities with National Bank for Social and Economic Development (Banco Nacional de Desenvolvimento Econômico e Social - BNDES), contain a number of significant covenants, the failure to comply with which could adversely impact our business. In particular, the terms of these agreements restrict our ability, and the ability of our subsidiaries, to incur additional debt, make capital expenditures, grant liens, pledge assets, sell or dispose of assets and make certain acquisitions, mergers and consolidations. Furthermore, in accordance with a number of our debt agreements, including our credit facilities with BNDES, we are required to comply with these covenants and maintain certain specified financial ratios in order to maintain the current maturity dates for these debt agreements. As a general rule, the occurrence of an event of default under an agreement may trigger the acceleration of other agreements representing our indebtedness.

On January 5, 2006, we announced that we intended to book provisions in our financial statements for the year ended December 31, 2005, in the amount of R\$622 million (see description in ITEM 10. Additional Information BNDES Loan Agreement). Such provisions, if booked, could affect our results and, accordingly, jeopardize the compliance in the fiscal year ended on December 31, 2005 until and including the third quarter of 2006 of financial covenants set forth in certain debt agreements, including the credit facilities with BNDES, and the *Escritura de Emissão*, relating to the Debentures of the 4th issuance, being the 3rd public, the loan agreements entered into with Japan Bank of International Cooperation (JBIC) and with Sumitomo Mitsui Banking Corporation.

Therefore, prior to making the decision to book the provisions, we initiated negotiations with our creditors to temporarily adjust the affected financial covenants, in particular the ratio between EBITDA under Brazilian GAAP and the financial expenses and EBITDA Margin.

On January 6, 2006, we entered into negotiations with BNDES and the financial institutions acting as its agents under the credit facilities. According to the provisions of our agreements with BNDES, in the event of a failure by us to comply with certain semiannual financial covenants, BNDES may request the retention of funds in a blocked account. If, after the creation of such blocked account, we fail to comply with the financial covenants in the following semester, BNDES together with the financial institutions may, at its own discretion, declare the acceleration of the outstanding debt. On February 3, 2006, we successfully obtained a waiver from BNDES in order to avoid the acceleration of the agreements in view of a potential failure to comply with the financial covenants in the first semester of 2006.

As a result of the booking of provisions in our financial statements, we failed to comply with certain financial covenants established in our agreements with BNDES for Brasil Telecom Participações S.A. Consequently, BNDES, together with the pool of financial institutions, ran a retention of R\$192.2 million of our cash investments during 2006, without penalties concerning interest or fees, which would be valid until the agreed covenants were restored.

On December 8, 2006, we entered into contractual amendments with BNDES and the pool of financial institutions, which altered the structure of financial covenants that must be fulfilled by us. Therefore, funds temporarily retained as guarantee were totally released since we complied with the current financial covenants.

On January 30, 2006, the holders of our outstanding debentures of the 4th issuance approved an adjustment to the financial covenant relating to the ratio between Consolidated EBITDA and Consolidated Financial Expenses, contained in Section 4.19.1(e)(i) *Escritura de Emissão* from equal or higher than 2.25, to equal or higher than 1.5, as of the fourth quarter of 2005, until and including the third quarter of 2006.

On February 17, 2006, we signed the First Amendment to the Loan Agreement entered into with JBIC, dated March 18, 2004, and the First Amendment to the Loan Agreement entered into with Sumitomo Mitsui Banking Corporation, dated March 24, 2004. These amendments adjusted the financial covenants in each respective loan agreement relating to EBITDA and the financial expenses from equal or higher than 2.25, to equal or higher than 1.5, as of the fourth quarter until and including the third quarter of 2006. For the fourth quarter of 2005 we achieved a Consolidated EBITDA to Consolidated Financial Expenses ratio of 2.17.

Compliance with these covenants in future periods will depend upon our financial and operating performance, which may be affected by adverse business, market and economic conditions. If we are unable to comply with these covenants, or to obtain waivers from our lenders, our debt agreements may be accelerated and the terms of our debt agreements may be otherwise amended adversely. If we are unable to meet our debt service obligations or comply with our debt covenants, we could be forced to restructure or refinance our indebtedness, seek additional equity capital or sell assets.

***Certain beneficial owners directly or indirectly control a large percentage of our voting shares, and their interests may conflict with the interests of our other shareholders, including minority shareholders. Disputes among our controlling shareholders and entities that manage our controlling shareholders have had and could in the future have a material adverse effect on our management and operations.***

We are controlled by Brasil Telecom Participações S.A. (the Parent), which is in turn controlled by Solpart Participações S.A. (Solpart), whose stockholders are Timepart, Techold and Brasilco S.r.L., a wholly owned subsidiary of TII (Brasilco). As the controlling shareholder of Brasil Telecom Participações S.A., Solpart has the power to modify our business plan, modify our dividend plan and sell our material assets. As of the date of this annual report, control of Solpart, as well as certain actions taken by Solpart's shareholders and their affiliates are the subject of a number of judicial and arbitration proceedings.

On March 9, 2005, International Equity Investments, Inc. as the sole shareholder of CVC/Opportunity Equity Partners LP (since renamed Citigroup Venture Capital International Brazil, LP) (CVC LP) which holds a direct stake in Brasil Telecom Participações S.A. and a substantial indirect stake in Zain Participações S.A. (Zain), a company that indirectly owns a majority of the voting interests in Solpart, and therefore indirectly owns a majority of the voting shares of Brasil Telecom Participações S.A. and our company, publicly announced the ouster of CVC/Opportunity Equity Partners, Ltd (CVC Ltd), currently named Opportunity Equity Partners, Ltd., (Opportunity Ltd.) from the management of CVC LP. Opportunity Ltd. was replaced by a new company incorporated abroad, Citigroup Venture Capital International Brazil LLC (CVC International Brazil).

On March 9, 2005, CVC LP, in compliance with CVM/SEP/GEA-2 Written Notice 225/05 and the terms of CVM Instruction 358, announced that International Equity Investments, Inc. and CVC International Brazil had entered into certain agreements with Investidores Institucionais Fundo de Investimento em Ações (Investidores Institucionais FIA), Caixa de Previdência dos Funcionários do Banco do Brasil Previ (Previ), Fundação dos Economistas Federais Funcef (Funcef) and Fundação Petrobrás de Seguridade Social Petros (Petros), including a voting agreement with respect to their shares of Zain (collectively, the Agreements).

Under the Agreements, CVC LP and Investidores Institucionais FIA, with combined holdings of approximately 90% of the voting shares of Zain, will jointly exercise the corporate control of Zain and Invitel S.A. (Invitel), a company controlled by Zain with approximately 68% of its voting shares, and in which Previ, Funcef, Petros and other Brazilian pension entities hold nearly all of the remaining shares. The Agreements also establish that the parties are to attempt to disinvest, under identical terms, jointly and in an organized manner, their shareholdings in Zain and Invitel, companies which control, among other companies, us, our Parent, and our subsidiary, 14 Brasil Telecom Celular S.A. (BrT Celular).

In connection with the execution of the Agreements, Previ, Funcef and Petros signed the Put Option on Shares issued by Zain granting CVC LP a put option on its Zain shares, which may be exercised under certain circumstances during a limited period of time, but not before November 2007. CVC LP's right to exercise the put option is conditioned on the occurrence of certain future events, some of which are beyond the control of CVC LP, Investidores Institucionais FIA, Previ, Funcef and Petros. If CVC LP exercises its put option, the exercise price is set at R\$1,045,941,692.43, adjusted by the variation of the IGP-DI Index + 5% p.a. The fulfillment of the conditions to the



exercise of such put option granted by Previ, Funcef and Petros does not depend and is not tied to the occurrence of any operation or business involving, directly or indirectly, property or other assets owned by Zain, Invitel or any of their controlled companies, including us, our Parent and BrT Celular.

On April 12, 2005, Anatel issued a decision approving among other things: (i) the replacement of Opportunity Ltd. by CVC International Brazil as the general partner of CVC LP; (ii) the replacement of CVC/Opportunity Equity Partners Administradora de Recursos Ltda. by Angra Partners Consultoria Empresarial e Participações Ltda. as the new manager of Investidores Institucionais FIA, an indirect shareholder of Brasil Telecom Participações S.A. and Brasil Telecom S.A.; and (iii) certain changes resulting from the Agreements entered into by

CVC LP and Investidores Institucionais. This decision was published in the Federal Gazette (*Diário Oficial*) on April 14, 2005. After reviewing our appeal filed by prior management related to Opportunity Ltd., Anatel upheld its April 12, 2005 decision.

On October 6, 2003, Fundação 14 de Previdência Privada ( Fundação 14 ), successor to Fundação Sistel de Seguridade Social, was prevented by the other shareholders of Investidores Institucionais FIA from exercising its voting rights at the Investidores Institucionais FIA's Unitholders Meeting. At such meeting, Banco Opportunity S.A. was ousted from the administration of Investidores Institucionais FIA. Consequently, Fundação 14 brought an ordinary action before the 5th Federal Court of Rio de Janeiro against Previ and several investors in Investidores Institucionais FIA, seeking a declaration that the resolutions adopted at the Investidores Institucionais FIA's Unitholders Meeting held on October 6, 2003 were invalid. On May 18, 2005, an injunction granted on May 17, 2005 in favor of Fundação 14 by a federal tribunal in Rio de Janeiro, which would have allowed Banco Opportunity S.A. to return to the management of Investidores Institucionais FIA s was revoked by a decision granted by Superior Tribunal de Justiça ( STJ ), the highest Brazilian court for non-constitutional matters; in the proceeding SLS 128. On July 12, 2005, Fundação 14 filed before the 5th Federal Court of Rio de Janeiro a motion to abandon this lawsuit. To the best of our knowledge, this STJ decision is being challenged by Banco Opportunity S.A.

On July 27, 2005, at an Extraordinary General Shareholders Meeting of our Parent, the shareholders removed and replaced the members of the board. The new board members assumed their board positions on August 25, 2005, and at their first formal meeting replaced the officers of our Parent.

At an Extraordinary General Shareholders Meeting held on September 30, 2005, our shareholders removed and replaced the prior members of our Board of Directors (except for Mr. Antonio Cardoso dos Santos, who was elected by the holders of our Preferred Stock and remains a director). Also on September 30, 2005, our newly constituted Board of Directors replaced all of the senior officers with a new management team, including Mr. Ricardo Knoepfelmacher, as Chief Executive Officer, Paulo Narcélio Simões Amaral, as Chief Financial Officer and Investor Relations Officer, Luiz Francisco Tenório Perrone as Human Resources Officer, and Francisco Aurelio Sampaio Santiago as Network Officer. Subsequently, at an Extraordinary General Shareholders Meetings held on November 17, 2005 and January 12, 2006, our shareholders removed and replaced the members of our fiscal council (which functions as our audit committee for purposes of SEC and NYSE rules and regulations).

The process of replacing the directors and officers of Brasil Telecom Participações S.A. and Brasil Telecom S.A. was litigious, as evidenced by various lawsuits filed by our former managers and their affiliates in an attempt to resume their former management roles. While we cannot predict the cumulative effect of this ongoing litigation on our business and results of operations, extensive litigation regarding ownership of our company creates uncertainty with respect to the identity of our current and future management, which may impair our ability to carry out our business plan.

In observance of their fiduciary duties, under the terms of the applicable legislation, the current management of Brasil Telecom Participações S.A. and the current management of Brasil Telecom S.A. have performed and continue to perform internal investigations of the businesses and operations conducted by the former managers appointed by Opportunity, Ltd. In the course of such investigations, the current managers identified management acts indicating abuse of controlling power, breach of fiduciary duties, and conflict of interest, as well as various violations of Brazilian law and our Bylaws.

Therefore, in accordance with a notice to shareholders released on December 12, 2005, we filed a formal complaint with the CVM - the Brazilian Securities and Exchange Commission, against our former management, Opportunity Fund and other individuals and companies, both domestic and foreign, linked to our former management, who have been involved with, or participated in any way, or benefited from the actions which are the object of the formal

complaint. On March 21, 2006, a second formal complaint, as an amendment to the first complaint, was submitted to CVM, in light of new management actions identified.

We intend to pursue all appropriate legal measures to recover potential losses and damages suffered, consistent with our best interests and fiduciary obligations. On April 28, 2006, at Ordinary and Extraordinary Meetings of Shareholders of Brasil Telecom S.A. and Brasil Telecom Participações S.A., the shareholders of each company approved the filing of damages lawsuits against prior management.

In addition, the disputes among the shareholders of Solpart, including the dispute over the ownership structure of Solpart, and management of entities which hold a stake in Brasil Telecom Participações S.A. and Zain may result in changes to our board and/or senior management.

***The issues arising out of overlapping of licenses with Telecom Italia Mobile and its affiliates resulted in disputes which may divert management's attention and increase our legal expenses, and may also result in sanctions by Anatel.***

When we received the certification of achievement of universalization targets for 2003, established by Anatel, we were already providing fixed-line telephone services ( PSTN ) at domestic local and long distance modalities ( DLD ) intra-regional in Region II of the General Concession Plan ( PGO ).

After the achievement of such targets, Anatel, in January 2004, issued authorizations enlarging our potential areas of operations: PSTN local and LDN (*Longa Distância Nacional* – Domestic Long Distance) in Regions I and III of PGO (and in a few sectors of Region II); International Long Distance Call ( ILD ) in Regions I, II and III of PGO; mobile telephone, by means of our subsidiary BrT Celular, in Region II of Personal Mobile Service ( SMP ). Our existing concession agreements were also expanded, allowing LDN calls to any Brazilian territory. If TII acquires an indirect controlling interest in our Parent, TII and TIM (Telecom Italia Mobile) could be viewed as affiliated companies under the Brazilian telecommunications law. As a result, our ability to render domestic (NLD) and international (ILD) fixed-line telephone services, as well as mobile telephone services, in the same regions as TIM, would be at risk of partial restriction or revocation by Anatel.

On January 16, 2004, Anatel issued Act 41,780, establishing a period of 18 months during which TII could reacquire an indirect controlling interest in our company, as long as TII neither participated nor voted on any issues related to the overlapping services offered by us and TIM, including domestic and international long distance calls and mobile telephone services. On June 30, 2004, the Administrative Council for Economic Defense – CADE, in the records of Writ of Prevention 08700,000018/2004-68, set forth restrictions on the exercise of control rights by TII and its representatives over the Boards of Directors of Solpart, our Parent and our company.

On July 7, 2005, Anatel declared, by means of Act 51,450, that the counting of an 18 month term to solve the overlapping of licenses would start on the date of the effective return of TII to our control group. On July 26, 2005, Anatel, by means of Order 576/2005, declared that the counting of term would start on April 28, 2005. Therefore, according to Anatel, the interested companies were required to adopt measures necessary to eliminate the overlapping of licenses by the end of the 18 month term, October 2006, under the penalty of legal sanctions.

Depending on the final decision of Anatel, the threatened sanctions could have a material adverse effect on the business and operations of us and our subsidiary, BrT Celular.

On October 18, 2006, Anatel communicated its preliminary consent to the operation presented by Telecom Itália Internacional (TII) with purpose of resolving the overlapping of licenses of Personal Mobile Service (SMP) in Region II of the General Authorization Plan (PGA), and of the domestic (NDL) and international (ILD) fixed-line telephone Service (STFC) in Regions I, II and III of the PGA.

Anatel maintained the prohibitions in connection with the exercise of voting rights and veto rights in the deliberations related to the services of STFC (NDL and ILD) and SMP. The operation consists in the transfer to Brasilco S.r.l. (TII whole-owned subsidiary, with headquarters in Italy) of the totality of the voting shares held by the TII in the capital stock of Solpart Participações S.A. (corresponding to 38%), controller of Brasil Telecom Participações S.A., Brasil Telecom S.A. and the 14 Brasil Telecom Celular S.A. The participation of TII in Brasilco S.r.l shall be managed by Credit Suisse Securities (Europe) Limited.

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On October, 27, 2006, we received the terms for resignation, dated October, 20, 2006, of two Members of our Board of Directors indicated by TII, as well as of their respective substitutes. Also in October, 27, 2006, the Company received a letter from its controlling shareholder, Solpart Participações S.A., communicating that TII already carried through the transference of the shares in the terms approved by Anatel - therefore, in time. In October, 30, 2006, the Company released to the market material fact relative to these two subjects.

Also, on October, 30, 2006, Anatel communicated that the Telecom International Italy timely filed with Anatel, the necessary complementary documentation for analysis and approval of the operation: (i) evidence of the

resignation of the Directors and substitutes of Telecom Italy International in the Board of Directors of Brasil Telecom and Solpart Participações S.A., and (ii) corporate documents related to the transfer of shares and the independent management of the Brasilco by Credit Suisse, as Trustee of Telecom Italia.

With the confirmation still pending of the approval by Anatel of the documentation presented by TII to Anatel in October, 27, 2006, evidencing the implementation of the operation until October, 28, 2006, the overlapping of licenses for the exploration of SMP in Region II of PGA and the STFC of long national and international distance in regions I, II and III of the PGO will be terminated.

On November, 2006, TII submitted to Anatel the act of concentration with Brasilco S.r.l.. On the same month, Anatel, following the legal proceeding, submitted this operation to the Council of Economic Defense -CADE.

It is important to make clear that this new operation does not have anything to do with the so-called April Merger Agreements. The next paragraphs make this point clear.

On April 28, 2005, certain TII affiliates and BrT Celular purported to enter into various corporate agreements, including an instrument called Merger Agreement and a Protocol related thereto. The April 28, 2005 agreements alleged that the proposed merger was justified as a possible solution to the overlapping regulatory licenses and authorizations with TIM, and to avoid sanctions and penalties which could be imposed by Anatel. Certain actions contemplated by these agreements have since been forbidden by injunctions issued by the US and Brazilian courts. The agreements are also subject to legal challenges by our indirect shareholders.

On March 15, 2006, we and our subsidiary, BrT Celular, began an arbitration against TIM International N.V. (TIMINT) and TIM Brasil Serviços e Participações S.A. (TIMB), seeking to annul the Merger Agreement. We disclosed such arbitration in a material fact on March 16, 2006

On May 2, 2006, TIMINT and TIMB announced their decision to terminate the Merger Agreement. In the same letter, TIMINT and TIMB reserved their alleged rights under sections 10.3 and 11.1 of the Merger Agreement.

The arbitration that we brought against the Merger Agreement and the counterclaims for damages presented by TIMINT and TIMB continues.

***Problems with billing, invoicing and collection services may adversely affect our earnings.***

By Resolution No. 343, dated as of July 17, 2003, Anatel established that carriers shall render invoicing and collection services to other carriers with which they had entered into traffic agreements. Upon the certification that we had achieved the then established universalization targets, we were authorized to complete long distance national and international calls. In addition, in July 2003, we were authorized to complete calls from mobile handsets serviced by other carriers. We have entered into co-billing agreements with several carriers to include on our telephone bills the long distance services rendered by such carriers, as well as the long distance services rendered by other collective interest carriers. Any problems with the execution of invoicing and collection services by other carriers may adversely affect our levels of bad debts.

***Any reduction in the offer of products by suppliers may adversely affect us.***

We rely on several technology, equipment and services suppliers. Any difficulty in obtaining these products, due to, for example, a decrease in supply, excessive demand by global telecommunication players (causing product price pressure), discontinuity in the operations of one or more relevant suppliers (including bankruptcy or production problems), problems with the transfer or any other factor which affects the supplying of goods, may jeopardize either

our expansion plans or the continuity of our services.

***We sponsor employee social security plans and any changes in the regulations regarding mortality rates may require us to book additional provisions on our financial statements.***

The amount, frequency and duration of our contributions to employee social security employees plans is directly related to the mortality rate, which represents the average life span of employees, among other factors.

Any change in these criteria may result in the need to contribute for longer periods in comparison to those initially provided. Consequently, we may be compelled to book additional provisions on our financial statements, which may adversely affect our results.

***We may need to enter financing agreements with third parties in order to conclude potential strategic acquisitions and investments, and maintain wireless and fixed telephone line plants.***

Funding necessary for proposed acquisitions and investments as well as for capital improvements to and maintenance of our wireless and fixed-line assets may not be available through funds arising out of ordinary cash flow. As a result, we may need to enter into financing agreements with third parties in the future. Such financing may not be available to us in acceptable and competitive conditions. If we are unable to obtain financings on terms favorable to us or at all, our strategic plans and operations may be materially and adversely affected.

***Problems with sophisticated information and processing systems may have a significant adverse effect on our financial condition and results of operations.***

Our sophisticated information and processing systems are vital for our growth and our ability to monitor costs, collect debts, detect frauds, provide services to consumers, maintain operational efficiency and accomplish service targets, particularly in view of the increase in competition in our region. The updating and modernization of our systems may not be sufficient to avoid future flaws in each of these systems, which may have a significant adverse effect on our financial status and operational results.

***We may be required to obtain certain environmental licenses or fines may be levied against us for the failure to obtain such licenses.***

In Brazil, environmental licenses are regulated specially by Resolution No. 237/97, enacted by the National Environmental Council ( CONAMA ). This resolution lists those activities that require an environmental license and also establishes compulsory licensing for certain activities which may have a significant potential environmental impact.

In Brazil, federal, state and local governments each have the authority to determine whether an activity may potentially result in significant environmental effects and, consequently, demand and award environmental permissions for the implementation of these activities. Our regular operations include the installation and maintenance of cables, wires and transmission antenna towers in our operating region. The installation and maintenance of cables, wires and transmission antenna towers are not referred to in CONAMA Resolution No. 237/97 as activities that require previous compulsory licenses. We cannot be assured, though, that a jurisdiction will not interpret installation and maintenance as activities that may potentially cause environmental impacts and therefore require us to obtain an environmental license for the implementation of these activities. If we are compelled to obtain environmental licenses in some jurisdictions and we fail to obtain these licenses, we may be subject to the imposition of fines, which may vary from R\$500 to R\$10 million, total or partial suspension of those activities, and/or civil and criminal sanctions. According to environmental crimes law (Law n° 9.605/98), the criteria for the imposition of fines include the degree of the violation, taking into account the motivation for the violation, the consequences for public health and for the environment, and the criminal precedents of the agent regarding the accomplishment of environmental law and its economic capacity. The imposition of fines or the compliance with these environmental regulations may have a significant adverse effect on our business or results of operations.

On July 12, 2006, we commenced litigation in the Probate Court of the Commonwealth of Massachusetts, U.S.A. (In re Brasil Telecom S.A. Irrevocable Trust, No. 06P3268T1), asking the court to appoint Professor Claudio M. Considera in place of Roberto M. Unger as trustee of the Brasil Telecom S.A. Irrevocable Trust. The trust contains



certain causes of action held by us in the courts of Brazil but is governed by Massachusetts law. CVC/Opportunity Equity Partners Administradora de Recursos Ltda. opposes our request, as it is currently empowered under the trust to appoint the successor trustee to Roberto M. Unger. The case is currently in the discovery stage, and resolution is expected to occur in the third quarter of 2007.

***Consumer litigation related to the legality of our basic monthly subscription fees may have an adverse effect on our business.***

We are a defendant in a considerable number of lawsuits, both individual and collective, which contest our right to charge users of our fixed-line service a basic monthly subscription fee for continuous access to the service. These lawsuits have been stayed by a preliminary decision in the conflict of jurisdiction proceeding brought by Anatel before the SCJ, in which we submitted a brief. As a result, all preliminary and final decisions in the basic monthly subscription fee lawsuits were suspended, and these lawsuits were no longer submitted to a brief due to the conflict of jurisdiction litigation. The conflict of jurisdiction disputes have been resolved and lawsuits have resumed their regular course. There are 85,000 lawsuits contemplating the monthly subscription fees issue. Of these lawsuits, 8,400 have had trial court judgments favorable to the temporary dismissal of the fees for fixed-line services access.

### ***Risks Related to the Brazilian Telecommunications Industry***

***We face increasing competition in all segments of the Brazilian telecommunications industry, and the telecommunications industry may not continue to grow or may grow at a slower rate than in the past. This may have a material adverse effect on our market share, margins, results of operations and financial condition.***

The telecommunications industry in Brazil is becoming increasingly competitive. Our public-regime fixed-line concessions are not exclusive, and Anatel could grant additional private-regime authorizations in our region. Our fixed-line services are also subject to competition from wireless service providers. However such competition is still limited by the fact that rates for wireless calls are currently much higher than rates for calls on our fixed-line network. We also face competition from wireless service providers in the low end of the market through the offer of prepaid plans by such wireless providers. To date, Telemar Norte Leste S.A. ( Telemar ), Empresa Brasileira de Telecomunicações S.A. ( Embratel ), Intelig Telecomunicações Ltda ( Intelig ), Telecomunicações de São Paulo S.A. ( Telesp ), Global Village Telecom ( GVT ), Telmex do Brasil Ltda ( Telmex ), Fonet Brasil Ltda ( Fonet ), and Novação Telecomunicações Ltda ( Novação ), Aerotech Telecomunicações Ltda. ( Aerotech ), Alpamay Telecomunicações e Participações Ltda. ( Alpamay ), Conceito Comercialização e Marketing Ltda. ( Conceito ), Easytone Telecomunicações Ltda. ( Easytone ), Empresa de Telefonia Multiusuário Ltda. ( TM ), Epsilon Informática e Telecomunicações Ltda. ( Epsilon ), Faulkland Tecnologia em Telefonia Ltda. ( Faulkland ), Fonar Telecomunicações Ltda. ( Fonar ), Global Osi Brasil Telecomunicações e Conectividade Ltda. ( Global Osi ), GT Group International Brasil Telecomunicações ( GT ), IDT Brasil Telecomunicações Ltda. ( IDT ), Impsat Comunicações Ltda. ( Impsat ), Linknet Tecnologia em Telecomunicações Ltda. ( Linknet ), Nexus Telecomunicações Ltda. ( Nexus ), Rednox Telecomunicações S.A. ( Rednox ), RN Brasil Serviços de Provedores Ltda. ( RN ), Sermatel Comércio de Serviço de Tecnologia Ltda. ( Sermatel ), T-Leste Telecomunicações Leste São Paulo Ltda. ( T-Leste ), Telebit Telecomunicações e Participações S.A. ( Telebit ), Telecomunicações Dollarphone do Brasil Ltda. ( Dollarphone ), Transit do Brasil Ltda. ( Transit ) and Viper Serviços de Telecomunicações S.A. ( Viper ) have been granted permission by Anatel to provide local fixed-line services in the totality of our region.

Additionally, to date, TNL PCS S.A. ( Oi ), Embratel, Intelig, Telesp, GVT, Albra Telecomunicações Ltda ( Albra ), TIM Celular S.A. ( TIM Celular ), Easytone Aerotech, Alpamay, Conceito, TM, Epsilon, Faulkland, Fonar, Global Osi, GT, IDT, Impsat, Linknet, Nexus, Rednox, Sermatel, T-Leste T-Leste, Telebit Dollarphone, Transit and Viper have been granted permission by Anatel to provide long distance telecommunications services in the totality of our region. Now we also have to compete in our region against competitors from outside of our region that offer fixed-line, mobile, data, local and/or long distance telecommunications services throughout Brazil. Increased competition could have a material adverse effect on our market share, margins, results of operations and financial condition. Since January 2004, we have developed the ability to counteract losses in our market share in the local fixed-line market by providing interregional and international long-distance telecommunications services.

In September 2004, we commenced offering wireless services. Wireless services are equally competitive and we face competition in Region II from (i) a joint venture between Telefônica S.A. ( Telefônica ) and PT Móveis SGPS S.A. ( Portugal Telecom ) (marketed under the brand name Vivo ), (ii) Telmex, which competes against us in our region

through América Móviles (marketed under the brand name Claro ), (iii) TIM Celular, (iv) Sercomtel Celular S.A. ( Sercomtel Celular S.A. ), and (v) CTBC Celular S.A. ( CTBC Celular ). Competition for wireless telecommunications customers may require us to increase our costs and marketing expenses or provide services at lower rates than those we currently expect to charge for such services. Competition in data transmission services is not subject to regulatory restrictions. The market is open to a great number of competitors. Increased

competition in data transmission services may require us to reduce the rates we charge for data transmission services. Anatel may grant new authorizations to explore wireless telecommunication services in 2007 that may increase the number of competitors in our region.

In addition, the Brazilian telecommunications industry is consolidating, which results in larger competitors with greater resources. There can be no assurance that increased competition in all segments of the Brazilian telecommunications industry will not have a material adverse effect on our market share, margins, results of operations and financial condition.

Our ability to continue to compete successfully will depend on the success of our marketing, financial and other resources (including our access to capital) in comparison to our competitors and on our ability to anticipate and respond to competitive factors affecting the industry, including the introduction of new services, changes in consumer preferences, changes in regulation, demographic trends, economic conditions, discount pricing strategies by competitors as well as further industry consolidation. Currently, we compete with our competitors primarily on the basis of features, pricing and customer service. However, we cannot predict exactly which factors in the future will be important in maintaining our competitive position, such as the increasing need to offer promotions, discounts and other marketing initiatives, or what expenditures will be required to develop and provide the necessary technologies, products and services to remain competitive. An inability to compete in any of these factors may adversely affect our market share, margins, results of operations and financial condition.

In addition, we may also face increased competition due to unbundling regulations. On May 13, 2004, Anatel issued Order (*Despacho*) 172, which establishes rules for partial unbundling of local telephone networks, which we refer to as line sharing, and full unbundling of local telephone networks, and requires us to make our networks available to other telecommunications service providers. This legislation limits the rate we can charge for line sharing per line for broadband speeds of up to 512 kbps. Additional charges, such as co-location charges, are applied over the line sharing base price, increasing the total cost of the unbundled line. Anatel has not yet fixed rates for full unbundling, although we expect that these rates will be lower than the rates we currently are permitted to charge. This regulation was designed to increase competition in the local fixed-line and broadband Internet access markets by making it easier for new telephone companies operating under either the public or private regime to enter these markets and for existing providers to provide new services or enter new regions, since the networks of all telecommunications service providers, including fixed-line operators such as us, will be made available at lower rates. Similarly, this legislation makes it easier for us to provide new services and enter into new regions in competition with other operators. However, operational rules for the implementation of unbundling have not yet been agreed to among Brazilian telecommunications operators. These regulations are recent, and as of December 31, 2006 no unbundled lines had been used by competitors in our region. We cannot assure you that we can compete without suffering an adverse impact on market share, margins, and results of operations or financial condition based on the implementation of unbundling.

Moreover, cable television services companies are beginning to offer telecommunication services, and increasingly there are other alternatives to for consumers to obtain their telecommunication services, such as satellite transmission and voice over the Internet protocol ( VoIP ). Another example is the conversion of fixed-line telephone users to wireless telephone users. These changes may lead to the migration of some of our subscribers, resulting in a reduction in earnings, which may adversely affect our company.

Any economic, technological or other developments resulting in a slowdown in growth or a reduction in demand for our fixed-line or other services may harm our business and revenues. To remain competitive we must diversify further our services, and there can be no assurance that we will be successful in doing so.

***We depend on other telecommunications services providers. We may not be able to enter into favorable interconnection and unbundling agreements.***

In order to receive or send calls from or to customers of other fixed-line and wireless Brazilian networks and international networks, we must interconnect with the networks of our competitors. The Brazilian General Telecommunications Law requires all telecommunications service providers to interconnect their networks with those of other providers on a non-discriminatory basis. The rates to be paid by one fixed-line network operator to the other for the use of each other's fixed-line network are currently regulated by Anatel.

The current interconnection model is asymmetric, with higher rates in effect for mobile interconnection than fixed-line interconnection. As a result, mobile operators generally retain more than 80% of net revenues from fixed-to-mobile calls, while fixed-line carriers, like us, may offer this service incurring negative margins. In light of such imbalance, Anatel established that from July 2004 on, interconnection rates for wireless networks (the VU-M) would be freely negotiated. The companies agreed to establish a provisional readjustment and submit the final decision to Anatel's arbitration under the telecommunication sector legislation. This process is ongoing and no decision has yet been reached. We can not assume that Anatel's arbitration regarding the interconnection tariffs will be favorable to us. Although we are working to mitigate this risk by continuing to increase our mobile market share, if Anatel's decision is unfavorable to us, our operating and financial results may be adversely affected.

***The failure to implement the technology necessary to assess and combat fraud on our network could adversely affect our results of operations.***

The fraudulent use of telecommunications networks imposes a significant cost upon service providers, who must bear the cost of services provided to fraudulent users. We suffer loss of revenue as a result of fraudulent use, and also cash costs due to our obligation to reimburse carriers for the cost of services provided to fraudulent users. During 2004, we installed a Fraud Management System to detect and prevent fraud. In addition to a system to monitor customers' usage based on their traffic behavior, we implemented a system to keep subscribers under close surveillance. The fraud system is based on a signaling network and has an interface to the call-blocking platform in order to limit revenue loss once fraudulent use has been identified. We cannot guarantee that our Fraud Management System will effectively detect and prevent fraud.

Since 2006, all wireline and wireless telephone service providers created a group against frauds, beginning to work together to control and reduce fraud cases. There can be no assurance that all operators with which our network is interconnected have appropriate anti-fraud treatment in their networks. In 2001, we created a fraud management department to provide specialized customer service to customers affected by fraud. During fiscal year 2002, several automated procedures were created and placed in various parts of our operations to detect and control possible abnormalities that could represent fraudulent activities. These controls have a preventive function, and work both pro-actively and, should a fraud occur, reactively. In 2003, we implemented controls to capture fraud events automatically, such as a non-billing mechanism for fraud-blocked terminals, a cut-off limit system for service usage, and a webpage to gather any fraud claims from the community. At the end of 2003, we created the IT Revenue Assurance Group, which develops systems to assist the revenue assurance department in fraud combating. During 2004, the Group implemented a significant number of applications to monitor and detect fraud in different areas including public telephone, bad debt, revenue chain, key performance indicators and others. These actions achieved a better level of control and mitigated the risk of loss from fraud as compared to previous years. We cannot guarantee that these fraud control measures will continue to be accurate and effective to reach the desired level of fraud control. We continue to deploy and implement the technology necessary to assess the accuracy and effectiveness of our fraud combative procedures. Should we not be able to correctly quantify and combat fraud on our network, our results of operations could be adversely affected.

***Developments in the global telecommunications industry and technology are difficult to predict, and a failure by us to respond to such developments may have a material adverse effect on our financial condition and results of operations.***

All companies in the global telecommunications industry must adapt to rapid and significant changes in technology that are often difficult to anticipate. While we have been upgrading our network with technologically advanced fiber optic cable with a microwave overlay, it is possible that our network will be challenged by competition from improved or new technologies in the future. Technological changes may adversely affect our competitive position, require substantial new capital expenditures and/or require write-offs of obsolete technology. If we fail to implement

technological advances, we may be unable to continue to compete in the global telecommunications industry.

The mobile telephone sector, in particular, requires considerable technological developments, constant capacity, quality and digital technology data transmission speed improvements, shorter development periods of new cycles and changes due to users' needs and preferences. New technologies, superior to the ones used by BrT GSM may be developed. Furthermore, it is expected that Anatel will promote 3G (Third Generation) mobile telephone auctions in the near future, which will allow eventual buyers of such licenses to adopt technological platforms which allow the offer of more advanced mobile telephone services than those allowed by our current mobile platform.

Thus, it cannot be assured that we will remain competitive due to the adoption, in due time, of the new technologies, as they are developed.

***In the event of a natural disaster, war, significant public disturbance or for economic reasons, the Brazilian government could temporarily seize or permanently expropriate our assets, which could have a material adverse effect on our financial condition and results of operations.***

The Brazilian government has the authority to temporarily seize all assets related to telecommunications concessions in the event of natural disaster, war, significant public disturbance, threats to internal peace, or for economic reasons and other reasons related to national security. In addition, the Brazilian government has the statutory right to permanently expropriate any telecommunications concession and claim any related assets for reasons of public interest. Brazilian law provides for compensation in connection with losses and damages related to temporary seizure or expropriation. However, in the event of a temporary seizure or expropriation of any of our assets there can be no assurance that the actual compensation paid would be adequate or that such payment would be timely. An inadequate or untimely payment would have a material adverse effect on our financial condition and results of operations.

***Restructuring of Governmental Regulatory Agencies may adversely affect the operations of our company.***

A bill of law subject to the approval of National Congress provides for the administration, organization and social controlling of Governmental Regulatory Agencies, such as Anatel. The purpose of this bill of law is to change the structure, functioning and competence of those agencies, by, among other measures: (i) implementing administration agreements to be entered into by and between the agencies and the correspondent related ministries; (ii) creating public hearings on the agencies, with the purpose of controlling the services rendered and monitoring the internal process of adjudication of accusations and complaints by citizens, either against the agencies' activities or the entities subject to their control; (iii) changing the mandates of managers, including presidents and directors, to four years; and (iv) transferring the authority to award concession licenses for rendering public services to ministries, leaving for the agencies the task of regulating, inspecting, monitoring bid proceedings and awarding authorizations for the operation of services under private-regime.

Considering the level of political influence over the ministries, the agencies may be subject to further instability in their administration, which may trigger unexpected changes in regulation and policies affecting public services concessionary companies, such as our company. We cannot foresee the impact of the approval of the referred bill of law on our operations and our competitive position.

***The failure to accomplish Anatel's targets may result in the imposition of sanctions and penalties on our company.***

We are required to accomplish targets established by the Federal Government and Anatel. Due to the public nature of the services rendered by our company, according to the terms of the concession contracts and of the applicable regulation, we must cover a geographic area and comply with targets on the execution of the services rendered.

In this regard, the PGMU and the PGMQ also provide for targets that we must achieve. Potential consequences of our failure to comply with such targets include the imposition of fines and/or other penalties and the termination of our concession contract, which may cause significant financial loss to business, financial condition and results of operations. In 2007, Anatel intends to establish a General Plan of Competition Targets ( *Plano Geral de Metas de Competição* ), that will create new obligations upon our company.

### ***Risks Related to Operations in Brazil***



***Brazilian political and economic conditions have a direct impact on our business and the market price of the Preferred Shares underlying our ADSs.***

Substantially all of our operations and customers are located in Brazil. Accordingly, our financial condition and results of operations are substantially dependent on Brazil's economy, which has been characterized by frequent and occasionally drastic intervention by the Brazilian government and volatile economic cycles in the past.

The Central Bank has reduced the base interest rate ( SELIC ) from 17.75% in December 2004 to 12.75% in March, 2007. During that time period, however, facing various economic, political and inflation indicators during 2005, the Central Bank increased the SELIC to 19.75% between June and September 2005. In 2002, as a reaction to political and economic uncertainties, the global economic downturn, the crisis in Argentina and the Brazilian presidential elections, the dollar appreciated by 52.3% against the *real* to R\$3.5333 per US\$1.00 at December 31, 2002. The *real* recovered in 2003, appreciating by 18.2% to R\$2.8892 per US\$1.00, at December 31, 2003. In 2004, the *real* appreciated by 8.1% against the dollar, quoted at R\$2.6544 per US\$1.00 on December 31, 2004. In 2005, the *real* appreciated by 13.4% against the dollar, quoted at R\$2.3407 per US\$1.00 on December 31, 2005. In 2006, the *real* appreciated by 9.5% against the dollar, quoted at R\$2.1380 per US\$1.00 on December 31, 2006. We cannot guarantee that the *real* will not substantially devalue again in the future.

In the past, the Brazilian government has often changed monetary, fiscal, taxation and other policies to influence the course of Brazil's economy. We have no control over and cannot predict what measures or policies the Brazilian government may take in response to the current Brazilian economic situation or how Brazilian government intervention and government policies will affect the Brazilian economy and, both directly and indirectly, our operations and revenues.

Our operations, financial condition and the market price of our Preferred Shares and ADSs may be adversely affected by changes in policy involving exchange controls, tax and other matters, as well as factors such as:

- fluctuations in exchange rates;
- base interest rate fluctuations;
- fiscal and taxation legislation changes;
- inflation; and
- other political, diplomatic, social and economic developments within and outside Brazil that affect the country.

On January 1, 2003, Luiz Inácio Lula da Silva from the Labor Party took office as the new President of Brazil. Although the government has not departed significantly from the economic policies of the former administration, the *real* appreciated 9.5% against the dollar during 2006 and concerns remain about the future policies of the Brazilian government. While the current administration's policies to date have not been adverse to the telecommunications industry, uncertainty over the future economic policies of the Brazilian government may contribute to economic uncertainty in Brazil and to heightened volatility in the Brazilian international securities markets, which may have a material adverse effect on our business and results of operations.

***If Brazil experiences substantial inflation in the future, our revenues and the market price of the Preferred Shares and ADSs may be reduced.***

Brazil has in the past experienced extremely high rates of inflation, with annual rates of inflation reaching as high as 2,489% in 1993 (according to the Brazilian National Consumer Price Index (*Índice Nacional de Preços ao Consumidor*) published by the *Instituto Brasileiro de Geografia e Estatística* ( IBGE ). Inflation and governmental measures to combat inflation have both in the past had significant negative effects on the Brazilian economy. In 1994 the Brazilian Government introduced the *Plano Real* ( Real Plan ) with the objective of reducing inflation and building a base to sustainable economic growth.

Since the introduction of *Plano Real*, inflation has remained at stable levels, substantially below prior periods. However recent international events like the emerging markets crisis, the US terrorist attacks, and the subsequent military conflicts, have caused and may continue to cause destabilization in international markets. These events may affect the Brazilian economy in the form of fluctuations in the exchange rate between the US dollar and the *Plano Real*, interest rate increases, oil price increases, and, consequently, increases in the rate of inflation.

In 2004, the inflation rate measured by the Extensive Consumer Price Index ( IPCA ) was 7.6%, above the established initial target of 5.5%, but within the 2.5 percentage points of tolerance above and below the target. In 2005, the inflation rate was 5.7%, above the established target of 4.5%, but within the 2.5 percentage points of tolerance above and below the target. For 2006 and 2007, the established target is 4.5% with 2.5 percentage points of tolerance. The measured inflation by IPCA in 2006 was 3.14% and until February 28, 2007 the cumulative inflation was 0.882% .

Actions taken to combat inflation and public speculation about possible future actions have also contributed to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities markets. If Brazil experiences substantial inflation in the future, our costs may increase, and our gross profit may be affected to the extent that our rate increases and our net operating revenues do not keep up with the rate of inflation. Additionally, our service debt and the cost of new financial funding may increase. We cannot predict the effect that an inflation increase would have on our financial condition, our capacity, our cash generation, or our operational results.

***Devaluation of the real may lead to substantial losses on our liabilities denominated in or indexed to foreign currencies and a reduction in our revenues.***

During the last four decades, the Brazilian Central Bank has periodically devalued the Brazilian currency. The exchange rate between the *real* and the dollar has varied significantly in recent years. For example, the *real*/dollar exchange rate fell from R\$1.9554 per dollar at December 31, 2000 to R\$3.5333 at December 31, 2002. In 2003, the *real* appreciated in value by 18.1% to R\$2.8892 per dollar. In 2004 the *real* appreciated in value by 8.1% to R\$2.6544 per dollar. In 2005 the *real* appreciated in value by 13.4% to R\$2.3407 per dollar. In 2006, the *real* appreciated in value by 9.5% to R\$2.1380 per dollar.

A significant amount of our financial assets and liabilities are denominated in or indexed to foreign currencies, primarily dollars. As of December 31, 2006, R\$1,026.1 million or 20.7% of our financial indebtedness was denominated in a foreign currency. When the Brazilian currency is devalued, we incur losses on our liabilities denominated in or indexed to foreign currencies, such as our dollar-denominated long-term debt and foreign currency loans, and experience gains on our monetary assets denominated in or indexed to foreign currencies, as the liabilities and assets are translated into *reais*. If devaluation occurs when the value of such liabilities significantly exceeds the value of such assets, including any financial instruments entered into to protect us from exchange rate variation purposes, we could incur significant reduction in our revenues, even if their value has not changed in their original currency. This could adversely affect our ability to meet certain of our payment obligations. A failure to meet certain of our payment obligations could trigger a default in certain financial covenants in our loan and credit facilities, which would have a material adverse effect on our business and results of operations.

***We are subject to delays and delinquency on our accounts receivable.***

Our business is affected by customers' ability to pay their bills. If the Brazilian economy worsens because of, among other factors:

- the level of economic activity;
- inflation;
- devaluation of the *real*; or
- an increase in domestic interest rates,

A greater portion of our customers may not be able to pay their bills, which would increase our bad debts and provisions for doubtful accounts. Strict regulation from Anatel prevents us from implementing certain policies that could have the effect of reducing delinquency, such as service restrictions or limitations on the types of services provided based on a subscriber's credit record. Losses from accounts receivable reached R\$384.3 million in 2006, against R\$449.3 million in 2005 and R\$411.3 million in 2004, decreasing in percentage of gross revenues terms, from 3.2% in 2004 to 3.1% in 2005 and 2.5% in 2006. However, if economic conditions worsen in Brazil or if we are unable to implement policies to limit subscriber delinquencies or otherwise select our customers, persistent subscriber delinquencies and bad debt can adversely affect our financial results. See Item 5. Operating and Financial Review and Prospects Critical Accounting Policies and Estimates Provision for Doubtful Accounts.

***Any increase in taxes levied on the telecommunications sector in connection with tax reforms expected to be implemented in the future could affect the results of our operations.***

Increases in Brazil's already high level of taxation could adversely affect our profitability. Increases in taxes for the telecommunications sector usually result in higher tariffs for our customers. High tariff levels generally result in lower levels of usage of our services and, therefore, lower net sales. Lower net sales result in lower margins because a significant portion of our costs are fixed and thus do not vary substantially based on the level of usage of our network or our services. Although mobile and fixed services are equally taxed, there can be no assurance that the Brazilian government will not increase current tax levels, at state and/or federal levels, and that this will not adversely impact our business.

In December 2003, the Federal Senate approved part of a tax reform bill, the text of which was consolidated in Constitutional Amendment 42, enacted on December 19, 2003. Constitutional Amendment 42 provides for an extension on the assessment of the Provisional Contribution of Financial Transfers (*Contribuição Provisória sobre Movimentação Financeira - CPMF*), the assessment of *Programa de Integração Social* ( PIS ); and *Contribuição para Financiamento da Seguridade Social* ( COFINS ) taxes on import transactions, and the assessment of COFINS under a non-cumulative regime. Certain issues that were under discussion in 2003, related to taxes on the commercialization of goods and rendering of services, were not included in Constitutional Amendment 42 and may be discussed again in 2007.

Some important issues originally provided for in the tax reform bill relate to: (i) harmonization of ICMS tax rules, which would be governed by a single federal legislation applicable to all states; (ii) equalization of ICMS rates; and (iii) limitations on granting tax incentives. If approved, such measures will be gradually adopted in 2007. Additionally, the Federal Senate has discussed the merger of the ICMS and IPI into a single federal tax assessed upon the commercialization of goods and rendering of interstate and intermunicipal transportation and communication services. We cannot guarantee that, if the merger of the ICMS and IPI is accomplished, certain tax incentives granted to us in the past will continue to be granted, and cannot determine the effect that a cessation of such tax incentives may have on our results of operations. See Item 10. Additional Information Taxation.

***Proposed changes in Brazilian labor law may affect our labor relations.***

In April 2003, the Lower House reopened discussions regarding changes in the Brazilian Labor Law (*Consolidação das Leis do Trabalho*, or CLT). A further revision of union relations in Brazil is also under discussion in the Lower House. Although the progress of these proposed modifications has slowed during the last year as political forces have showed some resistance, we cannot predict the effect of any such modifications on our labor relations, which could have a negative effect on our business.

***It may be difficult to effect service of process upon, or to enforce foreign judgments upon us, our directors and our officers.***

We are organized under the laws of Brazil, and all of our directors and officers reside outside the United States. In addition, a substantial portion of our assets, and most or all of the assets of our directors and officers, are located in Brazil. As a result, it may be difficult for an ADS holder to effect service of process within the United States or other jurisdictions outside of Brazil upon us or such persons. In addition, because substantially all of our assets and all of our directors and officers reside outside the United States, any judgment obtained in the United States against us or any of our directors or officers may not be collectible within the United States. There is doubt as to the enforceability of civil liabilities under the U.S. Securities Act of 1933, as amended (the Securities Act) or the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act) pursuant to original actions instituted in Brazil.

**Risks Related to Our Preferred Shares and American Depositary Shares**

*Our ADS holders may not have the same rights with respect to voting, dividends, distributions, and preemptive rights, among others, that may expose our ADS holders to greater risk than holders of our Preferred Shares.*

Our ADS holders may not have the same voting rights as holders of our Preferred Shares. Under our Bylaws and Brazilian Corporate Law, in the limited circumstances where holders of our Preferred Shares are able to vote, an ADS holder will be able to exercise voting rights with respect to the Preferred Shares represented by ADSs

only in accordance with the provisions of the deposit agreement relating to the ADSs. There are practical limitations upon the ability of holders of our ADSs to exercise voting rights due to the additional procedural steps involved in communicating with such holders. See Item 7. Major Shareholders and Related Party Transactions Major Shareholders and Item 10. Additional Information Memorandum and Articles of Association Voting Rights.

An ADS holder that is a resident of the United States may not be able to exercise preemptive rights or certain other rights with respect to our Preferred Shares. A holder of our ADSs may not be able to exercise preemptive rights with respect to the ADSs unless a registration statement is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. We are not required to file a registration statement relating to preemptive rights with respect to our Preferred Shares, and there can be no assurance that we will file any such registration statement. If a registration statement is not filed and an exemption from registration does not exist, Citibank, N.A., as depository (the Depository), will attempt to sell the preemptive rights, and our ADS holders will be entitled to receive their share of the proceeds of the sale. However, the preemptive rights will expire if the Depository cannot sell them, and therefore we cannot guarantee that our ADS holders will be able to either exercise their preemptive rights or receive the proceeds from their sale. For a more complete description of preemptive rights with respect to our Preferred Shares, see Item 10. Additional Information Memorandum and Articles of Association.

Pursuant to our deposit agreement with the Depository, any payments of cash dividends and distributions that we may make will be made in Brazilian currency to *Banco Bradesco S.A.*, as custodian for the Preferred Shares underlying our ADSs, on behalf of the Depository. The Depository will then convert such proceeds into dollars and cause such dollars to be delivered to the Depository for distribution to our ADS holders. Holders of ADSs could be adversely affected by devaluations of the Brazilian currency that may occur due to delays in, or a refusal to grant, any required government approval for conversions of Brazilian currency payments and remittances abroad in connection with the Preferred Shares underlying our ADSs. See Item 10. Additional Information Memorandum and Articles of Association Dividends.

We may agree with the Depository to modify the deposit agreement at any time without the consent of the holders of our ADSs. We will give holders of our ADSs 30 days' prior notice of any modifications that would materially prejudice any of their substantial rights under the deposit agreement. After receipt of such notice, our ADS holders will be bound by the modifications to the deposit agreement if such holders continue to hold ADSs after the modifications to the deposit agreement become effective.

***Holders of ADSs may have fewer and less well-defined shareholders' rights than in the United States.***

Our corporate affairs are governed by our Bylaws and Brazilian Corporate Law, which may differ from the legal principles that would apply if we were incorporated in a jurisdiction in the United States. Under Brazilian Corporate Law, the holders of our Preferred Shares and our ADSs may have fewer and less well-defined rights to protect their interests relative to actions taken by our board of directors or the holders of our Common Shares than under the laws of other jurisdictions outside Brazil.

Restrictions on insider trading and price manipulation, rules and policies against self-dealing and regarding the preservation of shareholder interests may not be as detailed, well-established and enforced in Brazil as in the United States, which may potentially disadvantage the holders of our Preferred Shares and/or ADSs. For example, when compared to Delaware corporate law, Brazilian Corporate Law and practice has less detailed and well-established rules, and fewer judicial precedents relating to the review of management decisions involving duty of care and duty of loyalty standards in the context of corporate restructurings, transactions with related parties and sale-of-business transactions. In addition, shareholders in Brazilian companies must hold at least 5.0% of the outstanding share capital of a corporation in order to have standing to bring shareholders' derivative suits. Furthermore, shareholders in Brazilian companies ordinarily do not have standing to bring class action suits.



***The relative volatility and illiquidity of the Brazilian securities markets may substantially limit an ADS holder's ability to sell the Preferred Shares underlying the ADSs at the price and time desired.***

Brazilian investments, such as investments in our securities, are subject to economic and political risks that may affect the ability of investors to receive payment, in whole or in part, in respect of their investments, including, among others:

- changes in the regulatory, tax, economic and political environment; and
- restrictions on foreign investment and on repatriation of capital invested.

The Brazilian securities markets are substantially smaller, less liquid, more concentrated and more volatile than major U.S. and European securities markets, and are not as highly regulated or supervised as those markets. As a consequence, the ability of our ADS holders to sell the Preferred Shares underlying the ADSs may be substantially limited.

***Our ADSs are traded in small volumes, limiting your ability to sell your ADSs that represent preferred shares at a desirable price, if at all.***

The trading volume of our ADSs has traditionally been very low. Even if the trading volume of our ADSs increases, we can give no assurance that it will be maintained or will result in a desirable stock price. As a result of this low trading volume, it may be difficult to identify buyers to whom you can sell your ADSs and you may be unable to sell your ADSs at an established market price, at a price that is favorable to you, or at all. A low volume market also limits your ability to sell large blocks of our ADSs at a desirable or stable price at any one time. You should be prepared to own our ADSs indefinitely.

***Sales of substantial amounts of our ADSs in the public market could harm the market price of our ADSs.***

We cannot predict the effect, if any, that future sales of our ADSs in the public market, or the availability of our ADSs for sale in the market, will have on the market price of our ADSs. We, therefore, can give no assurance that sales of substantial amounts of our ADSs in the public market, or the potential for large amounts of sales in the market, whether under any registration statement or otherwise, would not cause the price of our ADSs to decline considerably or impair our future ability to raise capital through sales of our ADSs.

***Developments in other countries may affect the Brazilian economy and the market price of our Preferred Shares and our ADSs.***

The securities of Brazilian issuers have been influenced by economic and market conditions in other countries, especially other emerging market countries. Since the end of 1997, and in particular during 2001 and 2002, the international financial markets have experienced significant volatility as a result of economic problems in various emerging market countries. Investors subsequently have had a heightened risk perception for investments in such markets. As a result, in some periods, Brazil has experienced a significant outflow of dollars and Brazilian companies have faced higher costs for raising funds, both domestically and abroad and have been impeded from accessing international capital markets. We cannot assure investors that international capital markets will remain open to Brazilian companies, including our company, or that prevailing interest rates in these markets will be advantageous to us or that we will be able to obtain additional financing on acceptable terms or at all. As a consequence, the market value of our securities may be adversely affected by these or other events outside of Brazil. See Item 9. The Offer and Listing Offer and Listing Details. There can be no assurances that future events elsewhere, especially in emerging market countries, will not have an adverse effect on the market value of our Preferred Shares and our ADSs.

***Changes in Brazilian tax laws may have an impact on the taxes applicable to the disposition of the ADSs.***

According to Law 10,833, enacted on December 29, 2003, capital gains earned by a non-Brazilian resident upon the sale of assets located in Brazil to a Brazilian resident or to another non-Brazilian resident are subject to Brazilian withholding tax. If the sale of assets in Brazil is interpreted to include a sale of our ADSs or Preferred Shares, this new provision could result in the imposition of income tax on the gains arising from their disposition by a non-resident of

Brazil to another non-resident of Brazil. However, gains obtained on transactions carried out at a stock exchange according to Resolution No. 2,689/00 are not subject to the provisions set forth by Law No. 10,833/03. Considering the general and unclear scope of Law 10,833 and the absence of judicial guidance in respect thereof, we cannot predict the exact scope of Law 10,833 or the effect that Law 10,833 will have on holders of our ADSs or Preferred Shares.

**ITEM 4. INFORMATION ON THE COMPANY****History and Development of the Company**

Brasil Telecom S.A. is a corporation organized under the laws of the Federative Republic of Brazil. We are one of the fixed-line telecommunications companies that resulted from the breakup and privatization of Telebrás by the Brazilian Federal Government in 1998. We are an amalgamation of the following operating companies formerly controlled by *Telebrás*: *Telecomunicações de Santa Catarina S.A. Telesc* ( *Telesc* ), *Telecomunicações de Goiás S.A. Telegoiás* ( *Telegoiás* ), *Telecomunicações de Brasília S.A. Telebrásília* ( *Telebrásília* ), *Telecomunicações do Mato Grosso S.A. Telemat* ( *Telemat* ), *Telecomunicações do Mato Grosso do Sul S.A. Telems* ( *Telems* ), *Telecomunicações de Rondônia S.A. Teleron* ( *Teleron* ), *Telecomunicações do Acre S.A. Teleacre* ( *Teleacre* ), *Companhia Telefônica Melhoramento e Resistência CTMR* ( *CTMR* ), and our predecessor, *Telecomunicações do Paraná S.A. Telepar* ( *Telepar* ) and CRT, a company acquired by us from Telefônica S.A. in July 2000.

Our principal executive office is located at SIA/Sul, ASP, Lote D, Bloco B 71215-000 *Setor de Indústria e Abastecimento*, Brasília, DF, Brazil, and our telephone number is (55-61) 3415-1140. Our agent in the United States is CT Corporation System, located at 111 Eighth Avenue, 13th floor, New York, New York 10011.

***Historical Background***

Prior to the incorporation of Telebrás in 1972, there were more than 900 telecommunications companies operating throughout Brazil. Between 1972 and 1975, Telebrás acquired almost all of the other telephone companies in Brazil and thus came to have a monopoly over the provision of public telecommunications services in almost all areas of the country. Beginning in 1995, the Federal Government undertook a comprehensive reform of Brazil's telecommunications regulatory system. In July 1997, Brazil's National Congress approved the *Lei Geral de Telecomunicações* (the General Telecommunications Law, and together with the regulations, decrees, orders and plans on telecommunications issued by Brazil's Executive Branch, the Telecommunications Regulations ), which provided for the establishment of a new regulatory framework, the introduction of competition and the privatization of Telebrás.

The General Telecommunications Law established Anatel as the regulator of the telecommunications industry in Brazil. Anatel is administratively independent from the Brazilian Government and financially autonomous. Anatel is required to report on its activities to the Ministry of Communications and to the Brazilian Congress on an annual basis. In addition, any proposed regulation of Anatel is subject to a period of public comment, including public hearings. Anatel's decisions may be challenged in the Brazilian courts. Among its functions are the following:

- to propose the implementation or elimination of services in the public regime;
- to manage the spectrum of radio frequency and the use of orbits;
- to approve tariff readjustment;
- to settle conflicts of interest among the companies that render telecommunications services;
- to protect and defend the rights of users of the telecommunications services;
- to prevent, control and impose economic penalties in the telecommunications industry;

- to impose restrictions, limits or conditions on corporate groups in obtaining or transferring the concessions, permissions and authorizations, in order to ensure a competitive environment; and
- to establish the rate structure for each kind of service rendered in the public regime.

On January 30, 1998, in preparation for the restructuring and privatization of Telebrás, the cellular telecommunications operations of Telebrás' operating subsidiaries were spun off into separate companies. On May 22, 1998, Telebrás was restructured to form, in addition to Telebrás, 12 new holding companies by means of a

procedure under Brazilian Corporate Law called *cisão*, or split-up. These new holding companies were allocated virtually all the assets and liabilities of Telebrás, including the shares held by Telebrás in its operating companies. The split-up of Telebrás into 12 new holding companies is referred to herein as the breakup of Telebrás.

These holding companies, together with their respective subsidiaries, consisted of (i) eight cellular service providers, each operating in one of the regions into which Brazil has been divided for purposes of cellular telecommunications services in the frequency range formerly used by each of the former operating companies of Telebrás, (ii) three regional fixed-line service providers, each providing local and intra-state long-distance service in one of the three regions into which Brazil has been divided for purposes of fixed-line telecommunications, and (iii) Embratel, providing domestic (including intraregional and interregional) long-distance telephone service and international telephone service throughout Brazil.

Set forth below are maps of Brazil showing the locations of the fixed-line, long-distance regions and cellular regions into which the country was split-up following the breakup of Telebrás:

*Brasil Telecom Participações S.A.* (formerly known as Tele Centro Sul Participações S.A.) is our parent company, and is one of the three holding companies providing local, interregional and international long-distance telecommunications services in Brazil. See Item 7 Major Shareholders and Related Party Transactions Major Shareholders. In the breakup of Telebrás, Brasil Telecom Participações S.A. was allocated all the share capital held by Telebrás in Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre, CTMR and Telepar, our predecessor; companies which provided fixed-line telecommunications service in the northern, western, central and southern regions of Brazil. See Business Overview Our Region. In July 1998, the Federal Government sold all of its voting shares in these holding companies, including the shares it held in Brasil Telecom Participações S.A., to private sector buyers. The sale of all of the Federal Government's voting shares in the holding companies to private sector buyers is referred to herein as the privatization of Telebrás. As a result of the merger of Telepar, Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre, CTMR and CRT, ultimately turning into Brasil Telecom S.A., we became the leading local and intraregional fixed-line telecommunications service provider in our region. The principal other relevant fixed-line telecommunications service provider in our region is Global Village Telecom (Sercomtel and CTBC also operate partially in our region but we do not service the same cities). For intraregional long-distance telecommunications services, Intelig and Embratel, among others, are providers that are authorized to provide

long-distance services in our region.

The other major telecommunications operators which were created as a result of the privatization of Telebrás are: Telemar which is our mirror telecommunications service provider in Region I, Telesp which is our mirror telecommunications service provider in Region III, and, Embratel which provides domestic and international long-distance service throughout Brazil. Brasil Telecom, Telemar, Telesp and Embratel all operate pursuant to public concessions granted by Anatel.

Since the privatization of Telebrás, Anatel has continued to implement regulations in order to promote competition and quality of service in the Brazilian telecommunications marketplace. As part of this policy initiative, Anatel has allowed new private competitors into the Brazilian market to compete directly against us. In addition, Anatel has required us and the other public concession service providers to meet certain quality and universalization targets before we could compete in other service providers' market areas. On January 19, 2004, we received certification by Anatel that we had accomplished our universalization targets, and accordingly we are authorized to



offer local fixed and domestic and international long-distance telephone services originated inside or outside our region as well as mobile services in our region. The certification of other service providers' compliance with universalization and expansion targets permits other service providers, including Telemar, Telesp and Embratel, to operate in our region. Any other service provider can get Anatel's authorization to provide service and compete with us. We cannot, however, confirm the identity of the service providers that will be so authorized, the timing of such authorizations, or the extent of the authorized services, should any service providers be so authorized.

### *History of Our Company*

The following bullet points briefly illustrate our history:

- November 27, 1963: Telepar was incorporated as a corporation under the laws of Brazil.
- June 5, 1975: The control of our company was transferred to the Brazilian government and we became a subsidiary of Telebrás.
- May 22, 1998: Restructuring of Telebrás System, with the creation of *Tele Centro Sul Participações S.A.* (currently *Brasil Telecom Participações S.A.*), a holding company of Telesc, Telepar, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre and CTMR.
- July 29, 1998: Solpart acquired our parent, *Tele Centro Sul Participações S.A.* (currently *Brasil Telecom Participações S.A.*), from the Brazilian government in the privatization process of Telebrás.
- February 28, 2000: The concessionaires Telesc, Telepar, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre and CTMR, controlled by *Tele Centro Sul Participações S.A.*, currently *Brasil Telecom Participações S.A.*, were reorganized and merged into Telepar and became a single company.
- April 28, 2000: In accordance with our strategy of becoming a national telecommunications company, we changed our corporate name from *Telecomunicações do Paraná S.A.-Telepar* to *Brasil Telecom S.A.*
- July 31, 2000: We acquired 98.8% of the corporate capital of *TBS Participações S.A.* ( TBS ), a company controlled by *Telefônica*, which held 85.2% of the voting capital of CRT, representing 31.6% of the total share capital of CRT, for approximately R\$1,446.3 million. CRT was the leading fixed-line telecommunications service company in the state of Rio Grande do Sul. The acquisition of CRT was financed partly through the use of our own cash reserves, as well as through the domestic placement of commercial paper of approximately R\$900.0 million.
- December 28, 2000: TBS was merged into CRT, and immediately afterwards CRT was merged with and into us. Pursuant to our merger with CRT, minority shareholders of CRT were given the right to exchange their CRT shares for Preferred Shares and Common Shares of us. The exchange of shares was made based on the market value of our shares compared to those of CRT.
- November 1, 2001: *BrT Serviços de Internet S.A.* ( BrTSi ), our wholly-owned subsidiary, acquired 15.4% of the total capital stock of *iBest Holding Corporation*, which controls *iBest S.A.*, a free Internet service provider, for approximately R\$10.0 million.
- November 16, 2001: We listed ADSs evidencing our Preferred Shares on the New York Stock Exchange.

- December 5, 2001: We acquired 19.9% of the capital stock of Vant, a leading corporate data solutions provider, for R\$3.9 million from AESCOM Sul Ltda. and Luiz Cruz Schneider together with an option to purchase the remaining 80.1% after certification by Anatel of compliance with the 2003 targets stipulated in our concession contracts.
- May 9, 2002: We joined the Special Corporate Governance Level 1 of the *São Paulo Stock Exchange* ( BOVESPA ). See Item 9. The Offer and Listing Markets The Special Corporate Governance Levels of the São Paulo Stock Exchange.

- June 3, 2002: Our shares listed on BOVESPA started trading under new symbols: BRTO3 for Common Shares and BRTO4 for Preferred Shares.
- December 18, 2002: We acquired licenses for the PCS for R\$191.5 million through the auction held on November 19, 2002. The minimum price was R\$182.9 million and we paid a premium of 3.6%.
- February 18, 2003: We acquired 19.9% of the capital of *MTH Ventures do Brasil Ltda.* ( MTH ), a company that holds 99.99% of the capital of Brasil Telecom Comunicação Multimídia, a leading local fiber optic network provider, for US\$17.0 million together with an option to purchase the remaining 80.1% of the capital of MTH for US\$51.0 million after certification by Anatel of compliance with the 2003 targets stipulated in our concession contracts.
- June 11, 2003: We acquired, through BrTSi, the entire submarine fiber-optic cable system from GlobeNet Communications Group Ltd. for US\$ 46.8 million. A total of US\$ 27.6 million was paid on June 11, 2003, with the remaining US\$19.2 million payable within 18 months of the first installment.
- June 26, 2003: We acquired the remaining capital of iBest Holding Corporation for US\$ 36.0 million.
- January 19, 2004: Anatel certified that we had met our universalization targets and authorized us to provide interregional long-distance services throughout Brazil and international long-distance services, also from any point in the country. We also received authorization to offer local services outside our original concession area and to offer wireless services in our region.
- May 13, 2004: We purchased the remaining 80.1% of the capital of MTH for US\$51.0 million.
- May 13, 2004: We purchased the remaining 80.1% capital of Vant for R\$15.6 million.
- September 27, 2004: We began offering wireless telecommunications services through our subsidiary 14 Brasil Telecom Celular S.A. (hereinafter referred to as Brasil Telecom GSM. )
- November 24, 2004: We acquired approximately 63% of the capital stock from Internet Group (Cayman), Ltd. ( iG ), for US\$ 104.9 million. Considering that Brasil Telecom Participações S.A. already held, indirectly, 10% of iG's total capital, both companies at the moment held approximately 73% of the total capital of iG.
- July 2005: We acquired 25.6% of the capital stock of Internet Group (Cayman) Ltd. ( iG ) for approximately US\$ 27.9 million. Considering that Brasil Telecom Participações S.A. and Brasil Telecom S.A. already held, indirectly, 73% of iG's total capital, both companies now hold approximately 98.2% of the total capital of iG. iG is the leading dial-up Internet service provider in Brazil. The acquisition of iG made us the largest Internet company in Latin America. Among the sellers of iG Cayman stock, there was an Opportunity Group affiliate. Under our current management, we filed a complaint with the Brazilian Securities Commission questioning pricing and disclosure issues related to this iG Cayman transaction.

### ***Organizational structure***

Brasil Telecom Group is composed of companies engaged in the telecommunication sector, which offer myriad services, including local fixed telephone, domestic and international long distance fixed line telephone services, wireless telephone, data transmission, as well as data center services, internet and real estate management. The main companies from the Brasil Telecom Group are divided as follows:

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Internet Operations: BrT Serviços de Internet S.A., Freelance S.A., Internet Group (Cayman) Ltd., Internet Group do Brasil S.A.;

Telecommunication Network: Brasil Telecom Cabos Submarinos Ltda., Brasil Telecom Subsea Cable System (Bermuda) Ltd., Brasil Telecom of América Inc. and Brasil Telecom de Venezuela S.A.; and

Data Operations in Brazil: Brasil Telecom Comunicação Multimídia Ltda. and Vant Telecomunicações S.A.

We have eleven branches in operation in Tocantins, Goiás, Acre, Rondônia, Mato Grosso, Mato Grosso do Sul, Paraná, Santa Catarina, Rio Grande do Sul, Pelotas and Brasília. During the last years, we have made important acquisitions in the telecommunication sector, becoming a full service telecommunications supplier. Always trying to reach the convergence, we are represented in all stages of the telecommunication chain.

In August 1<sup>st</sup>, 2006, our Board of Directors approved a Corporate Organizational Project in order to simplify the structure of the companies under its control, reducing operational costs, and grouping companies with the same activity. Today, we have three subsidiaries: BrT Serviços de Internet S.A., 14 Brasil Telecom Celular S.A. and Santa Bárbara dos Pinhais S.A. In addition we hold 99.99% of the outstanding shares of Vant Telecomunicações S.A. and 99.99% of the outstanding quotas of Brasil Telecom Cabos Submarinos Ltda.

The following chart sets forth a summary of our organizational structure, including the percentage of total capital held in each of our significant subsidiaries as of May 1<sup>st</sup>, 2006. All of our significant subsidiaries are organized and existing under the laws of the Federative Republic of Brazil, except for Brasil Telecom Subsea Cable Systems (Bermuda) Ltd., which is incorporated under the laws of Bermuda, Brasil Telecom of America Inc., which is incorporated under the laws of the State of Delaware in the United States of America, Brasil Telecom de Venezuela S.A., which is incorporated under the laws of Venezuela, and Internet Group (Cayman) Limited and iBest Holding Corporation, which are incorporated under the laws of the Cayman Islands.

Observation: we will send the organizational structure as an attached document, since we are not able to update it in this file.

*BrT Serviços de Internet S.A.*

We formed BrTSi in October 2001. Through BrTSi, we provide broadband Internet services through our Internet service provider ( ISP ) BrTurbo and data center services.

Through BrTurbo, a broadband Region II leader, iBest, the largest Internet service provider in Region II for dial-up Internet access, and iG, the first dial-up access provider and one of the largest content providers with a broadband presence outside Region II, we compete in all territories in Brazil, in all Internet segments. The following is a description of iBest and iG.

*iBest*

In November 2001, we acquired 15.4% of iBest Holding Corporation for approximately US\$10.0 million. iBest Holding Corporation controlled iBest S.A. ( iBest ), a free Internet service provider. On June 26, 2003, we acquired through our fully owned subsidiary, BrTSi, the remaining capital of iBest Holding Corporation for US\$36.0 million, consolidating our 100% ownership of iBest. The iBest Group is composed of the following main entities: iBest Holding Corporation and Freelance S.A. Freelance S.A. became the owner of iBest's trademark.

*iG*

In July 2005, we acquired 25.6% of the capital stock of Internet Group (Cayman) Ltd. ( iG ). With this acquisition, combined with previous holdings of 73% of iG's total capital by Brasil Telecom Participações S.A. and Brasil Telecom S.A., we hold 98.6% of the total capital of iG. iG is the leading dial-up Internet service provider in Brazil, acting in the dial-up and broadband access provision market. Furthermore, it offers value added products and services to clients in the residential and corporate market.

*Grupo BrT Cabos Submarinos (Submarine Fiber-Optic Cable System)*

On June 11, 2003, we acquired a submarine fiber-optic cable system from GlobeNet Communications Group Ltd., which we now refer to as Grupo Brasil Telecom GlobeNet ( Grupo BrT GlobeNet ), for US\$46.8 million. A total of US\$27.6 million was paid on June 11, 2003, with the remaining US\$19.2 million payable within 18 months of the first installment. We signed a final agreement on April 20, 2005, when we paid US\$16.2 million. US\$3.0 million were retained to cover contingences discovered after the acquisition. Grupo BrT GlobeNet is composed of the following companies: Brasil Telecom Cabos Submarinos Ltda., Brasil Telecom of America, Inc., Brasil Telecom Subsea Cable Systems (Bermuda) Ltd. and Brasil Telecom de Venezuela, S.A. These companies, which we control, own and operate the Grupo BrT Cabos Submarinos fiber optic cable system that connects the United States, Bermuda, Brazil and Venezuela. Brasil Telecom of America, Inc. is headquartered in Boca Raton, Florida, and coordinates all activities and supports the commercial activities of the group in the international market.

*14 Brasil Telecom Celular S.A*

14 Brasil Telecom Celular S.A. ( Brasil Telecom GSM ) is our mobile telephone services subsidiary, which became operational on September 27, 2004 and allows the Brasil Telecom Group to offer integrated telecommunications solutions. Brasil Telecom Mobile offers wireless telecommunications services using Global System for Mobile Communications ( GSM ) technology under the brand name Brasil Telecom GSM. See Business Overview Wireless Services. During 2006, Brasil Telecom GSM became a profitable business unit within the group, leaving behind its status as a development stage company.

*Vant Telecomunicações S.A.*

On May 13, 2004, we exercised our option to purchase for R\$15.6 million the remaining 80.1% of the capital of Vant, giving us 99.99% of the capital of Vant. Vant offers internet protocol as well as other products to the corporate market throughout Brazil.



*Brasil Telecom Comunicação Multimidia*

On May 13, 2004, we exercised our option to purchase for US\$ 51.0 million the remaining 80.1% of the capital of MTH, giving us 99.9% of the capital of MTH. Brasil Telecom Comunicação Multimidia is a leading local fiber optic network provider, with 343 kilometers of local network in São Paulo, Rio de Janeiro and Belo Horizonte, and a 1,600 kilometer long-distance network linking these three metropolitan areas. Brasil Telecom Comunicação Multimidia also has an internet solutions data center in São Paulo which provides internet support to our customers. As part of the acquisition, we also integrated a management team with expertise in these markets.

**Capital Expenditures**

The following table sets forth our capital expenditures on plant expansion and modernization for each of the years ended December 31, 2004, 2005 and 2006.

	<b>Year ended December 31,</b>		
	( millions of reais)		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Conventional Telephone	179.7	256.5	262.7
Data Network	300.0	411.5	275.0
Network Operation	270.2	292.2	249.8
Information Technology	216.1	180.8	97.0
Other <sup>(1)</sup>	725.2	395.4	285.0
Total Fixed Telephone	1,691.2	1,536.4	1,169.5
Total mobile Telephone	1,175.7	441.4	281.5
Total capital expenditures	2,866.9	1,977.8	1,451.0

- (1) These investments include the acquisition of PCS licenses, the acquisition of Grupo BrT Cabos Submarinos, Brasil Telecom Comunicação Multimidia, iBest, Vant and iG, the investments in these enterprises and in transmission backbone, special platforms, technical and operational support such as telecommunications management network systems (not including regulatory and interconnection projects that are in Conventional Telephone).

Our capital expenditures decreased by approximately 26.6% to R\$1,451.0 million in the year ended December 31, 2006, from R\$1,977.8 million for the corresponding period in 2005. Of our total 2006 capital expenditures, R\$1,169.5 million related to fixed-line telephone and internet operations and R\$281.5 million to mobile telephone operations. The capital expenditures on the expansion and modernization of our fixed-line telephone operations related primarily to upgrading the capacity of our transmission backbone, the expansion of the data network and implementation of regulatory projects to meet Anatel's requirements.

*Acquisition of PCS Licenses*

As part of our strategy of providing integrated solutions to our clients, we acquired PCS licenses for R\$191.5 million at an auction held on November 19, 2002.

On December 18, 2002, we paid the equivalent of 10.0%, in December 18, 2005 we paid the equivalent of 15.0% and in December 18, 2006 we paid the equivalent of 15% of the total bid amount at auction. The remaining 60.0% will be paid in four equal installments annually, each respectively due 12, 24, 36 and 48 months after the last payment date (December 18, 2006). The amount of the installments will be adjusted monthly by the IGP-DI index plus 1.0% interest rate over the indexed amount calculated from the execution date.

### **Business Overview**

We provide fixed-line telecommunications services in Region II under concessions which we assumed from each of Telepar, Telesc, Telegoiás, Telebrasil, Telemat, Telems, Teleron, Teleacre, CTMR and CRT for each of the states in our region. These concessions were granted by the Brazilian government to us and to each of these

companies as a result of the privatization process. Until January 2004, these concessions authorized us to provide local and intra-regional fixed-line telecommunications services in nine states located in the northern, western, central and southern regions of Brazil and in the Federal District. These concession areas constitute our region. See [Our Region](#). As a result of these original concessions, we are the leading provider of local fixed-line telecommunications services and intraregional fixed-line telecommunications services in our region. Local fixed-line telecommunications services include all calls that originate and terminate within a single local area, as well as, installation, monthly subscription, public telephones and supplemental local services. Intra-regional fixed-line telecommunications services include all calls between states within a concession area. We also offer broadband services to our customers that allow them to access the internet which represents an important new source of revenue.

Since January 2004, we have been able to offer interregional and international long-distance telecommunications services. We also provide a variety of data transmission services through various technologies and means of access. Since 1999, we have invested in data transmission capacity in response to the growing demand in Brazil for data, images and text transmission services, mainly for corporate networks and corporate and residential Internet access.

Our business, including the service we provide and the rates we charge, is subject to comprehensive regulation by Anatel, an independent regulatory agency, under the General Telecommunications Law and various administrative enactments thereunder. The licenses and concessions under which we operate our fixed-line services imposed certain universalization, expansion and modernization targets on us. On January 19, 2004, we received certification by Anatel that we had accomplished our universalization targets established for December 31, 2003. Accordingly, we were authorized to offer local fixed and domestic and international long-distance telephone services, whether originated inside or outside our region. We also acquired a license to provide mobile telephone services in our region.

Our main competitors in the fixed-line telecommunications area are Embratel, Intelig, Global Village Telecom, Telesp, Telemar, Companhia de Telecomunicações do Brasil Central ( CTBC Telecom ) and Sercomtel Telecomunicações S.A. ( Sercomtel ). The mobile telephone business is a highly competitive one, and Region II has the highest penetration rate in the country. Our main competitors in the mobile telecommunications area are TIM, Claro and Vivo.

In 2004 we obtained authorization from the Anatel to provide wireless services through our Brasil Telecom GSM arm, for the acquisition and installation of network equipment and the integration of mobile telephone with other products of the Brasil Telecom Group. Our license to provide wireless service is valid for fifteen years and may be renewed for another fifteen years.

### ***Strategic Results for 2006***

As our strategic priorities for 2006, we resolved to (1) defend our main business, that of fixed-line voice traffic; (2) expand our mobile telephone service, seeking to achieve a satisfactory balance between scale and profitability; (3) exploit growth opportunities in data and internet, ensuring profitability; (4) build a portfolio of converging promotions in the customer environment – voice, data and images – to reduce client turnover and increase the average customer bill; (5) increase operational efficiency, applying the necessary rigorous controls in terms of cash allocation; and (6) create value for our shareholders, in an ethical and transparent manner, through our relationships with our partners.

### ***Strategy for 2007***

In recent years, the telecommunications industry has been through transformations never seen before in its history. The forms of communications are transforming and multiplying. The importance of formatting, storage, distribution and exchange of content has significantly modified society's behavior. This modification has caused significant changes in the telecommunications business model, especially for traditional operators.

Trends which were just conceptual are now in a process of acceleration and consolidation, obscuring the borders among the several business models, with a direct impact in the chain of value generation.

As a consequence, competition is increasing, originating not only in traditional operators, but also with new players such as: internet portals, pay-TV, wireless broadband ISPs and Information Communications Technology integrators, among others.

Within this context, the following are highlights:

- Fixed mobile replacement as the major market trend;
- The increase in relevance of the Internet Protocol, including broadband and ISPs;
- Regulatory issues are vital in the sustainability and growth of the telecommunications industry, mainly due to the technological convergence and services;
- Emerging technologies: WiMAX, Wi-Fi and 3G, facilitating the entrance of new providers;
- The growing need for sub-segmented market treatment; and
- The need to focus rigorously on operational expenses and capital expenses.

Each of these issues contains opportunities and threats and all broaden the complexity level in the management of the business.

With these challenges in mind, we see our strategy for 2007 as follows:

- Act proactively to adjust to the new convergent regulatory scenario;
- Manage the fixed-mobile replacement by defending our main business: Fixed voice;
- Expand the mobile business to increase scale, profitability and compensate the losses in fixed line voice;

- Implement sub-segmented approaches with the client, focusing in loyalty and profitability;
- Protect the broadband subscriber base, in view of its importance for value generation and offer of new converging products;

- Reduce the costs, expenses and investment levels, with rigorous control of the use of cash;
- Optimize and expand the exploration of portals (Internet Service Providers - ISPs), adding and distributing content and exploring other opportunities;
- Use emerging technologies and explore opportunities associated with such technologies; and
- Work to provide quadruple play (fixed voice, mobile, data and TV) offers.

Regarding each business line and we act in businesses with distinct dynamics we also defined a set of specific priorities for each segment:

#### **- Mobile Telephony**

Internationally, mobile telephony has been continuously growing in recent years. In the period of 2002 to 2005, the world subscriber base increased 28%, revenues increased 16% and traffic increased 21%, led mainly by the emerging countries. The increase in competition is principally the appearance of the MVNO – Mobile Virtual Network Operators – and growth through mergers and acquisition are fundamental for these operators to increase scale and become more competitive and profitable. Value added services have represented an increasing role in the revenues of operators and the launch of new mobile technologies (3G and Wi-Max) in Brazil should accelerate this development.

Within this context and considering the characteristics of the market where Brasil Telecom acts, certain priorities were established for the mobile telephony business:

- Rationalize offers;
- Keep the growth momentum;
- Optimize costs, expenses and investments; and
- Increase the offer of converging and value added services.

#### **- Data Corporate Market**

The use of communications network based on the Internet Protocol (IP) is a world-wide trend in the area of data communications for the corporate market, demanding additional bandwidth to support new applications. Thus, the services are migrating from connectivity and simple applications to complete customized solutions and sophisticated integrated packages, in a highly competitive market.

In order to be well positioned in this market, Brasil Telecom defined the following priorities for the corporate data market:

- Defend its current position;
- Increase the average revenue per user; and,
- Develop new markets.

**- Broadband**

The existing challenge to offer greater speeds along with mobility is being hit by the rise of new technologies such as Wi-Max, 3G, integrated Wi-Fi networks, MMDS. Besides mobility, the growing need for greater bandwidth and speed with decreasing prices to allow integrated offers is already a reality in developed countries.

Facing all these technological and market matters, Brasil Telecom defined the following priorities for the broadband business:

- Geographically expand the service, focused on profitability;
- Optimize the portfolio of new speeds and services; and,
- Improve client satisfaction and improve the retention process.

#### **- Internet Service Providers**

Internet Service Providers are offering more sophisticated services and beginning to compete directly with companies that offer conventional voice services. In parallel, telecommunications companies focused on convergence are increasing content in their portals to create a distinction.

The arise of personal content, where the user acts as the main player through sharing websites or community networks, is increasing the online time, increasing the value of the website and creating WEB 2.0. The availability of content on demand, unrelated and distributed via broadband, makes the business models of paid content feasible, such as videos (Video on Demand) and music (iTunes).

The growth of internet access is causing the migration of advertising in traditional media to online spaces. The efforts of the advertiser to optimize investments in communications and the creation of online tools for the segmentation of the message resulted in revenues associated with online advertising increasing 22% (CAGR) between 1999 and 2006 in the US.

Operating the second largest broadband ISP in Latin America and the largest dial-up ISP in the country, Brasil Telecom defined the following priorities for its three portals, iG, BrTurbo and iBest.

- Reposition its brands;
- Improve profitability and retain users;
- Consolidate position in corporate products; and,
- Optimize the operation with the integration of its ISPs.

#### **- Fixed Line Voice**

The replacement of fixed line telephony to mobile telephony is already a reality in several countries and the determining factor in the speed of this replacement is the price of the minute in mobile telephony. As the price of the mobile minute reaches the price for the fixed line minute, the traffic replacement increases. In the US and in Europe, between 2004 and 2005, fixed lines decreased 2.5% and 0.5%, respectively.

The popularization and growth of broadband and new applications developed on IP platforms also affect the usage of the fixed line telephony. Currently in Europe, 2% of the total traffic is VoIP and this value is projected to reach 10% by 2010.

With theses changes in mind, the new technologies and converging services, the telecommunications sector is going through a period of acquisitions and international expansions, with consolidation into ever larger players and



rationalization of costs.

For Brasil Telecom, the priorities for this business segment are:

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- Manage the migration from fixed line to mobile telephony;
- Increase loyalty and retention actions;
- Approach the market in a more sub-segmented manner; and,
- Explore converging services.

### *Our Services*

The fixed-line telecommunications services offered to our customers consist of (i) local services, including all calls that originate and terminate within a single local area in the region, as well as installation, monthly subscription, measured services, public telephones and supplemental local services, (ii) intraregional long-distance services which include intrastate (calls between local areas within a state in our region) and interstate (calls between states in our region), (iii) interregional and international long-distance services, (iv) network services, including interconnection and leasing, (v) data transmission services, (vi) wireless services and (vii) other services.

The following table sets forth our revenue by type of service for the indicated years. Our rates for each category of service are discussed below under Rates. Trends and events affecting our operating revenue are discussed under Item 5. Operating and Financial Review and Prospects.

	<b>2004</b>	<b>Year ended December 31 2005</b>	<b>2006</b>
		(millions of <i>reais</i> )	
Local services	7,491	7,724	7,470
Intraregional (Intrastate and Interstate) long-distance service	2,394	2,626	2,464
Interregional and International long-distance service	249	364	306
Network services	970	941	771
Data transmission	1,069	1,531	2,001
Mobile Services	88	732	1,323
Other	502	768	777
Gross operating revenues	12,763	14,687	15,111
Taxes and discounts	(3,698)	(4,549)	(4,814)
Net operating revenues	9,065	10,138	10,297

A concession of a telecommunication service is defined under the General Telecommunications Law as the delegation of the rendering thereof under the public regime, by means of a written agreement and for a determine period of time. The concessionaire will bear all business risks and its compensation will be the tariffs charged from the users and other alternative revenues. The concessionaire is directly responsible for the fulfillment of the underlying obligations and the damages it may cause. Concessions may only be granted to companies incorporated under Brazilian laws, and with both head office and management located in Brazil. Concessions will be granted by

Anatel on a non exclusive basis and must comply with the general plan of awards approved by the Executive Branch as mentioned above. The maximum term of a concession will be twenty years, renewable only once for an equal period.

Concessions of telecommunications services have always been granted by means of a bidding procedure. The rules governing such bidding procedures were established by Anatel in Resolution No. 65, dated October 29, 1998. The provisions of Resolution No. 65 observe the constitutional principles and provisions of the General Telecommunications Law, particularly the following:

- (a) the purpose of the bidding procedure is to determine the party which may provide and expand the service under the public regime, as well as fulfill the relevant universalization obligations, on an efficient and secure basis and charging reasonable tariffs;

- (b) the draft request for proposal of each procedure will be submitted to public consultation;
- (c) the request for proposal will (i) identify the relevant service and the conditions for the rendering, expansion and universalization thereof, (ii) establish objective criteria for acceptance and judgment of the proposals, (iii) regulate the procedure, (iv) indicate the applicable sanctions, and (v) determine the clauses and conditions of the relevant concession agreement;
- (d) the technical and operational and economic-financial requirements to be fulfilled for purposes of qualifying each bidder, as well as occasional bid or performance bonds, must be applicable equally to all bidders, compatible with the purpose of the procedure and proportional to the nature and dimension thereof;
- (e) all bidders must evidence that the same are in good standing and situation before the tax and social security authorities;
- (f) the judgment of the proposals must always be made in accordance with the criteria established in the relevant request for proposal, provided that one of the following criteria is adopted: (i) lowest tariff to be charged from the service users; (ii) highest price offered for the concessions; (iii) highest quality level of the services; (iv) best fulfillment of the demand; or (v) a combination of any two or more of the foregoing criteria; and
- (g) the rules governing the bidding procedures must ensure publicity of the request for proposal, adequate term of submission of the proposals and ample defense rights.

According to the General Telecommunications Law and Resolution No. 65, the authorization by Anatel is an administrative act which permits the exploitation under the private regime of a telecommunications service, provided that the applicable objective and subjective requirements are duly met.

Resolution No. 65 sets forth the procedures for the granting of authorizations by Anatel. Anatel may only deny a request for authorization if the maximum number of service providers is already achieved, if the granting of the authorization would jeopardize the rendering of the services under the public regime or in case of a relevant reason, in each case as duly justified by Anatel.

There are certain objective requirements for the award of an authorization, including: (i) availability of the required radio frequency, if applicable; and (ii) submission of a project that is technically feasible and compatible with the applicable regulations.

In relation to the subjective requirements for obtaining an authorization for the exploitation of a collective interest service under the private regime, (i) the interested party must be organized under Brazilian laws, with both head office and management located in Brazil; (ii) such party may neither be prevented from participating in bidding procedures carried out by the public authorities, nor from entering into agreements with public authorities; (iii) the Brazilian authorities may not have declared the forfeiture of any concession, permission or authorization held by the interested party in the prior two years; (iv) the interested party must have technical qualification to provide service, economic-financial capacity, be in good standing before the tax and social security authorities; and (v) the interested party must not be, in the same region, place or area, a provider of the same category of service.

On June 20, 2003, Anatel approved a new General Plan on Quality and the concession contract model under which all fixed-line telecommunications have operated since January 1, 2006. On June 28, 2003, Decree 4769 was entered approving the General Plan on Universal Service. See Obligations of Telecommunications Companies New Telecommunications Regulations. The new Concession Contracts for Public Switched Telephone Network were signed in December 22, 2005 and begin as of January 1, 2006. It has duration until 2025. Five year reviews are

budgeted during the concession period.

Additionally, the AICE regulation was included in the General Plan on Universal Service in order to facilitate the progressive universalization of individual fixed telephone access. AICE is a class of PSTN basic plan in which subscriber must pay a monthly subscription of R\$16.5 (net of taxes). On the AICE plan, the rate paid is the same as that of a local call with a 2 minute increment per each realized call (customer care rate) and a 2 minute minimum call rate. The plan operates as a pre-paid model in that the subscriber has to obtain credits in order to use the service. The service is being offered in households that do not have other residential lines.

#### *Local Services*

We are the leading provider of local telecommunications services in our region with an estimated 92% market share as of December 31, 2006. In local fixed-line services, our main competitor is Global Village Telecom. Global Village Telecom is an independent service provider operating under an authorization from Anatel. As of December 31, 2006, we had approximately 8.4 million lines in service. We own and operate public telephones throughout our region. At December 31, 2006 we had approximately 277,854 public telephones and a ratio of public telephones per 100 inhabitants equal to 6.4 which meets Anatel's service targets. We also provide a variety of other supplemental local services that include voice mail, call waiting, call forwarding, conferencing, speed dialing and caller ID.

To date, numerous companies have been authorized by Anatel to provide local fixed telecommunications services in our region. Our fixed-line services are also subject to competition from wireless service providers. See Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry We face increasing competition in the Brazilian telecommunications industry which may have a material adverse effect on our market share, results of operations and financial condition. We have also been authorized to provide local fixed telecommunications services outside our region, although as of December 31, 2006, we have not done so.

Our local services also include fixed-to-mobile services, consisting of calls that originate on a fixed-line telephone and terminate on a mobile or cellular device. The fixed-to-mobile basic tariff per-minute are generally known as Communication Value-1, or VC-1.

#### *Intraregional (intrastate and interstate) long-distance services*

Calls from one local area in a region to another local area in the same region are referred to as intraregional long-distance calls. Intraregional long-distance service includes intrastate long-distance calls (calls within a given state in a region) and interstate long-distance calls (calls between states in a region). Prior to merging into us, each of Telepar, Telesc, Telegoiás, Telebrasil, Telemat, Telems, Teleron, Teleacre, CTMR and CRT were the exclusive provider of intrastate long-distance service in their respective state. As a result we became and still are the leading provider of intrastate fixed-line telecommunications services in our region with a 90.8% intrastate average market share and an estimated 85.2% interstate average market share in 2006.

Pursuant to Anatel regulations, callers are able to choose a service provider for each long distance call by selecting a carrier selection code that identifies the carrier. Until July 6, 2003, this was permitted only for calls made from fixed-line phones. Since such date, mobile callers can also choose a service provider by selecting a carrier selection code. Our carrier selection code is 14.

Until July 1999, Embratel was the exclusive provider of interstate long-distance service. In July 1999, Embratel and Intelig were authorized by Anatel to provide intrastate long-distance services within the states in our region, and we were authorized to begin providing interstate long-distance services between the states in our region. See

Competition. As a result we expanded our network to provide interstate long-distance service in our region to compete against Embratel, and Embratel and Intelig expanded their networks to provide intrastate long-distance service to compete against us. Even with this expansion, we may from time to time lease transmission facilities from other

carriers to complete interstate long-distance calls between states in our region. To date, numerous companies have permission by Anatel to provide intraregional long distance telecommunications services in our region. See Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry.

Our intraregional services also include fixed-to-mobile services, consisting of calls that originate in a fixed-line telephone and terminate on a mobile or cellular device. The fixed-to-mobile rate per-minute charges are generally Communication Value 2, or VC-2, for calls outside the cellular subscriber's registration area but inside the region where the respective cellular provider provides service, and Communication Value 3, or VC-3, for calls outside the subscriber's registration area and outside the region where the respective cellular provider provides service. The use of our fixed-to-mobile services has increased significantly in the past five years as the penetration rate of mobile phones in our region has increased. We are the leading operator in the inter-city fixed-to-mobile services segment in our region and reached, in December 2006, a market share of 85.9% and 67.3% for interregional calls in VC-2 and VC-3 areas, respectively.

#### *Interregional and International Services*

Historically, under Anatel rules, regional fixed-line companies, such as us, generally were not permitted to offer interregional or international long-distance services until December 31, 2003. As a result of Anatel having certified our compliance with universalization targets, on January 19, 2004, we began offering interregional long-distance and international long-distance services. Interregional long-distance services consist of calls between regions within Brazil. International long-distance services consist of calls between different regions within Brazil and a location outside of Brazil. In order to provide these services, we have entered into interconnection agreements with Telemar and Telesp and we will also make use of the cable network we acquired through the Grupo BrT Cabos Submarinos acquisition (linking Brazil with the United States, Bermuda and Venezuela) and through the Brasil Telecom Comunicação Multimídia acquisition (providing network facilities in São Paulo, Rio de Janeiro and Belo Horizonte). Our market share for these services increased rapidly throughout 2005 and 2006 and reached averages of 62.3% and 36.0% in the interregional and international segments in our region, respectively, as of December 31, 2006. To date, numerous companies have been authorized by Anatel to provide interregional and international long distance telecommunications services in our region. See Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry.

#### *Network Services*

Our network services consist of interconnection and lease of facilities.

#### *Interconnection Services*

Interconnection services consist of the use of our network by other telecommunications providers in order to:

- receive calls that originate on our network;
- complete calls that terminate on our network; and
- connect switching stations to our network.

Use of our interconnection services has grown substantially since they were introduced in 1998, as a result of:

- the spin-off of the cellular telecommunications businesses of each of Telepar, Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre and CTMR;
- the breakup of Telebrás; and
- the advent of competition in the telecommunications sector in Brazil.



Telecommunications service providers are required to provide interconnection services on a nondiscriminatory basis. Subject to certain requirements, they are free to negotiate the terms of their interconnection agreements, but if the parties fail to reach an agreement, Anatel will arbitrate the controversy and

establish the terms and conditions of interconnection. See History and Development of the Company Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies Interconnection and Rate Regulation. The terms of our interconnection services, particularly the pricing and technical requirements of these services, may affect our results of operations, competitive environment and capital expenditure requirements.

We provide interconnection services to long-distance providers, such as Embratel, Intelig, Global Village Telecom, small private regime operators referred to as mirror companies, and certain operators of trunking services. We also provide interconnection services to the cellular service providers that were spun off from each of Telepar, Telesc, Telegoiás, Telebrasil, Telemat, Telems, Teleron, Teleacre and CTMR as well as all Band B, Band D and Band E cellular service providers in our region.

#### *Lease of Facilities*

Other telecommunications service providers, particularly cellular service providers, lease trunk lines from our company for use within their own network, which are used for bulk transmission of voice and data messages. Large corporate customers lease lines from our company for use in private networks connecting different corporate sites. We also lease our telecommunications facilities to Embratel and Intelig in order to provide access to our network.

#### *Data Transmission Services*

We provide a variety of data transmission services through various technologies and means of access. Since 1999, we have invested in data transmission capacity in response to the growing demand in Brazil for data, images and text transmission services, mainly for corporate networks and corporate and residential Internet access.

The primary data product that we offer for mainly residential customers is Turbo, our broadband access service based on Asymmetric Digital Subscriber Line (ADSL) technology. During 2006, our strategy was to increase the margins on this product, offering to our subscriber base of 1 million customers higher speeds and value added services, like the Turbo Jogos, an access designed for gamers. For new customers we created a strategy based on different offers according to the competition level of each city. In 2006 we also reached more than 1,400 cities with our broadband offering, creating a lower dependence in the sales of the bigger cities, in which we face greater competition.

ADSL2+ is a DSL (Digital Subscriber Line) format, a data communications technology which allows much faster data transmission through telephone lines than conventional ADSL. ADSL2+ is the fourth ADSL generation. This standard expands the basic ADSL capacity, in which data transference may reach speeds of up to 24 Mbps in downstream and 1 Mbps in upstream. With all these new functionalities, ADSL2+ is far more robust for the offer of services which require greater data transmission rates. Therefore, ADSL2+ lines will only be used for the Turbo 2.0 service and the IPTV. Approximately 40% of our network is prepared to offer ADSL2+.

In October we launched a first phase of IPTV service, in Brasília, for a small base of customers, in order to make a commercial launch of a VoD service for our broadband clients in Brasília in 2007. We intend to continue to invest in our broadband business focusing on the growth of average revenue per user, or ARPU, and the expansion of our network in order to better serve the expected increase in demand for this type of service, particularly in the Internet access market.

To complete our residential offering we also launched, in the first quarter, a flat-fee dial-up service, called Internet Toda Hora (Internet all the time). With this product we expect to foster the culture of a flat fee internet access in customers not yet prepared for a broadband access, which should facilitate future upgrades.



In addition to ADSL, we offer various data transmission services that are designed specifically for corporate and government customers. Since October 2004, in order to deliver services that fulfill the needs of our customers applications, our data transmission services portfolio was reformulated into four product families.

*Point-to-Point Family* designed for corporate customers that need point-to-point dedicated services, with high security, protocol transparency and national or international coverage. The Point-to-Point Family includes a Digital Dedicated Line Service ( DATAlink ( SLDD ) ), which is a leased dedicated line service offering wider band width with 100% guarantee protocol transparency.

*Network Infrastructure Family* designed for corporate customers that need security, performance and flexibility for image, data and voice transmission through corporate networks. The Network Infrastructure Family includes Asynchronous Transfer Mode (ATM), Frame Relay and xDSL, which is a new product we market to corporate customers under the InterLAN brand name. InterLAN offers switching service and data transmission service for corporations through a secure, reliable and low cost technology. The Network Infrastructure Family also includes Virtual Private Networks, or VPN, based on MPLS IP VPN solution. This solution, called VETOR, is our main network product and allows multiple access technologies and interconnects with Interlan networks.

*Internet Access Family* designed for corporate customers that need a high performance and high quality connection to the Internet backbone. The Internet Access Family includes a Dedicated access ( IP Corporate ), which is a leased line that functions as a dedicated gate for access to the Internet backbone typically used by Internet service providers. We have also a shared access ( IP Empresas ) with cheaper prices, targeted to small and medium companies. The Internet Access Family also included Dial up Internet access, a remote dial up Internet access which we market under the name DialNet. DialNet is used primarily by corporate Internet service providers to provide remote access to corporate networks.

*Advanced Services Family* comprised of value-added technologies and services to complement our data transmission services portfolio. The Advanced Services Family includes a new service, launched recently, called Solução Card (Card Solutions), to give access to Credit Card transactions and similar operations with our existent network services. Advanced Services Family also includes PLUS, which is a set of services that provide rental and management of telecommunications equipments to corporate customers, (2) VIP, which is a set of services that provide corporate customers the transparency of the network quality by combining on-line reports, differentiated service level agreements and pro-active network supervision, and (3) Audio, Video and Web Conferencing Services, which is a new product that we market to corporate customers under the MultiConferências brand name as a value-added service, which is fully integrated, with expert advice, support and management.

#### *Brasil Telecom Comunicação Multimidia*

On May 13, 2004, we purchased the remaining 80.1% stake giving us 99.99% of the capital share of MTH, the parent company of Brasil Telecom Comunicação Multimidia. Brasil Telecom Comunicação Multimidia established its Brazilian branch in August 1997, beginning its commercial operations in December 1998 by providing private digital telecommunications network capabilities to the corporate segment.

Brasil Telecom Comunicação Multimidia plays a key role in our strategy to expand outside Region II, due to its excellent positioning in the key data service markets (São Paulo, Rio de Janeiro and Belo Horizonte) as well as its highly qualified executive team. With a technologically advanced data network which complements our existing networks, Brasil Telecom Comunicação Multimidia gives us direct access to main corporate clients in Brazil to whom we can offer national as well as international services, through Grupo BrT Cabos Submarinos' infrastructure. The integration process of Brasil Telecom Comunicação Multimidia with our other services, carried out throughout 2004, captured many synergies, not only on sales opportunities but also in reduction of general and administrative, and

information technology costs. According to a study we conducted in 2002, approximately 80.0% of the interregional long-distance traffic originating in our region terminates in the three states where Brasil Telecom Comunicação Multimídia has its network, and using its infrastructure, we realize savings, as we do not have to use a third party infrastructure to complete these calls. The integration of Brasil Telecom Comunicação Multimídia with our existing services also increases our competitiveness in the other regions, furthering our strategy of expanding beyond Region II.

Brasil Telecom Comunicação Multimídia provides services in data center, internet, data transmission, and was the first Brazilian company to use fiber optics to provide high quality performance and security for offices. The BrT Multimídia Communication infra-structure has 343 km of metropolitan network in São Paulo, Rio de Janeiro and Belo Horizonte, and 1,600 km of long-distance network connecting these three cities.

In addition to its private network, Brasil Telecom Comunicação Multimídia also has an Internet solution center of 3,790 square meters, which offers data center services and support including co-location and hosting. As part of our acquisition, we acquired a management team with expertise in these markets. Currently, Brasil Telecom Comunicação Multimídia has 636 clients in Brazil, comprised primarily of corporate clients.

#### *Vant*

On May 13, 2004, we exercised our option to purchase for R\$15.6 million the remaining 80.1% of the capital of Vant, giving us 99.99% of the share capital of Vant. Founded in October 1999, Vant was the first telecom company in Brazil to offer a network based on the Internet Protocol, or IP, technology. Vant offers Internet protocol as well as other products to the corporate market throughout Brazil, with a presence in the most territories of the country. In order to create a better synergy between the companies of our group, and to decrease costs and operational expenses, we currently intend to cease the operations of Vant, with its corporate client base and assets being distributed to the rest of our group.

#### *Grupo BrT Cabos Submarinos*

We offer to our clients connectivity services and international broadband circuits between South and North America, using state-of-the-art fiberoptic network connecting Brazil, US, Venezuela and Bermuda, through Brasil Telecom GlobeNet. This network is comprised of a 22 thousand km state-of-the-art sub-sea network, totally redundant and with the smallest latency connecting the Americas.

Since our backbones are fully integrated, Brasil Telecom GlobeNet allows the expansion of Brasil Telecom's services portfolio to our clients in the international market.

With offices in Boca Raton, São Paulo and Caracas, Brasil Telecom GlobeNet is comprised by four companies: Brasil Telecom Cabos Submarinos Ltda., Brasil Telecom of America Inc., Brasil Telecom Subsea Cable Systems (Bermuda) Ltd. and Brasil Telecom Venezuela S.A., all directly or indirectly controlled by Brasil Telecom S.A.

Seeking to consolidate its leadership position in the markets it is present in, Brasil Telecom GlobeNet concentrated its efforts during 2006 on the upgrade of available capacity, increase in capillarity, developing new services and creation of strategic partnerships.

The SDH network was increased by 40 Gbps and the expansion of the sub-sea DWDM network was initiated and is already in an advanced stage, which will result in a greater available capacity for the clients and greater economy in scale. Currently, the network has an installed capacity of 80Gbps, and may be increased to 1.36 Tbps.

The opening of new Points of Presence ( PoP s ) in Miami and New York increased our capacity to provide service to new clients through the expansion of the network capillarity and by adding capacity to offer new interfaces. As a result, we were able to attract several large north American operators as new clients. This initiative also resulted in cost reductions in our network formation in the US.

Seeking an increase in the business value chain, new service based on IP and Ethernet technologies were developed, which allowed Brasil Telecom GlobeNet to serve new demands from its clients, at the same time it

maximizes its operating margins. Additionally, the fine tuning of partnerships in Latin America and US have created important business opportunities.

Our systems operations have a reliability of 99.99% which results in excellent service quality for our customers, and allows us to support our international traffic of voice, data and IP without the need for third party

support. This autonomy has a direct and beneficial effect on interconnection cost reduction and transport. In 2005 and 2006, we saved US\$16 million and US\$21 million, respectively in expenses we would otherwise have incurred for international capacity rent. In 2007, this amount is expected to be approximately US\$25 million.

### *Internet Services    Internet Group*

By late October 2005, we initiated the operational integration process of the three Internet service providers under the Internet Group brand name. The consolidated operation will allow us to increase traffic and paid services revenues, benefit from operational synergies and offer a broader portfolio of products and services. We intend to use our Internet business to extend our footprint in the Brazilian market through the creation of an important customer relationship channel with the audience of our portals. The Internet Group will be our main distribution vehicle for entertainment, communication, information, services and access in the market.

Together our portals comprise a base of 3.7 million dial-up users active in the last 30 days of 2006, 1.1 million broadband customers, 0.3 million paid services customers, 5.1 million active e-mail accounts in the last 90 days and 8 million residential unique visitors to our portal, which makes us the largest dial-up service provider in Latin America and the second largest Brazilian broadband ISP.

### *BrTurbo*

BrTurbo was created in 2002 as a broadband ISP to offer competitively priced broadband access and Internet content in Region II. Throughout 2006, BrTurbo's content has been integrated and enriched by iG's content and its product portfolio. We also extended the coverage offered by BrTurbo Asas utilizing Wi-Fi technology through new partnerships.

2006 was a year to strengthen our brand position. We focused on maintaining a strong presence of our BrTurbo brand in Region II through tactical sales campaigns and the extension of our distribution channels. We launched several marketing relationship programs in the region whose successes were recognized with two significant awards: Marketing Best 2006 and Ampro Globe Awards.

On December 31, 2006, BrTurbo reached 0.8 million broadband customers, an increase of 39.6% over 2005, and a market share of 57.4% in Region II.

### *iBest*

iBest was conceived in 1999 to promote the Prêmio iBest, an Internet award instituted in 1995 that quickly became a national reference for Internet awards in Brazil. The 11th award ceremony held in 2006 included 25 thousand sites, 1,800 executives, and over 1 million votes.

In December 2001, iBest extended its activities in the Internet market by providing free dial-up Internet access. The acquisition of iBest in June 2003 was a significant step in our Internet strategy. iBest is 100% controlled by Brasil Telecom, and consolidates our existing leading position in the ISP market in Region II, giving us approximately 56% of the market share as of December 31 2006 with 1.6 million users active in the last 30 days.

iBest generated approximately 21.1 billion minutes of incoming calls during 2006, an increase of 12% over 2005. Through iBest, we have been able to minimize the risk of traffic drain by stimulating the use of iBest dial-up access, thereby increasing incoming traffic to our network. Traffic drain occurs when a competitor offers free Internet services to customers in our region. Because the interconnection regime in Brazil requires us to pay an interconnection fee to the service provider who completes a call originating from our network, free Internet increases the traffic in the



only direction that generates interconnection revenue for the service provider. Without a matching increase in traffic in the other direction, the continued traffic imbalance would result in increasing costs for us.

*iG*

We also offer Internet services through iG which we acquired in November 2004. iG was the first Brazilian portal to offer free Internet access. Since inception, its business model has evolved significantly and the portal generates important revenue streams through advertising, e-commerce, broadband access, content commercialization, traffic generation, and other paid services such as connection accelerator, telephone customer support, wireless portal, premium email, hosting services, among others.

Throughout 2006 additional efforts have been placed in the online advertising market to develop new product lines, advertising formats and applications. These efforts have paid off during the year and we were able to achieve advertising revenue growth above market levels.

iG is considered the largest Brazilian dial-up Internet service provider measured in both traffic and number of users with a market share of more than 11% of dial-up Internet minutes in Region II. iG has a presence in more than 2,100 cities, with approximately 2.1 million active dial-up users in the last 30 days of 2006. The 21.3 billion Internet minutes generated from iG positions was the leader of traffic generation in Regions I and III. As of December 31, 2006, iG's broadband client base totaled 0.3 million and the paid services base reached 0.2 million.

The iG brand is being re-positioned to promote increased traffic by empowering the Internet user. Since its acquisition, iG has launched several collaborative tools like blogs, chat, photo album, video player and online dating service, and has developed new channels that promote the creation and distribution of the content created by the user like Minha Notícia, Fale com o candidato e Jornal de debates. The portal also formed new partnerships in several areas such as entertainment, news, sports and education. iG was also able to enter an important agreement to bring the Internet game Second Life to Brazil.

Through its wireless content portal, iG extends its reach and offers to mobile users a variety of products, such as ring tones, cards, images, news and videos.

*Wireless Services*

In 2004, we satisfied all the prerequisites for the launch of our operations, including the authorizations for the rendering of mobile services conferred by Anatel on January 19, 2004, the acquisition and installation of network equipment and the integration of mobile telephone with other products of the Brasil Telecom Group. Our license to provide wireless service is valid for fifteen years and may be renewed for another fifteen years.

Competition in wireless services is intense, as the market is open to a number of larger competitors. Region II has the highest penetration rate by external competitive service providers in the country. The following table shows the percentage of total wireless services provided by outside service providers into Region II:

<b>Penetration</b>	<b>September 2004</b>	<b>December 2006</b>	<b>Percent Change Over Period</b>
Region I	26.6%	46.8%	20.1%
Region II	40.2%	63.0%	21.8%
Region III	38.7%	58.8%	20.1%

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Source: *Anatel*.

With effective implementation of mobile operations, we became the largest integrated telecommunications carrier in Region II. In 2006, our convergent and innovative products and our one-stop-shop flagship store point of sales program helped both our mobile and fixed operations.

We are a member of the Fixed Mobile Convergence Alliance, or FMCA, a 22 member association with the principal goal of offering integrated products and technologies to clients from all members. We have also announced the entry of Brasil Telecom GSM as a sponsor member of the Internet Segura Movement, or MIS, and associated with Electronic Market Brazilian Commission ( E-Net Commission ). We are the first telecommunications company of the sector to participate in MIS. We believe that the best way to prevent Internet

fraud is to educate our users. MIS acts to educate users on the necessary steps that must be taken to safeguard security information while using the Internet.

Furthermore, in relation to wireless Internet services, Anatel issued an invitation to bid for the rendering of services of broadband wireless system between 3.5 GHz and 10.5 GHz (such as WiMax). The invitation provided that only companies that already held authorization for the rendering of Switched Fixed Telephone Services or for the Multimedia Communications Services could participate. On the other hand, the invitation also provided that a concessionary that renders Switched Fixed Telephone Services or the Multimedia Communications Services, such as our company, cannot render the services of broadband wireless system in the same location.

The provision which prohibited us from rendering the broadband wireless system services at the same location as the fixed switched telephone services received several comments and reconsideration requests, including from us. Notwithstanding, Anatel maintained its decision of prohibiting us from providing these services at the same location. We, along with the other incumbents, represented by the Brazilian Association of Concessionaries of the Public Switched Telephone Network ( ABRAFIX *Associação Brasileira das Concessionárias do Serviço Telefônico Fixo Comutado*) have filed a judicial order against the restriction noticed by Anatel and, on August 31 2006, an injunction was granted, allowing us to participate in the bid. All the appeals filed by Anatel were not accepted. Thus, ABRAFIX s injunction is still in effect, allowing us to participate in the bid within our concession area. We are still attempting to participate in this bid. However, there are no assurances that we will succeed.

Recently, on September 4, 2006, the Brazilian Audit Court ordered Anatel to suspend the bid procedure until the Brazilian Audit Court gives its opinion over the merits of the procedure. Since then, there has been no development on such bidding procedure.

### *Products and Services*

Through Brasil Telecom GSM, we offer three types of plans: post-paid, pre-paid and control (a plan where clients establish a pre-determined monthly rate and buy pre-paid credits if they wish to make extra calls). In addition to voice services, Brasil Telecom GSM clients can also take advantage of value-added services, some of them exclusive to our clients. For example, we are the only operator to offer mobile banking service to our clients (regardless of the service provider of the mobile phone the client is using). We also offer Brasil Virtual Net, allowing our corporate clients to control their employees use of the Internet, and mobile E-Mail, allowing our corporate clients to communicate, receive and answer e-mails through the use of a voice phone.

The following table summarizes some of the services that we currently provide to our wireless service clients:

<b>Games</b>	<b>Downloads</b>	<b>Infotainment</b>	<b>Messaging</b>	<b>Others</b>
Ego	Wall Paper	Interactivities	Album	Mobile E-Mail
Java Games	Screen Saver	Menu BrT (1)	Blog	Brasil Virtual Net
Perfil	Monofonics Ringtones	News	Multimedia Card	Voice Mail
Quiz	Truetone	Jokes Services	Messenger	Caller Id
Senhor da Guerra	Polyphonic Ringtones	Casseta Portal	BRT GSM SMS	Call-Waiting
Super Trunfo	Videos	Voice Portal	SMS Chat	Conference
Fulano Premiado		Wap	MMS	GPRS/EDGE
Alien Revolt		Wap Show (2)	Rybenas SMS (3)	Follow-Me
Futcel			WEB SMS	Banking

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Bolão Adidas			Beltrano	Integrate Virtual Answer Machine (5)
Joga Brasil			PakEros (4)	Advanced Voice Mail
Scotland Yard			m-Encontra (4)	
			WEB SMS	

- (1) Menu BrT is a menu where the users can find services offered by Brasil Telecom, such as games, dating services, news, etc.

- (2) Wap Show is a tool that our clients use to create and administer personal or business websites, allowing them to make available for download mobile phone ring tones, applications, or photos.
- (3) Rybena SMS allows everyone to communicate with the deaf and hard of hearing through messages that are translated into the Signal Brazilian Language, enabling the deaf and hard of hearing to see messages in written form, through flash animation on their mobile phones.
- (4) m-Encontra and PakEros are dating services. Those services allow the user to complete a profile which is then matched with someone compatible.
- (5) Integrate Virtual Answer Machine is a tool for clients who have fixed-line and mobile phone service from our company. With this service is possible to integrate fixed line voice mail for up to eight of our mobile voice mails, allowing our customers to receive voice mail message in one of eight distinct mobile voice mail boxes.

In addition to our basic services, we have offered several incentives designed to increase recognition of our brand name and foster customer loyalty, including convergence products, launch promotions, our one-stop-shop flagship stores, real time customer retention programs, and roaming incentives.

#### *Convergence Products*

*Bônus Todo Mês (Bonus Every Month).* This product allows post-paid clients (described under Post Paid Plans below) to designate any Brasil Telecom fixed-line number to earn up to 50 minutes per month, equivalent to 25 pulses, (20 minutes per month, equivalent to 10 pulses, to control clients (see the description of control plans below) and 10 minutes per month, equivalent to 5 pulses to pre-paid clients) in free local calls to any fixed-line number.

*Bumerangue 14 (Boomerang 14).* This product allows Brasil Telecom GSM clients to earn credits from long distance calls made using our carrier selection code ( CSC 14 ). Clients can then use their credits to make free local calls from their mobile phone to any Brasil Telecom fixed or mobile number.

*Grupo Toda Hora (All Time Friends).* This product allows Brasil Telecom GSM post-paid clients to designate up to 14 numbers to connect with at a reduced rate of only R\$0.10 (excluding taxes) per minute, at any time. The designated numbers may be fixed-line numbers of any operator or Brasil Telecom GSM mobile numbers. Brasil Telecom GSM pre-paid clients and control clients can elect seven numbers to connect with at 50% reduced rate,.

*Cartão Único (The Unified Card).* This pre-paid service merges mobile, fixed-line and payphone services. Clients buy credits for their pre-paid mobiles, but also have the option to use the same credits to make phone calls from fixed-line or payphones. The client simply calls a toll free number and identifies the number to be called. The cost of the call is deducted from the pre-paid credits, and the rate charged is lower than the pre-paid s.

Telecom GSM is also the only operator to offer SMS credits every time a calling card is purchased, regardless of the face value of the card.

*Telefone Único (Unified Phone):* The Unified Phone is a breakthrough in telecom services. This product allows clients to make calls either as a mobile or as a fixed, through a cellular phone, depending on his or her location. For example, when at home the client can chose to make a call through his fixed or through his GSM line. This way the consumer can benefit from the best call prices provided. Brasil Telecom is one of the few operators in the world to offer such a product .

*Secretária Virtual Integrada (Integrated Voice Mail):* This product integrates the voice mails (messages) left in the Brasil Telecom GSM client's mobiles (up to 8 different numbers) and fixed lines.

#### *Two Years of Operations*



After two years of operations, we believe Brasil Telecom Mobile has demonstrated that, although Anatel considers it the fourth mobile operator, in fact, its strong concepts of convergency qualify it as the first convergent operator in Brazil and Region II.

In these two years, several innovative processes have been led by Brasil Telecom, such as the Pula-Pula, Brasil Vantagens, Banking, Convergent Pre-Paid Card, Único Phone, among others.

This inclination to revolutionize the market resulted in the acknowledgement of the clients within Region II, who made Brasil Telecom one of the record holding fourth entrant companies in terms of market share after two years of operations, with 3,377 thousand subscribers by the end of December 2006.

Brasil Telecom's highlights are not only in its number of terminals, but also in the post-paid mix, Average Revenue Per User (ARPU) and in the Subscriber Acquisition Cost (SAC), related further on the chapter dedicated to the Operating Performance.

#### *New Service Plans*

It would be normal to expect that after two years of operations Brasil Telecom would reformulate its family of plans, adjusting it to its strategy.

The change in the interconnection regime from traffic unbalancing (where operators only paid the interconnection tariff for other mobile operators when the local traffic exceeded 55% of the total traffic) to full bill (the tariff is paid for all the outgoing local traffic) was a great change which occurred in 2006, directly affecting the profitability of the companies and creating a new dynamic for the business model of the operators. As a response, Brasil Telecom Mobile repositioned significantly the prices to its clients and the services with less profitability, creating a new family of plans.

**Corporate and Business Plans** Sua Empresa Plan (Your Company Plan): the promotional discounts were reduced due to the implementation of the full bill system.

**Brasil Virtual Net Plan** this plan was extinguished due to the implementation of the full bill system.

**Control Plan** this plan was changed in February 2006. Previously the client paid for the services (minutes included or *franquia*) every other month, now they pay every month, but receives bonus minutes in the same amount as the minutes included (*franquia*).

**Post-Paid Plans** *Conta Light* and *Sua Empresa Plans* (*Light Account and Your Company, respectively*)

These plans offers to individuals and corporations the best tariffs for calls within Brasil Telecom's network, including mobile and fixed line phones. Additionally, the *Fale Ganhe* (Speak Win) promotion distributed bonuses to clients of these plans to be used to make free calls for cell phones of other operators. The bonuses are generated in the ratio of one-to-one, every time the client receives calls incoming from other mobile operators. Basically these plans seek to link the client's bonuses to their economic-financial results even in the current inter-connection rules.

**Pre-Paid Plans** *New Pula-Pula*

This plan was created in August 2006, after the implementation of the full bill. The bonus limits were extended from R\$30 to R\$100, however, the bonus may be used only for intra-network calls.



*Flagship Stores One-stop-shop*

With the launch of our mobile operations in September 2004, we opened integrated flagship stores following the one-stop-shop concept. In those stores, clients have access to our entire portfolio of products and services and we are able to capitalize on the competitive advantages of an integrated telephone operation. The

majority of our flagship stores are located in the main shopping centers of the capitals of the states of Region II. Our mobile brand, Brasil Telecom GSM, is also marketed in other points of sales, including kiosks, exclusive authorized sales agents, non-exclusive authorized sales agents and resellers among the main retailers.

#### *Real Time Customer Retention*

With our convergence offers and the Pula-Pula promotion, we became the first company in Brazil to offer a Real Time Customer Retention program, eliminating the need for our clients to subscribe to a program, earn points, view catalogs, and request prizes. After acquiring a Brasil Telecom GSM mobile phone, our clients can immediately enjoy the benefits of our convergence offers and the Pula-Pula promotion.

#### *Roaming*

The use of Brasil Telecom GSM phones is not restricted to Region II. Our clients have countrywide coverage through roaming agreements. Brasil Telecom GSM preferred roaming partners are Oi and TIM in Regions I and III, respectively. As a result of an agreement between Brasil Telecom GSM and Oi, our clients do not pay for roaming charges and can benefit from advantageous rates when using their phones in Oi's authorization area, comprising the three south-eastern states (Minas Gerais, Rio de Janeiro, and Espírito Santo), the four northern states (Amazonas, Amapá, Pará, and Roraima) and the nine states in the northeast of Brazil (Bahia, Sergipe, Alagoas, Pernambuco, Paraíba, Rio Grande do Norte, Ceará, Piauí, and Maranhão). In the cities not covered by Oi the roaming will be done by Claro or Tim, with additional collection. In 2005 Brasil Telecom GSM established roaming data (GPRS) agreements with Claro and Oi operators, giving us coverage in all states for data services and therefore giving our customer the mobility to roam not just within Region II but to all Brazilian States. As of December 2006, we had 93 agreements with international operators in 91 countries, covering the main tourist routes in South America, North America, Europe and Asia (Japan).

#### *Other Services*

In addition to the services described above, we provide telecommunications services beyond local, long distance, network and data transmission services including value-added services (such as 1-900 calling, call forwarding, voice mail, caller ID, call waiting, directory inquiry voice service) and advertising on public telephone cards. In accordance with our concessions, we are prohibited from providing cable television services, but we may lease our network to providers of such services.

#### *Wireless Clients*

As of December 31, 2006, Brasil Telecom GSM had 3.37 million clients, which represented a 12.1% market-share in Region II, an increase of 3.4% from the prior year, with 29.4% of the clients in the post-paid category. A market research study conducted in July 2005 indicated that Brasil Telecom GSM has a 15.0% market share among corporate clients. The 2006 blended average revenue per user ( ARPU ) was R\$31.80 resulting from a pos-paid ARPU of R\$43.10 and a pre-paid ARPU of R\$26.50 (affected by the interconnection regime change established by Anatel in July 2006). These values reflect the promotion discounts Pula-Pula and Fale por Menos.

#### *Subscriber Acquisition Cost*

For fiscal 2006, our subscriber acquisition cost was R\$139.40, considered to be a fair amount, given the excessive competition for mobile telephone clients in our region. We expense our subscriber acquisition costs as incurred as opposed to capitalizing them and expensing them over time, a common practice for other operators.

*Investments in our Infrastructure*

In 2006, investments in our infrastructure totaled R\$281.5 million. This amount includes disbursements to network implementation, IT equipments and platforms, installation of twenty stores, pre-operational costs realized

until October 2005 and the acquisition of an additional 900 MHz license to improve the quality of data and voice services offered to our clients.

### *Investments in Coverage*

In 2006, we implemented 297 new wireless facilities, for a total of 2,406 facilities as of December 31, 2006, covering 87% of the population in Region II. In addition, we have made infrastructure investments in many locations in order to improve the signal quality and provide coverage to indoor locations, such as shopping malls, stadiums and other public locations.

### *Integration*

Our Brasil Telecom GSM sales team works with the commercial business areas of the rest of our Group to offer to our wireless telephone clients our entire portfolio of products and address the needs of our clients within Region II.

### *Points of Sales*

As of December 31, 2006, Brasil Telecom GSM had 28 points of sale, including 20 flagship stores, 52 kiosks, 829 exclusive authorized dealers, 2,191 non-exclusive authorized sales agents, and 82 pre-paid card resellers.

### *Employees*

Brasil Telecom GSM had 636 employees as of December 31, 2006, dedicated to commercial area, new business and planning and management sales. Our employees are trained to recognize and implement synergies across the various services and products that are offered by our numerous platforms.

### *Our Region*

Until January 2004, we were authorized by our original concessions to provide fixed-line telecommunications service only in nine states of Brazil located in the western, central and southern regions of Brazil, and in the Federal District, as listed in the chart below, excluding small areas in the States of Goiás, Mato Grosso do Sul and Paraná, which we refer to as our region. We have a unique advantage in this region as we inherited the telecommunications business in this region upon privatization of Telebrás. We are now authorized to provide interregional long-distance services throughout Brazil, international long-distance services from any point in Brazil, local services out of our original concession area and wireless services in our region. Our primary source of revenues continues to come from operations in our region.

The states in our region, Region II, cover an area of approximately 2.8 million square kilometers, representing 33% of the country's total area and generating approximately 27% of Brazil's Gross Domestic Product ( GDP ). The estimated population of our region was approximately 44 million, representing approximately 24% of the population of Brazil. Our region has four metropolitan areas with populations in excess of one million inhabitants, including Brasilia, the capital of Brazil. Our business, financial condition, results of operations and prospects depend on the performance of the Brazilian economy and the economy of our region, in particular.

The following table sets forth certain key economic data for the states in our region in 2002, the date of Brazil's most recent Civil Register census.

<b>Population</b>	<b>Population per square</b>	<b>Percentage of Brazil's GDP</b>	<b>Per capita income (R\$)</b>
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<b>State</b>	<b>(millions)<sup>(1)</sup></b>	<b>kilometer<sup>(1)</sup></b>	<b>for 2002<sup>(1)</sup></b>	<b>for 2002<sup>(1)</sup></b>
Paraná	9.9	49.59	6.05	8,241
Santa Catarina	5.6	58.63	3.85	9,272
Distrito Federal	2.2	375.78	2.65	16,361
Tocantins	1.2	4.36	0.26	2,931

<b>State</b>	<b>Population (millions)<sup>(1)</sup></b>	<b>Population per square kilometer<sup>(1)</sup></b>	<b>Percentage of Brazil's GDP for 2002<sup>(1)</sup></b>	<b>Per capita income (R\$) for 2002<sup>(1)</sup></b>
Mato Grosso	2.6	2.92	1.33	6,773
Mato Grosso do Sul	2.2	6.06	1.14	7,092
Rondônia	1.5	6.33	0.54	4,843
Rio Grande do Sul	10.5	37.23	7.76	9,958
Acre	0.6	3.86	0.17	3,833
Goiás	5.3	15.54	2.33	5,921

<sup>(1)</sup> *Source: Instituto Brasileiro de Geografia e Estatística ( IBGE ), pursuant to the 2002 Regional Accounts of Brazil.*

Set forth below is a map of Brazil showing the location of our region.

### ***Seasonality***

Our main activity, which is to provide fixed-line telecommunications services, is generally not affected by seasonal variations.

### ***Targets Established by Anatel Applicable to Us***

We are required to achieve certain targets established by Anatel and required under the terms and conditions of our concessions, in connection with the quality and universalization of our services.



*Quality Targets*

Pursuant to the Telecommunications Regulations and our concession contracts, we are required to meet certain service quality targets relating to call completion rates, repair requests, rate of response to repair requests, operator response periods and other aspects of our telecommunications services. Noncompliance with these quality targets can result in certain fines. See [History and Development of the Company](#) [Regulation of the Brazilian Telecommunications Industry](#) [Obligations of Telecommunications Companies](#) [Quality of Service](#) [General Plan on Quality](#).



The following table indicates the individual performance of each of our concessions in accomplishing their respective quality of service obligations as of December 31, 2006.

**Quality Performance of Services measured on December 31, 2006**

	Teleacre	Teleron	Telemat	Telegoías	Tele-brasília	Telems	Telepar	Telesc	CRT	Pelotas	Target
Rate of completed originated local calls Morning	72.60	76.72	71.91	72.66	70.09	71.57	72.41	70.68	71.29	70.36	70.00
Rate of completed originated local calls Night	77.86	76.35	71.29	73.83	70.57	70.25	70.50	70.15	70.14	70.28	70.00
Rate of completed originated DLD calls Morning	77.44	72.81	71.67	73.88	74.22	72.59	71.83	73.39	71.89	74.21	70.00
Rate of completed originated DLD calls Night	78.75	81.95	71.02	74.25	71.51	73.67	68.72	70.86	71.22	71.01	70.00
Rate of amount of repair requests per 100 accesses in service Integral	1.16	1.13	1.37	1.30	1.23	1.02	1.26	1.30	0.00	1.14	1.50
Rate of amount of repair requests per 100 public telephones Integral	1.33	5.78	5.14	7.03	6.73	5.51	7.27	5.25	3.60	4.78	8.00
Response rate for user telephones of the PSTN within 10 seconds Morning	100.00	99.89	99.87	97.83	99.76	99.95	98.11	97.67	97.68	97.83	95.00
Response rate for user telephones of the PSTN within 10 seconds Night	100.00	100.00	100.00	99.66	99.79	99.81	99.82	99.70	99.82	100.00	95.00
Amounts of bills with complaints of errors in every 1,000 bills issued loca mode	2.58	3.46	2.69	2.52	1.99	2.56	2.49	2.56	2.72	2.99	2.00
Amounts of bills with complaints of	1.97	2.65	2.27	2.55	1.96	2.00	2.14	1.68	1.14	1.87	2.00

errors in every 1,000 bills issued DLD mode Rate of claimed inaccurate bills with credit issued (for each 100 bills) for the local mode Integral	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	98.00
Rate of originated DLD calls not completed due to traffic jam Morning	1.60	1.26	0.91	1.13	1.53	1.01	0.83	0.96	0.64	0.08		4.00
Rate of originated DLD calls not completed due to traffic jam Night	4.82	1.54	1.18	1.19	2.02	1.05	1.01	1.33	0.75	0.42		4.00
Rate of originated local calls not completed due to traffic jam Morning	0.96	0.56	0.59	0.55	1.18	0.52	0.44	0.53	0.46	0.23		4.00
Rate of originated local calls not completed due to traffic jam Night	0.76	0.76	0.72	0.87	0.85	0.89	0.38	0.58	0.93	0.77		4.00
Response rate to repair requests made by residential users in up to 24 hours Integral	98.54	99.45	99.45	99.60	99.60	99.48	99.64	99.63	99.27	100.00		98.00
Response rate to repair requests made by non-residential users in up to 8 hours Integral	98.88	98.67	99.08	99.45	98.99	98.79	99.26	99.09	98.83	98.03		98.00
Response rate to repair requests made for public telephones in up to 8 hours Integral	100.00	99.10	99.66	99.83	100.00	100.00	99.42	99.71	99.95	100.00		98.00

**Quality Performance of Services measured on December 31, 2006**

	<b>Teleacre</b>	<b>Teleron</b>	<b>Telemat</b>	<b>Telegoías</b>	<b>Tele- brasilía</b>	<b>Telems</b>	<b>Telepar</b>	<b>Telesc</b>	<b>CRT</b>	<b>Pelotas</b>	<b>Target</b>
Response rate to address change requests from residential users in up to 3 business days	100.00	99.61	100.00	99.83	99.76	99.76	99.93	99.83	99.81	100.00	98.0
Integral Response rate to address change requests from non residential users in up to 24 hours	100.00	99.00	99.42	99.42	98.17	98.40	99.92	98.73	99.24	100.00	98.0
Rate of completed calls for Call Center Morning	99.10	99.10	99.10	99.54	99.59	99.21	98.82	99.27	99.73	99.49	98.0
Rate of completed calls for Call Center Night	100.00	98.20	99.46	99.35	99.51	99.15	99.01	99.35	99.48	100.00	98.0
Rate of delivery of bills to the customer before 5 days of the expiration	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100

*Universalization    Network Expansion*

We are also required under the Telecommunications Regulations and our concessions to meet certain targets relating to network expansion and modernization. See History and Development of the Company Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies Network Expansion General Plan on Universal Service.

During 2006, all our universalization targets of the General Plan on Universal Service were met.

The following table indicates certain of our obligations relating to the expansion of our network in 2006 and our performance in satisfying those obligations as of December 31, 2006.

	<b>Targets at December 31, 2006</b>	<b>Company status at December 31, 2006</b>
Fixed-line service available to all communities larger than (inhabitants)	300	obligation met
At least one public phone available to all communities larger than (inhabitants)	100	obligation met
Maximum waiting time for installation of a line (weeks) <sup>(1)</sup>	1	obligation met
Minimum number of public telephones (per 1,000 inhabitants)	6	6.4

<sup>(1)</sup> Applies only to areas where fixed-line service is fully available.

### ***Our Rates***

For basic plans, our concessions establish a mechanism of annual rate adjustment, based on rate baskets and the use of a price index. Until December 2005 this index was IGP-DI, in January 2006, it was replaced by the Telecommunications Industry Index ( IST ), a sectorial price index. Two rate baskets are defined, one for local services (local basket) and one for long-distance services (DLD basket). The rates for the provision of services through payphones and the rates for address changes are treated separately.

Until December 31, 2005, the adjustment index considers the IST index variation, discounting the pre-established productivity factor in the concession contract. Within each basket, the rates have a cap price, which can be adjusted up to a percentage above the established index (up to 5.0% higher for the local basket and up to 5.0% higher for the DLD basket). However, the application of a higher index to one of the items in the basket will require a balancing of the remaining items so as not to exceed the established limit for such basket. After December 31, 2005, some changes were introduced due to concession contract renewal. The adjustment index considers the IST

index variation, discounting the pre-established productivity factor which is calculated according to methodology defined on Norma 418/05. Within each basket, the rates have a cap price, which can be adjusted up to a percentage above the established index (up to 5.0% higher for the local basket and up to 5.0% higher for the DLD basket). However, the application of a higher index to one of the items in the basket will require a balancing of the remaining items so as not to exceed the established limit for such basket

The local basket includes basic subscriptions and local pulse/minute, and represents the weighted average of these rates. The national long-distance basket includes all different prices for calls, which vary according to the distance and the time of connection.

On the adjustment dates for the local and DLD baskets, the adjustments for network usage rate are also approved. These rates apply when our networks are used by other telecommunications carriers.

The maximum adjustment indexes allowed for the baskets within the period of 2002 to 2006 are as follows:

	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Local Basket	8.3%	16.0%	6.9%	7.3%	(0.42)%
DLD Basket	4.9%	12.5%	3.2%	2.9%	(2.77)%

On July 11 and 18, 2006, Anatel confirmed a decrease in rates, in connection with local and long distance services and network usage, as provided for in our concession contract. These rate decreases were equal to an average of 0.42% on local services and 2.77% on domestic long distance services. The maximum rates for international long distance calls were increased by 8.4% (basic plan).

The renewal of the concession contracts also established what parameters will be used to the adjustment rates. IST, created by Anatel as an index basket of existing public prices, is now the official index to measure sector inflation and adjust rates. For 2006 and 2007, the agency has established a model which will reduce the readjustment levels to pass part of the productivity gains obtained by the companies to the users. In 2006, the IST index was lower than IGP-DI, which may reduce the rates adjustment in 2007.

#### *Local Rates*

Our revenue from local services derives from fees charged for service access, service availability, service usage and change of address. An activation fee is applied for service access and consists solely of a charge paid when terminals are activated.

The monthly subscription charge is the amount paid for the availability of fixed switched telephone service, regardless of utilization. There are three types of monthly subscriptions, depending on the category of the terminal, which can be residential, non-residential or trunk. Payment of this charge includes 100 free pulses per month for residential clients and 90 free pulses per month for remaining clients (non-residential and trunk). Any pulses in excess of such amounts are billed to the customer as a measured service.

Since July 11, 2006, the date of the last rate adjustment, average monthly subscription charges (net of taxes) have been R\$27.28 for residential customers, R\$40.36 for non-residential customers, and R\$33.32 for trunk customers.

Users of measured service pay for local calls depending on usage, which is measured in pulses. Pulses occur systemwide every four minutes and are recorded independently of when the individual calls are actually made. In

addition to system-wide pulses, the system records one pulse for every call when the call is connected. After the first pulse, only system-wide pulses are used in determining the charge for a call. As a result, the time between the first and the second (system-wide) pulse may vary. For example, for a call being charged using four-minute pulse increments, the time between the first pulse and the second (system-wide) pulse may vary between one second and four minutes. In the first quarter of 2007, the pulses will be substituted by minutes, and all calls will be charged by their duration, in minutes, rather than by the number of pulses.

Local call charges for calls made on weekdays between 6:00 a.m. and 12:00 a.m. and on Saturdays between 6:00 a.m. and 2:00 p.m., are determined by multiplying the number of pulses by the charge per pulse. For calls being made any weekday and on Saturdays between midnight and 6:00 a.m., on Saturdays between 2:00 p.m. and midnight and all day on Sundays and holidays, a caller is charged for only one pulse regardless of the duration of the call.

Since the last rate adjustment, on July 11, the average pulse charge (net of taxes) has been of R\$0.10996.

The following table sets forth selected information regarding our subscription charges and measured service charges for local telephone services for the periods indicated.

	<b>Year ended December 31</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Average rates for local telephone service <sup>(1)</sup>		<i>(reais)</i>	
Monthly subscription:			
Residential	25.5	27.4	27.28
Commercial	36.7	39.5	40.36
Measured service (per local pulse)	0.10294	0.11042	0.10996

<sup>(1)</sup> Average rates, net of taxes.

In addition to the average pulse charge, since the last rate adjustment on August 1, 2006, we have been charging an activation fee for a new line, net of taxes, between R\$6.78 and R\$47.59 (depending on the state). In 2006, Anatel determined that the fee for address change should be the same amount of the activation fee of a new line.

From the first semester of 2007 on, the pulses will be converted into minutes and all calls shall be charged by their effective duration in minutes. With this new criteria, our receipts may be affected due to possible changes of tariff plans by our customers.

#### *Domestic Long-Distance Rates*

Domestic long-distance, or DLD, calls between fixed-line telephones are measured by the duration of the call and registered in the telephone bill call by call. The value per minute is defined by the distance involved (rate degrees from one to four), the day of the week and the time of the call. The measurement is based on a rate unit of one tenth of a minute (six seconds) and the minimum billable time is thirty seconds.

The following table sets forth selected information regarding our domestic long-distance rates during the periods indicated.

	<b>Year ended December, 31</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Domestic long distance rates <sup>(1)</sup>		<i>(reais)</i>	
0 to 50 km	0.62	0.63	0.67
50 to 100 km	0.90	0.93	0.93
100 to 300 km	1.05	1.08	1.05
Over 300 km	1.13	1.16	1.07

<sup>(1)</sup> Average rates for a domestic long-distance call (interstate), three minutes in duration between the hours of 9 a.m. and noon and 2 p.m. and 6 p.m. (peak hours) on weekdays, net of taxes.

*Network Usage Charges*

The network usage rates, responsible for a large part of our interconnection revenue, are applied in the following situations:



- in DLD calls originating and terminating at our network, executed with the use of the selection code of other providers;
- in calls terminating at our network, originating from networks of mobile carriers; and
- in local fixed-to-fixed type calls made between two local telephone carriers at the same location. In this case, network usage rates apply to the volume of traffic received above 55.0% of the total volume of minutes between the two networks. The revenue will be calculated on the amount exceeding this limit. Anatel intends to change the interconnection revenue to consider the total volume of minutes between the two networks, but this change of criteria still depends on further regulation.

The Local Network Usage Rate (*Tarifa de Uso de Rede Local*, or TU-RL ) is applied when third parties use our local network to complete their calls. When third parties use our long-distance network the Intercity Network Usage Rate (*Tarifa de Uso de Rede Interurbana*, or TU-RIU ) is applied.

The following table sets forth the average per-minute rates that we charged for network services during the indicated years.

**Year ended December, 31**

	<b>2004</b>	<b>2005</b>	<b>2006</b>
		<i>(reais)<sup>(1)</sup></i>	
Network usage rate (local)	0.05248	0.04548	0.03663
Network usage rate (long-distance)	0.11083	0.11408	0.08109

<sup>(1)</sup> Net of taxes.

On January 1, 2006, the Local Network Usage Rate was set at 50% of the tariff for each minute of the local service and the Intercity Network Usage Rate was set as 30% of the D4 tariff for long distance service.

Our revenue from network services also includes payments from other operators based on specific agreements to share our network and other infrastructure. Other telecommunications service providers, such as providers of trunking and paging services, may use our network to connect a central switching station to our network. Some mobile service providers use our network to connect mobile central switching stations to the mobile radio base stations. We also lease transmission lines, certain infrastructure and other equipment to other providers of telecommunications services.

The maximum value for the Local Network Usage Rate was set at R\$0.02930 effective in January 2007.

#### *Fixed-Mobile Rates*

Wireless telecommunications services in Brazil, unlike in North America, are offered on a calling party pays basis. Under this policy, a mobile subscriber generally pays mobile usage charges only for calls made by such subscriber and not for calls received. In addition, a subscriber pays roaming charges on calls made or received 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 per-minute rate. For example, a fixed-line phone has specific rates for calls made to other mobile users. These mobile rates are divided in Communication Value 1, or VC-1, for local calls, Communication Value 2, or VC-2, for calls outside the subscriber's registration area but still inside the region where the respective operator provides service, and Communication Value 3, or VC-3, for calls outside the subscriber's registration area and outside the region where the respective operator provides service.

We charge our fixed to mobile calls based on per-minute charges, on either VC-1, VC-2, or VC-3 rates, when a fixed-line service customer calls a mobile subscriber. In turn, we pay the cellular service provider a mobile network usage charge for such calls. For local calls, the VC-1 is applied, and for national long-distance calls, the VC-2 and VC-3 rates are applied. Local calls where VC-1 is applied are included in our local services revenues, while intraregional calls where VC-2 or VC-3 are applied are included in our intraregional and long distance service revenues.

The criteria for measurement of these calls are defined in the concession contract and have the following rules:

- Rating unit: six seconds (one tenth of a minute);
- Billable Minimum: 30 seconds; and
- Billable Calls: only calls with duration of more than three seconds are billed.

Like the local and DLD basket rates, rates for calls involving mobile telephones are set in the concession contract and are adjusted annually based on IGP-DI price index, after approval by Anatel.

At the same time, rates for mobile network use ( VU-M ) are also readjusted and are used to determine the amount that fixed-line carriers will have to pay for fixed to mobile calls, whether in local range (VC-1) or in national long-distance range (VC-2 and VC-3).

Since July 6, 2003, through regulation changes, mobile customers must choose, via the carrier selection code, the DLD carrier they prefer to complete their calls, following the same system adopted by the fixed telephone sector. With the introduction of this new system, the DLD carriers began to take part in this new market.

On June 12, 2005, VC-1 was adjusted by 7.99%, while the VU-M (for local calls, VC-1) was adjusted by 4.5% . However, operators did not reach an agreement to adjust VC2 and VC-3, and, as a consequence, these rates have not changed.

The following table sets forth the average per-minute rates that we charged for fixed-to-mobile services during the indicated years.

	<b>Year ended December, 31</b>		
	<b>2004</b>	<b>2005</b> <i>(reais)<sup>(1)</sup></i>	<b>2006</b>
VC-1	0.443	0.479	0.479
VC-2	0.906	0.906	0.95
VC-3	0.997	0.997	1.05

<sup>(1)</sup> Net of Taxes

#### *Data Transmission Rates*

Most of our data transmission revenues are obtained by monthly fees charged for private leased circuits. These revenues consist mainly of charges for access to networks and usage related to the amount of data transmitted. The following table sets forth selected information about our average monthly line rental charges for private leased circuits during the indicated years.

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>

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Average rates for monthly line rental per leased circuit:

(*reais*)

Local circuit			
4.8 Kbps	302.00	302.00	302.00
9.6 Kbps	302.00	302.00	302.00
64 Kbps	586.00	586.00	586.00
2 Mbps	6,636.00	6,636.00	6,636.00
Long-distance circuit <sup>(1)</sup>			
4.8 Kbps	1,303.00	1,303.00	1,303.00
9.6 Kbps	1,303.00	1,303.00	1,303.00
64 Kbps	3,317.00	3,317.00	3,317.00

**Year ended December 31,**

	<b>2004</b>	<b>2005</b>	<b>2006</b>
2 Mbps	37,566.00	37,566.00	37,566.00

<sup>(1)</sup> Maximum rates, net of taxes, assuming a transmission distance between 300 and 500 kilometers.

The table below sets forth the rates that we charged for ADSL services in 2006. These costs do not include the fees normally paid by customers to their ISPs. The portfolio was changed in 2006 with higher speeds and a new product for games, called Turbo Jogos.

<b>Residential Plans</b>	<b>Downstream/Upstream Speed</b>	<b>Monthly Subscription<sup>(1)</sup></b>
<i>Turbo 250</i>	Up to 250 Kbps/Up to 128 Kbps	59.90
<i>Turbo 400</i>	Up to 400 Kbps/Up to 200 Kbps	79.90
<i>Turbo 600</i>	Up to 600 Kbps/Up to 300 Kbps	99.00
<i>Turbo 800</i>	Up to 800 Kbps/Up to 300 Kbps	118.99
<i>Turbo Jogos 600</i>	Up to 600 Kbps/Up to 512 Kbps	108.99
<i>Turbo Jogos 1000</i>	Up to 1.0 Mbps/Up to 512 Kbps	219.99
<b>Corporate Plans</b>	<b>Downstream/Upstream Speed</b>	<b>Monthly Subscription<sup>(1)</sup></b>
<i>Turbo Empresas 400</i>	Up to 400 Kbps/Up to 200 Kbps	119.90
<i>Turbo Empresas 800</i>	Up to 800 Kbps/Up to 400 Kbps	253.12
<i>Turbo Empresas 1.5 Mbps</i>	Up to 1.5 Mbps/Up to 256 Kbps	593.44

<sup>(1)</sup> Monthly rates in *reais*, including taxes.

*Wireless Rates*

Our authorization establishes a price-cap mechanism of annual rate adjustment, based on the IST price index for basic and alternative plans. The price-cap is a weighted average price for the services offered in our Basic and Reference Plans, that can include monthly subscription and particular roaming charges, depending on the plan, such as toll per call and local minute-basis tariffs. These Basic and Reference Plans are defined as compulsory by Anatel, and have to be offered by all operators.

However, tariffs and prices for value-added services, such as data communications services, are not subject to regulation and can be defined on a competitive basis. Such services are offered as pay-per-use or volume-based packages.

The Basic Plan follows a post-paid system, whereby clients pay a monthly charge for the availability of mobile services, regardless of utilization. In addition to this charge, subscribers are charged for the utilization of voice and data services. The Reference Plan (*Brasil Cartão* Plan) follows a pre-paid system, whereby our clients purchase credits in advance for the availability of mobile services.

The following table sets forth selected information about the average charges for our Basic Plan in 2006:

**Year ended December**

**31, 2006**

Average rates for the Basic Plan <sup>(1)</sup> :	(reais)
Activation	0.00
Monthly Subscription	27.74
Local calls to fixed-line numbers (per minute)	0.4138
Local calls to Brasil Telecom GSM (per minute normal rate)	0.4138
Local calls to other wireless operators (per minute normal rate)	0.4507

<sup>(1)</sup> Average rates, net of taxes.

Different types of alternative plans are offered to our wireless clients: the *Brasil Conta Plan*, the *Brasil Controle Plan*, the *Brasil Empresa Plan*, the *Brasil Conta Light Plan* and the *Sua Empresa Plan*.

The *Brasil Conta Plan* follows a post-paid system, whereby clients pay a monthly charge for a given package of inclusive minutes. Any minutes used in excess of such amounts are billed to the customer according to the selected package, so that packages with a greater amount of inclusive minutes are generally charged a lower rate. We offer 14 different packages of monthly inclusive minutes ranging from 50 to 2000 minutes. If subscribers do not use the total amount of inclusive minutes in any given month, the balance cannot be carried to the following month.

The *Brasil Controle Plan* has characteristics of both pre-paid and post-paid systems. Clients pay a fixed monthly charge for the availability of mobile services, regardless of utilization. Payment of this charge includes cash credits of equal amount. Once all credits have been used, subscribers may purchase extra pre-paid credits. Rates charged for pre-paid and post-paid plans are not the same. If subscribers do not use the total amount of cash credits during its validity term they shall lose the unused credits.

The *Brasil Empresa Plan* is exclusively offered to legal entities, and follows a post-paid system, whereby the client pays a monthly charge for several access codes and a given package of inclusive minutes, depending on the needs of the client. Any minutes used in excess of such amounts are billed to the customer according to the selected package, so that packages with a greater amount of inclusive minutes are generally charged a lower rate. If subscribers do not use the total amount of inclusive minutes in any given month, the balance cannot be carried to the following month.

The *Conta Light Plan* follows a post-paid system, whereby clients pay a monthly charge for a given package of inclusive minutes for callings between subscribers of our wireless operator and from a subscriber of our wireless operator to a local fixed-line user. Any minutes used in excess of such amounts and the calls originated by a subscriber of our wireless operator to any access code of other wireless operator are billed to the customer, with different rates. The packages with a greater amount of inclusive minutes are generally charged a lower rate. We offer 14 different packages of monthly inclusive minutes ranging from 50 to 2000 minutes. If subscribers do not use the total amount of inclusive minutes in any given month, the balance cannot be carried to the following month.

The *Sua Empresa Plan* is also exclusively offered to legal entities, and follows a post-paid system, whereby clients pay a monthly charge for a given package of inclusive minutes for callings between subscribers of our wireless operator and from a subscriber of our wireless operator to a local fixed-line user. The minutes of the package depends on the client's necessity. Any minutes used in excess of such amounts and the calls originated by a subscriber of our wireless operator to any access code of other wireless operator are billed to the customer, with different rates. The packages with a greater amount of inclusive minutes are generally charged a lower rate. We offer 14 different packages of monthly inclusive minutes ranging from 50 to 2000 minutes. If subscribers do not use the total amount of inclusive minutes in any given month, the balance cannot be carried to the following month.

### ***Taxes on Telecommunications Services***

The cost of telecommunications services in Brazil includes a variety of taxes. The principal tax is a state value-added tax, the *Imposto sobre Circulação de Mercadorias e Serviços* ( ICMS ), which Brazilian states impose at varying rates on telecommunications services. The current average ICMS tax rate for telecommunications services is 25.0% . However, the ICMS tax rate varies between states. In the State of Acre and the Federal District, for example, the ICMS tax rate is 25.0%, while in the State of Mato Grosso do Sul the ICMS tax rate is 27.0% and in the State of Goiás, the ICMS tax rate is 29.0% . The average effective ICMS tax rate for telecommunications services in 2006 is 23.3% . The difference between the nominal and effective ICMS tax rate is due to the non taxation of services rendered to clients who are exempt and to other telecommunications operators, according to the regulation in effect.

The telecommunications tax burden also includes four other federal taxes, the *Programa de Integração Social* ( PIS ) and *Contribuição para Financiamento da Seguridade Social* ( COFINS ), which are two social contribution taxes based on our gross revenues, and the *Universal Telecommunications Service Fund* ( FUST ) and the *Fund for Technical Development of Brazilian Telecommunications* ( FUNTTEL ), which are two



telecommunication taxes based on our gross operating revenues, incurring from the provision of telecommunications services, net of certain deductions.

PIS is applied at a 0.65% rate and COFINS is applied at a 3.0% rate for telecommunications services. Since December 2002, we have been subject to a 1.65% PIS rate for services other than telecommunications services and may be entitled to PIS credits calculated on our costs and expenses to offset the PIS due on those services. Since February 2004, we have been subject to a 7.6% COFINS rate for services other than telecommunications services and may be entitled to COFINS credits calculated on our costs and expenses to offset the COFINS due on those services. The FUST and FUNTTEL are imposed on certain telecommunications services at the rates of 1.0% and 0.5%, respectively. See Item 10. Additional Information Taxation Brazilian Tax Considerations Other Brazilian Taxes.

In 2006, we paid taxes on telecommunications services in the amount of approximately 28.36% of our annual operating revenues.

### ***Billing and Collection***

We send each customer of local services, long-distance services and other services a monthly bill covering all the services provided during the prior period. We group our customers into six different monthly cycles with six different payment dates. The telephone bill itemizes long-distance calls, calls made to cellular telecommunications networks, 300, 500 and 800 services and other services such as call waiting, voice mail and call forwarding.

For interregional and international long-distance services, customers either receive separate monthly bills from each company they use for long-distance calls or a combined bill issued by us. Customers make payments by direct payment to a bank or an alternative agent, or by allowing their checking account to be debited.

Pursuant to Brazilian law, subscribers must receive a bill at least five days before the due date. When a payment is not made by the due date, we must send the customer, 15 days after the due date, a notice informing the customer of the right to contest the debt and if payment is not made within 30 days after the due date, all outgoing service will be suspended, and the customer will only be able to receive incoming calls. If payment is not made within 45 days after the due date, we send another notice informing the customer that if payment is not made within 60 days after the due date, all services will be suspended, the contract will be cancelled and the customer's failure to pay will be reported to a credit protection agency.

The following table sets forth information about our accounts receivable for the year ended on December 31, 2006. For the discussion of provisions for past due accounts, see Item 5. Operating and Financial Review and Prospects Operating Results.

#### **At December 31, 2006**

Due	59.5%
Past due 01 to 30 days	20.0%
Past due 31 to 60 days	5.9%
Past due 61 to 90 days	3.7%
Past due 91 to 120 days	2.8%
Past due More than 120 days	8.1 %

### ***Network and Facilities***

#### *General*

The network is the combination of the physical and logical infrastructure which provides telecommunications services, whether it is voice, data and/or image. In 2006, we took various steps to expand our voice, data and image networks.

*Voice Network*

During 2006, we diminished our voice network through the disconnection of 394,000 lines. As a result, as of December 31, 2006, our voice network plant consisted of approximately 10.4 million installed lines, of which 8.4 million were in service. Of the lines in service at that time, approximately 66.0% were residential lines, 18.5% were commercial lines, 3.3% were public telephone lines and 12.2% were other service lines. Long-distance transmission is provided by a fiber-optic cable network and by microwave links.

The following table sets forth combined information about our voice network for the periods indicated.

	<b>At the year ended December 31,</b>	
	<b>2005</b>	<b>2006</b>
Installed lines (millions)	10.8	10.4
Lines in service (millions)	9.6	8.4
Average lines in service for year ended (millions)	9.5	8.5
Lines in service per 100 inhabitants	22.3	19.4
Percentage of installed lines connected to digital exchanges	99.9%	100.0%
Number of public telephones (thousands)	296.6	277.9

*Data Network*

As of December 31, 2006, we had 1,561,732 ADSL installed ports and 1,317,425 accesses in service, and in excess of 1 million customers, an increase of 30.6%, or 366,375 new ADSL accesses added, when compared to the previous year. During 2006, we increased the number of cities where we have ADSL ports from 1,256 to 1,475. The following table sets forth combined information about our data network for the periods indicated.

	<b>Year ended December 31</b>		
	<b>2005</b>	<b>2006</b>	<b>% Change</b>
<b>ADSL</b>			
Installed Ports	1,195,357	1,561,732	30.6
Accesses in Service	1,013,893	1,317,425	29.9

ATM, Frame Relay, and Dedicated IP expanded by 8.9% in 2006 compared to 2005. As of December 31, 2006, we had installed 14,831 ATM, Frame Relay or Dedicated IP ports. The DialNet service increased from 197,244 ports installed at the end of 2005, to 196,314 ports installed at the end of 2006, representing a decrease of 0.47%. The following table sets forth combined information about our ATM, Frame Relay and Dedicated IP networks for the periods indicated.

	<b>Year ended December 31</b>		
	<b>2005</b>	<b>2006</b>	<b>% Change</b>
DialNet	197,244	196,314	(0.5)

ATM / Frame Relay / Dedicated IP	13,619	14,831	8.9
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The following table sets forth certain information about our active customers in the several data communications networks.

**Aggregate value as of December 31, 2006**

	<b>Total number of ports</b>	<b>Total ports in service</b>	<b>Utilization rate (%)</b>
RAS (DialNet)	196,314	165,960	84.5
ATM/Frame Relay (Cisco Network)	9,936	8,911	89.7
SLDD, EILD and Frame Relay (Deterministic Network)	46,651	33,441	71.7
Dedicated IP / IP Light (Access routers)	4,895	3,517	71.9

*Mobile Network*

During the second quarter of 2004, we launched our mobile network with the challenge of implementing an extensive mobile network from the state of Acre to the state of Rio Grande do Sul, using the most advanced wireless technology available worldwide while simultaneously integrating the network into one of the largest wireline networks of Brazil.

As of December 31, 2006 this mobile network incorporates the following network characteristics:

- Technology 1,800/900 MHz for voice;
- GPRS/EDGE technology for data;
- Technological evolution guaranty;
- Unique Voice Core distributed in an topology of 8 MSCs, 2 MSS and 9 MGW organized regionally according to the traffic interest of each region; the MSS and MGW are elements of NGN;
- Two HLRs, geographically separated, assuring security and flexibility;
- Unique Data Core, fully integrated to the fixed-line data network of our company;
- Access network distributed through 819 localities covered by 2,406 Radio Base Stations;
- GPRS coverage in 100% of the localities covered and EDGE in all capitals (10 cities) from cover area states;
- Full integration with the existing transmission resources of our wireline network;
- Intensive sharing of our existing wireline infrastructure and other wireless operators in the market; and
- Integration with our fixed-line platforms, leveraging technical/operational synergies between companies.

*Network Modernization*

Our network infrastructure applies an operational model designed to use cutting-edge technological resources to efficiently provide flexibility and quality services for our users. Since 2005, we have been implementing significant modifications and improvements in our network infrastructure in order to provide a more efficient service to our customers. The improvements in our network infrastructure were based on a convergence model of services and applications, as well as a single and flexible network accessible to all clients from any location and at any time. With our network infrastructure, we are able to provide fully integrated services, whether fixed-line or wireless, voice, data or image, thereby optimizing available resources.

In 2006 the technological achievements were:

- IPTV;
- Único phone (Bluetooth and GSM)
- Next Generation Network (NGN) architecture to the mobile network
- deployment of ADSL 2+

- Brasil Mail

We are currently in the process of transitioning our voice and data networks to a more unified structure to provide better efficiencies across our service and product platforms. This transition is designed to unify our offerings of media forms (voice, data and images) above a unique transport structure based on IP, including media transmitted through fixed access points and mobile access points in an integrated environment unifying the Telecom and IT worlds. This structure is designed to create a more efficient service environment to complement the services we offered by our Next Generation Network. In this new structure, our services are implemented in a centralized way and are available in a homogenous and efficient way to any network telecommunication user. In addition, this structure allows us to develop and implement all of our services in an open market pattern utilizing a wide variety of suppliers, eliminating the need for different networks to be serviced by different services and allowing network applications to be shared in order to promote optimization of our network usage.

We have finished consolidation process of our call center structure, by merging our 30 pre-existing sites into five sites (Goiânia, Campo Grande, Florianópolis, Brasília and Curitiba). We have improved our customer relationship management system which integrates our systems and provides a database of information for each customer so that we can provide better service and identify sales opportunities during each contact we have with our customers. In addition, we are targeting small and medium-sized companies, in order to render more specialized customer services to them.

We also continued to implement our DSLAMs/Ethernet network, better prepared to support ADSL 2+ technologies that would allow us to offer higher speed services. In addition, to accommodate the continuous demand for high speed services, we are deploying a new Metro-Ethernet access network. Finally, we implemented an address control and name resolution system for our IP networks with the objective of optimizing resources and improving the availability of Internet access services.

In 2006, we kept competitive in the technological marketplace, participating in telecommunication standards bodies, technical associations and committee Forums such as the European Telecommunications Standards Institute (ETSI), 3rd Generation Partnership Project (3GPP), Telecoms & Internet Converged Services & Protocols for Advanced Networks (TISPAN) and Fixed-Mobile Convergence Alliance (FMCA).

Also, in 2006, we launched an Internet Protocol Television (IPTV) pilot project to 300 customers. Another innovation was the convergent (fixed-mobile) phone called UNICO with both Bluetooth and GSM technologies. In addition, we are considering several new technologies for implementation in the near future, including Worldwide Interoperability for Microwave Access ( Wimax ), , IP Multimedia Subsystem ( IMS ), Gigabit Passive Optical Networking ( GPON ) and Services Oriented Architecture ( SOA ).

## **Competition**

The telecommunications industry in Brazil is becoming increasingly competitive. We operate in the local fixed-line telecommunications, data communications and wireless telecommunications markets in our region. Domestic and international long distance telecommunications are offered to our clients not only in our region but in the whole country. We compete primarily on the basis of features, pricing and customer service. In general, the increasingly competitive marketplace has resulted in decreasing prices for telecommunications services, also driven by the implementation of new technology and an increase in regulatory oversight.

### *Local Services*

Currently, we are the leading local fixed-line telecommunications services provider in our region, with an estimated 92.0% market share, based on statistical estimates using volume of outgoing and incoming local calls of our competitors that interconnect through our network. Global Village Telecom is our main competitor in providing local

fixed-line telecommunications services in our region. Our position in the local fixed-line telecommunications market is due, among other things, to the fact that we did not face any competition in this market until the entry of Global Village Telecom in November of 2000. Global Village Telecom is an independent service provider operating under an authorization from Anatel. Since its entry into the market, we have been able to maintain our market share in our region due to our extensive network and competitive features, prices and services.



In March of 2006, a new player entered in the fixed-line market, NET Serviços. It is a company that provides cable TV, broadband based on cable modems and telephone service. They have offered their products as a bundle which allows them to charge a very competitive price. In 2007 we expect this company to increase the number of cities where they offer their services.

In the short-term, despite the fact that there are already numerous companies with permission from Anatel to provide local fixed telecommunications service in our region, we could lose additional market share, mainly in the corporate segment, if additional competitors are allowed to enter the fixed-line market in our region. Our fixed-line services are also subject to competition from wireless service providers. See **Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry** We face increasing competition in the Brazilian telecommunications industry which may have a material adverse effect on our market share, results of operations and financial condition.

#### *Intraregional (intrastate and interstate) Long-Distance Service*

We are currently the leading intraregional long-distance telecommunications service provider in our region, with an estimated 85.2% of the intraregional market share in 2006, based on the volume of outgoing long-distance calls that select us to carry such calls by inputting our carrier selection code. Pursuant to Anatel regulations, callers are able to choose a service provider for each long distance call by selecting a carrier selection code that identifies the carrier. Until July 6, 2003, this was permitted only for calls made from fixed-line phones. Since such date, mobile callers can also choose a service provider by selecting a carrier selection code. Our carrier selection code is 14. Accordingly, domestic long distance carriers, including us, compete in the mobile long distance market. As our carrier selection code 14 was widely used for calls originating from fixed telephones, we quickly gained a significant share of the long-distance calls originating from mobile phones. Embratel is our most significant competitor in providing intraregional long-distance telecommunications services in our region with approximately 9.3% of the total market share in 2006. The remaining market share is divided among Global Village Telecom, Intelig and other operators. The licenses awarded to Embratel, Intelig and Global Village Telecom are not subject to the same service quality and network expansion and modernization obligations that we are subject to under our concessions.

In the short-term, we expect to lose market share in the provision of intraregional long-distance telecommunications services due to increased competition from Embratel. To date, numerous companies have permission by Anatel to provide intraregional long distance telecommunications services in our region, but we do not expect that these companies will gain meaningful market share. See **Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry** We face increasing competition in the Brazilian telecommunications industry which may have a material adverse effect on our market share, results of operations and financial condition.

#### *Interregional and International Service*

Until December 31, 2003, under Anatel rules, regional fixed-line companies, such as ours, generally were not permitted to offer interregional or international long-distance services. Having received certification by Anatel of our compliance with universalization targets on January 19, 2004, we began offering interregional and international long-distance services. Due to our unique position in Region II combined with competitive marketing and promotional pricing, by December 31, 2006, we were able to attain a 62.3% interregional market share and 35.9% international market share in Region II, which represented an increase of approximately 6.7% and 3.6%, respectively, from the prior year. We compete primarily against Embratel, which, as of December 31, 2006, had approximately 30.3% of the interregional market share, representing a loss of 4.1% in these services from the prior year. Embratel also controls approximately 48.6% of the international long-distance service market share. We expect our market share to increase as clients are no longer concerned about selecting a carrier based on where the call ends.

To date, although numerous companies have permission by Anatel to provide interregional and international long distance telecommunications services in our region, we do not expect to experience a significant decrease in our market share due to increased competition in the near future. See Item 3. Key Information Risk Factors Risks Related to the Brazilian Telecommunications Industry We face increasing competition in the

Brazilian telecommunications industry which may have a material adverse effect on our market share, results of operations and financial condition.

#### *Data Transmission Services*

Over the past few years, the data communications sector of the telecommunications industry has shown the highest annual growth rates and has accordingly attracted many participants. We believe that within data transmission services, the broadband market will grow substantially over the next few years as broadband, and in particular ADSL, can offer users a single access point through which they can obtain voice, data and image services.

We have increased our market share in the data communications market primarily through the development of our ADSL service that has grown substantially in the last year, giving us the highest penetration rate of ADSL access per fixed-line in service among Brazilian carriers. We are the leading provider of broadband ADSL access in Region II with 1,317,425 ADSL accesses in 2006. Our leading position in ADSL is based upon our market share of the local service market as ADSL accesses are provided through the local telephone lines in our region. Global Village Telecom also provides ADSL accesses in our region, and we also face competition from cable TV operators who provide broadband access through cable modems. In 2006 we faced competition from cable providers providing telephone or quasi-telephone services which compete with the telephone services we offer, however the penetration of cable television in our region is still limited.

In the dial-up market, our market share is approximately 66.0% in our region, based upon our share of the total volume and duration of dial up calls that are made using our network which we can identify as calls made to dial up service providers. We compete in the dial up Internet market primarily with Global Village Telecom.

#### *Internet Services*

The Internet Group faces different competitors in all its main business lines. As a portal, it competes not only with other Brazilian Internet service providers such as Terra, from Telefonica, UOL from Grupo Folha and Globo.com from Organizações Globo, but also with international based players such as Google, MSN and Yahoo!. In the broadband access provision market, our main competitors are other large Brazilian Internet service providers such as Terra, Uol, Virtua, Oi Internet and Globo.com as well as smaller local area ISPs. In Region II, our main dialup competitors are Click 21 and Pop, which are controlled by Embratel and Global Village Telecom, respectively.

#### *Wireless Services*

We launched our wireless operations in September 2004. Wireless services are equally competitive and we face competition in Region II mainly from (i) a joint venture between Telefônica and Portugal Telecom (marketed under the brand name Vivo ), (ii) Telmex, which competes against us in our region through América Móviles (marketed under the brand name Claro ) and (iii) TIM. In addition, wireless services compete directly against fixed-line services.

The mobile telephone business is a highly competitive one, and Region II has the highest penetration rate in the country by service providers based outside of the Region. As of December 31, 2006, we had 3.4 million mobile telephone clients, representing 12.1% of the market share in our region. We have become the largest integrated telecommunications carrier in Region II. In 2006, our convergent and innovative products and our one-stop-shop flagship store point of sales program helped both our mobile and fixed operations.

We are a member of the Fixed Mobile Convergence Alliance, or FMCA, a 22 member association with the principal goal of offering integrated products and technologies to clients from all members. We have also announced the entry of Brasil Telecom GSM as a sponsor member of the Internet Segura Movement, or MIS, and associated of

Electronic Market Brazilian Commission ( E-Net Commission ). The company is the first telecommunications company of the sector to participate in MIS. We believe that the best way to prevent Internet fraud is to educate our users. MIS acts to educate users on the necessary steps that must be taken to safeguard security information while using the Internet.

### ***Effects of Competition***

Competition in the telecommunications business is expected to increase as a result of the deregulation that began in 2002, including the certification and authorization process by which companies are permitted to provide additional services inside and outside of their regions. Although we believe we have a unique infrastructure in Region II (having inherited the incumbent network upon privatization of Telebrás) and we have been developing strategies to effectively protect our business, we expect that competition as a result of the entry of additional competitors into the market for local, long distance and wireless services in Region II, as well as significant industry consolidation, may adversely affect our revenues. We anticipate, however, that our growth in the Brazilian market will partially offset this competition, since we are able to offer long distance and data services on a nationwide basis in addition to wireless services in our region. While we expect that local traffic per line will continue to decline as we expand our network to lower-income customers who, on average, make fewer calls, we expect that our expansion into other new business areas will provide us with new growth opportunities.

The impact of these competitive pressures will depend upon a variety of factors that cannot currently be assessed at this time, some of which are beyond our control. Among such factors are the technical and financial resources available to our competitors, the business strategies and capabilities of our competitors, prevailing market conditions, the regulations applicable to new entrants and us, and the effectiveness of our efforts to prepare for increased competition and consolidation. Our ability to continue to compete successfully will also depend on the success of our marketing, financial and other resources (including our access to capital) in comparison to our competitors and on our ability to anticipate and respond to competitive factors affecting the industry, including the introduction of new services, changes in consumer preferences, changes in regulation, demographics trends, economic conditions, discount pricing strategies by competitors as well as further industry consolidation.

### ***Customer Service***

We provide customer service primarily through call centers and flagship stores. In addition we provide services through our website and in physical locations through lottery booths for the acceptance of payments and post offices which provide services such as terminal activation and repair requests.

In 2006, we centralized the customer care services in four sites, improving and optimizing the services, reducing in the monthly costs by approximately 20%.

In addition, we restructured the Relationship Directorship, creating management positions to oversee areas, like planning and traffic, projects, and infrastructure and development. These managers are responsible for the implementation of new methodologies at call centers, designed to provide more efficient management of the services provider.

### ***Sales Channels and Marketing***

We have improved our sales channels in order to render specialized customer services in different niches and sectors of our market, but primarily in the corporate market. Our sales channels consist of direct marketing, our website, and our customer service contacts. Our residential sales are primarily handled through our 800 numbers or our website. Our corporate sales are primarily handled through direct sales contacts with our sales representatives.

With the launch of our mobile operations in September 2004, we opened integrated flagship stores following the one-stop-shop concept. In those stores, clients have access to our entire portfolio of products and services and we are able to capitalize on the competitive advantages of an integrated telephone operation. The majority of our flagship stores are located in the main shopping centers of Region II. Our mobile brand, Brasil Telecom GSM, is also marketed

in other points of sales, including kiosks, exclusive authorized sales agents, non-exclusive authorized sales agents and resellers among the main retailers.

We have increased our use of direct marketing in conjunction with outbound and inbound telemarketing as a way of targeting our market sectors (residential, commercial and corporate). At the same time, we have developed

a complete portfolio of products and services, such as SLDD, Frame Relay, ATM, IP WAN, Dedicated IP, Light IP and DialNet, to meet the needs of our customers.

We have also developed and improved our website, in an effort to deliver some of our services online. Currently, customers are able to access over 16 different types of services online, including: registration for the purchase of a telephone line, issuance of a second copy of a bill, consultation of a detailed and summarized bill, download of a bill, verification of receipt of payment, and requests for repairs.

### ***Intellectual Property***

We conduct research and development in the areas of telecommunications services, but we do not independently develop any new telecommunications technology.

#### *Our Patents in Brazil*

We own four patent applications in Brazil, filed before the Brazilian Trademark and Patent Office ( INPI ) to protect telecommunication systems and methods (patents are valid for 20 years counted from the filing date). All of them were published. In order to determine whether they are in accordance with Brazilian Legislation, the request for technical analysis has to be completed in 2007 for three of them, and in 2008 for one of them. In case such technical analysis is not requested up to 38 months from the filing date, the patent application is automatically cancelled. Additionally, according to the Brazilian Industry Property Law, it is necessary to pay an annual fee starting as of the third year, counted from the date of the filing of the patent applications, in order to maintain the validity of patents and utility models. The first annual fee of three of the patent applications was paid in 2006, and the remaining fee is due in 2007. In case the annual fees are not paid, INPI will automatically cancel the patent and/or the utility model, and INPI's cancellation decision is then published on the INPI's Official Gazette. After the publication of such decision, the owner of the patent and/or utility model can request the reversal of a cancellation decision by INPI by the payment of extra fees.

Moreover, there are four patent applications owned by Brasil Telecom Celular S.A. The request for technical analysis and the payment of the first annual fee will occur in 2007 or 2008, depending on the date of filing of those four patents. Furthermore, Brasil Telecom Participações S.A. owns one industrial design in Brazil valid until October 25, 2010 and we own one duly registered patent.

#### *Our Trademarks in Brazil*

We currently own 426 trademarks filed in different classes of products and services, with the majority protecting communication services and we received the proper registration for 202 of these trademarks. Some trademarks, however, protect advertising, business management, administration, insurance, financial, monetary and real state affairs as well as scientific and technological services and research, design and industrial analysis and research services, design and development of computer hardware and software as well as apparatus for recording, transmission or reproduction of sound or images, magnetic data carriers, recording discs.

Some of these applications have been published for third party opposition and are still under examination at INPI, a process that may take up to six years to be concluded. Some of our trademark applications have been opposed by third parties we cannot insure that they will be granted by INPI if such oppositions are accepted.

Additionally, some of our trademark registrations are due for renewal. According to the Brazilian Industrial Property law a trademark must be renewed after 10 years from the date of the granting of the registration.

*Our Domain Names in Brazil*

We currently own 153 domain names covering our various subsidiaries and platforms of business registered in the name of Brasil Telecom, 227 additional domain names registered under the name of Internet Group do Brasil Ltda., 14 domain names registered under the name of iBEST S.A., and 51 domain names registered under the name of BrTSi.



## Regulation of the Brazilian Telecommunications Industry

### *General*

Our business, including the services we provide and the rates we charge, are subject to comprehensive regulation under the General Telecommunications Law. We operate in each of the states in our region based on the concessions that were granted to each of Telepar, Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre, CRT and CTMR. We also operate outside our original concession area based on the new authorizations received from Anatel as a result of our achievement of universal service targets certification. These concessions and authorizations allow us to provide specified services and set forth certain obligations with which we need to comply.

Anatel is the regulatory agency for telecommunications that acts under the *Regulamento da Agência Nacional de Telecomunicações* (the Anatel Decree ). Anatel is administratively independent from the Government and financially autonomous. Anatel is required to report on its activities to the Ministry of Communications and to the Brazilian Congress. Any proposed regulation of Anatel is subject to a period of public comment, including public hearings, and Anatel's decisions may be challenged administratively before the agency itself or through the judiciary system in the Brazilian courts. Under Brazilian law, we, like all public-regime companies, must have the rates that we charge for products and services approved by Anatel. On June 20, 2003, Anatel enacted Resolution 341, which provides for new types of Anatel concession contracts that became effective on January 1, 2006 and remain effective until 2025.

### *Concessions and Licenses*

#### *General*

We operate under public-switched telephone network concessions (local and domestic long-distance), which grant us the right to offer local and domestic long-distance services in Region II.

Concessions to provide public-switched telephone network services are granted under the public regime but such services may also be provided through authorizations granted under the private regime.

In addition to us, the companies that operate in the public regime in Brazil include Telemar, Telesp and Embratel. The four main public regime companies are the largest primary providers of fixed-line telecommunications services in Brazil, including local services and intraregional, interregional and international long-distance services. All other telecommunications service providers, including the other companies authorized to provide fixed-line services in Region II, operate in the private regime.

According to the terms of Article 63 of the General Telecommunications Law and of Article 13 of the Brazilian Telecommunications Services Regulation, public regime companies are subject to certain obligations as to continuity and the universal service. Public regime companies are also subject to Anatel's supervision with respect to the rates that they may charge. On the other hand, private regime companies are generally not subject to the requirements as to universal services, but they are subject to certain network expansion and quality of service obligations set forth in their licenses.

Public regime companies, like our company, normally offer certain services in the private regime, of which the most significant are data transmission services through *Serviço de Comunicação Multimídia* (SCM) Multimedia Communication Services (MCS) authorizations. In addition, on December 18, 2002, we acquired a license to offer our mobile services under the private regime.

#### *Fixed-line Services Public Regime*

Each public regime company operates under a concession that was granted a 20 year extension in December of 2005. As part of the extension, public regime companies became subject to the rules for providers of new services, including universalization rules. See Brazilian Telecommunication Sector Regulation New Telecommunications Regulations. During the 20-year extension period, companies will be required to pay

biannual fees equal to 2.0% of their annual net revenues from the provision of their public switched telephone network (excluding taxes and social contributions) during the immediately preceding year.

Prior to January 2004, we were not permitted to offer interregional and international long-distance services. On January 20, 2004, our concession contracts were amended to provide for Anatel's certification in connection with our achievement of universalization targets, and we became qualified to receive a concession to provide such services. Thus, we were able to originate long-distance calls and terminate them at any point in the country, as well as outside the country. For more information, see [Obligations of Telecommunications Companies](#) [Public Regime](#) [Service Restrictions](#).

#### *Fixed-line Services* [Private Regime](#)

The Brazilian Telecommunications Services Regulation precipitated the introduction of competition in telephone services in Brazil by enabling the Brazilian federal government to authorize, through Anatel, four private regime companies—three to provide fixed-line local services and intraregional long distance services, one in each of the three regions of the General Concession Plan, and one to provide intraregional, interregional and international long distance services throughout Brazil—to provide services concurrently with the public regime companies. Anatel has granted private regime operators licenses to operate in Region II. Anatel has also granted licenses to other private regime companies to operate in Regions I and III of the General Concession Plan and licenses to other private regime companies to provide intraregional, interregional and international long distance service in Region IV of the General Concession Plan. The number of authorizations that may be granted by the Brazilian federal government is unlimited.

After receiving the certification for the accomplishment of our universal service targets, we obtained authorization under the private regime to provide local and domestic long-distance services in certain sectors of our Region II where we were not present before, and in Regions I and III through the General Concession Plan. In addition, we were authorized to provide international long-distance services in Regions I, II and III (the entire country) of the General Concession Plan. The other primary public regime companies received similar authorizations.

#### *Regulation of Wireless Services* [PCS](#)

In September 2000, Anatel amended the regulations related to the provision of wireless telecommunications services for PCS. These amended PCS authorizations enable new participants in the Brazilian telecommunications market to compete with already existent telecommunications service providers. The amended PCS regulation divides Brazil into three distinct regions, each of which corresponds to the regions applicable to the public regime fixed-line telephone service providers. PCS services are provided within the 1,800 MHz band, which contains Bands C, D and E. Anatel held auctions for PCS authorizations during 2001 and 2002, but no Band C PCS authorizations were granted.

The PCS license sets forth certain obligations and targets that must be met by a PCS service provider. These obligations were initiated in May 2004, when we received the radiofrequency authorization from Anatel, which allows Brasil Telecom GSM to provide the mobile services, to buy and install our wireless network and to integrate the mobile services with our other products. This license is valid for 15 years and can be renewed for the same period. Under these obligations and in our region (Region II under the General PCS Authorization Plan), we are required to:

- service an area equivalent to at least 50.0% of the urban area in 50.0% of the state capitals, the Federal District and cities with more than 500,000 inhabitants by May 3, 2005;
- service all state capitals, the Federal District and all cities with more than 500,000 inhabitants by May 3, 2006;

- service an area equivalent to at least 50.0% of the urban area in 50.0% of the cities with more than 200,000 inhabitants by May 3, 2007;

- service all cities with more than 200,000 inhabitants by May 3, 2008; and
- service all cities with more than 100,000 inhabitants by May 3, 2009.

A locality is considered serviced when the covered service area contains at least 80.0% of the urban area. Failure to meet these targets may result in the imposition of penalties established in the regulations and, in extreme circumstances, in revocation of the PCS license by Anatel.

#### *Obligations of Telecommunications Companies*

Like other telecommunications service providers, in addition to the service requirements, we are also subject to obligations concerning quality of service and network expansion and modernization. As a public regime company, we are also subject to a set of special restrictions regarding the services we may offer, contained in the General Concession Plan, and special obligations regarding service quality, network expansion and modernization contained in the General Plan on Universal Service and the General Plan on Quality.

#### *Telecommunications Regulations*

On June 10, 2003, the Brazilian government issued a presidential decree, Decree No. 4733, setting forth a number of changes in the regulation of Brazil's public switched telephone network. The decree sets forth general policies regarding, among others, universal access to telecommunications services, stimulation of employment, labor market and development of the Brazilian industry in the telecommunications sector, stimulation of competition and the adoption of rate adjustment policies that took into account Brazilian socio-economic conditions and the financial equilibrium of the existing concession contracts. The decree also established some changes including the concessions contracts extension to public switched telephone network.

Pursuant to Decree No. 4769, the Federal Government approved the General Plan on Universal Service, which required that providers achieve new targets beginning on January 1, 2006. The purpose of the plan is to allow all Brazilians, regardless of where they are located or their socio-economic status, to have access to the public switched telephone network. The costs related to meeting the targets contemplated by the new plan must be covered solely by the concessionaries of the PSTN (incumbents) pursuant to terms stipulated in each provider's concession contract. Anatel may revise the universalization targets, pursuant to the concession contracts, as well as propose additional targets and accelerate the plan. The plan applies to local, domestic and long-distance service providers in varying degrees.

Telecommunications services providers are required to:

- install a public switched telephone network to provide access for individual residential, non-residential and trunk classes in locations with more than 300 inhabitants. Priority must be given to requests for individual access made by schools, hospitals, public security establishments, public libraries, museums, judiciary agencies, federal public prosecutor's agencies, and consumer protection agencies. Special services access condition and equipment must also be provided for the physically, hearing, visually and speech impaired;
- activate one public telephone in each location with more than 100 inhabitants and less than 300 inhabitants located within 30 km from other locations already serviced by such PSTN to provide individual access;
- activate public telephones, which allow any person to access the public switched telephone network, regardless of subscription or registration with the provider, ensuring that the density of such public telephones

per General Concession Plan sector is equal to or over six public telephones per 1,000 inhabitants from January 1, 2006 onwards. By way of comparison, the old General Plan on Universal Service required at least 7.5 public telephones per 1,000 inhabitants for year-end 2003 and eight public telephones per 1,000 inhabitants for year-end 2005. When activating public telephones, providers must ensure there are at least three public telephones per group of 1,000 inhabitants evenly distributed over the service area. 50% of the required public telephones must be installed in areas which are accessible twenty-four hours a day and 2.0% must be adapted for every kind of special necessity. Local services providers are responsible for meeting the targets in areas located 30 kilometers from any locality attended by individual PSTN. PSTN domestic and international long-distance providers must meet the targets in those service areas located 30 kilometers or more from any other service area attended by individual PSTN:

- provide a telecommunication center with a public phone and a public Internet terminal in thirty percent of all cities with less than fifty thousand habitants and six percent of all cities with more than fifty thousand habitants, granting access to, at least, twenty percent of the totality of the habitants;
- provide a telecommunication center with a public phone and a public Internet terminal in all rural cooperative corporations with less than one hundred and eighty members;
- provide a telecommunication center with a public phone and a public Internet terminal in thirty five percent of all rural cooperative corporations with more than one hundred and eighty and less than two hundred and fifty members;
- provide a telecommunication center with a public phone and a public Internet terminal in fifty five percent of all rural cooperative corporations with more than two hundred and fifty and less than seven hundred members;
- provide a telecommunication center with a public phone and a public Internet terminal in thirty five percent of all rural cooperative corporations with more than seven hundred members.

In addition, local service PSTN providers must activate and maintain telecommunications services centers in each General Concession Plan sector in varying numbers. Such numbers will be determined by the estimated population of the sector. The public switched telephone network incumbent services providers must also activate telecommunications services centers in each General Concession Plan sector in cooperative service centers located in rural areas. For the year 2008, the requirement will vary according to the size of the cooperative. By the end of 2009, all cooperatives must be serviced.

Local service providers must also comply with the Special Individual Access Class rules, which are designed to require service for the less economically advantaged population. Under the Special Individual Access Class, a user may enter into a plan under which he or she is required to pay a lesser amount of monthly fee for service than the basic plans.

The concession contracts also contain terms that incorporate the Telecommunications Political Decree, the new General Plan on Quality and the new General Plan on Universal Service described above, which refer to:

- universalization targets that were met in December, 2006;
- changes in local rate measurement criteria from pulse to minute measurement, to be implemented by August 1, 2007;
- reduction in chargeable rates for local interconnection rates;
- In 2006, the Telecommunication Industry Index was created by Anatel as an index basket of existing public prices, became the official index to measure sector inflation and adjust rates. For 2006 and 2007, the agency also elaborated a calculus model to the Transference Factor in order to reduce the readjustment levels to pass part of the productivity gains obtained from the companies to the users.
- the user's right to request a detailed bill as of 2007 and the right to request the temporary suspension of the service without additional charges.

Both the General Plan on Quality and the General Plan on Universal Service were approved in June 2003, and became effective on January 1, 2006 after the extension of the concession contracts that expire in 2025.

The major differences between the old and new models of the concession contracts relate to universal targets and rate structure. Concessionaires will be required to implement the PSTN in new locations, including smaller communities, and the IGP-DI is no longer used to determine the annual inflation-based adjustments to the rates. It was replaced by the Telecommunications Industry Index ( IST ). The new concession contracts also contemplate future number portability, service resale and the General Target Competition Plan. This will enable customers to change telecommunications service providers without the inconvenience of having to change their contact number, which is especially important for corporate customers.

#### *Public Regime Service Restrictions*

Until December 31, 2001, according to the General Concession Plan, all fixed-line telecommunications service concessionaires, like our company, were prohibited from offering new services, such as mobile services, fixed-line telecommunications services in the local mode outside our region and in the interregional or international long-distance mode. In January, 2004, the accomplishment of the universalization targets by the concessionaires enabled them to be exempt from this restriction. Today, every public fixed-line telecommunications service provider is authorized to offer all other telecommunications services, with the exception of cable television services. See Network Expansion General Plan on Universal Service and Quality of Service General Plan on Quality.

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

- a restriction on holding more than 20% of the voting stock of any other public regime company, if the acquisition is deemed detrimental to competition, puts at risk the execution of the concession contract or is not duly authorized by the necessary agencies; and
- a legal restriction on offering cable television services.

#### *Quality of Services General Plan on Quality*

Each PSTN public or private regime company must comply with the provisions of the General Plan on Quality and also with the terms of their respective concessions, licenses or authorizations. All costs related to the attainment of the goals established by the General Plan on Quality must be exclusively borne by the respective telephone service provider. The General Plan on Quality establishes minimum quality standards with regard to:

- attending to repair requests;
- attending to change of address requests;
- servicing users by phone;
- quality of public telephones uses;
- informing the user s access code;
- personal services to users;



- send issuance of bills;
- rate of call completion for originating calls;
- modernization of the network; and
- responding to mail received from users.

These quality standards are measured according to the definitions and quality indicators established by Anatel. Companies are required to present monthly reports to Anatel regarding their performance in attaining the quality goals. Additionally, companies are obligated to provide Anatel with an in-depth report and analysis regarding each quality goal that is not achieved. Anatel may also collect such data from companies at any time and without prior notice.

Companies that fail to attain the Anatel quality goals may be subject to warnings, fines, intervention by Anatel, temporary suspensions of service or cancellations of concessions and authorizations. See [Fines and Penalties](#) below.

#### *Fines and Penalties*

Failure to meet the network expansion and modernization obligations established by the General Plan on Universal Service, or any act or failure to act that harms competition in the telecommunications sector, may result in fines and penalties of up to R\$50.0 million, as well as potential revocation of concessions.

Failure to meet the quality of service obligations established by the General Plan on Quality may result in fines and penalties of up to R\$40.0 million.

#### *Interconnection*

General rules regarding interconnection are described in the General Interconnection Regulation, enacted by Anatel. All operating companies providing telecommunications services must, if technically feasible, make their networks available for interconnection on a non-discriminatory basis whenever one request is made by any other telecommunications provider. Anatel currently sets and adjusts the fixed and mobile interconnection rates between fixed-line networks. Anatel has allowed fixed-line and wireless network operators to freely negotiate interconnection rates. With the contracts extension new rules were preview to the interconnection collection tariffs.

#### *Unbundling of local networks*

On May 13, 2004, Anatel issued Order (*Despacho*) 172, which establishes rules for partial unbundling of local telephone networks, which we refer to as [line sharing](#), and full unbundling of local telephone networks, and requires us to make our networks available to other telecommunications service providers. This legislation limits the rate we can charge for line sharing per line for broadband speeds of up to 512 kbps. Additional charges, such as co-location charges, are applied over the line sharing base price, increasing the total cost of the unbundled line. Anatel has not yet fixed rates for full unbundling, although we expect that these rates will be lower than the rates we currently are permitted to charge. This regulation was designed to increase competition in the local fixed-line and broadband Internet access markets by making it easier for new telephone companies operating under either the public or private regime to enter these markets and for existing providers to provide new services or enter new regions, since the networks of all telecommunications service providers, including fixed-line operators such as us, will be made available at lower rates. Similarly, this legislation makes it easier for us to provide new services and enter into new regions in competition with other operators. However, operational rules for the implementation of unbundling have not yet been agreed to among Brazilian telecommunications operators. These regulations are recent, and as of December 31, 2006 no unbundled lines had been used by competitors in our region.

#### *Rate Regulation*

Until December 31, 2005, for basic plans, our concessions established a mechanism of annual rate adjustment, based on rate baskets and the use of the IST price index. A rate basket was defined for local services (local basket) and long-distance services (DLD basket). The rates for the provision of public telephones and the rates for address changes

were treated separately.

The adjustment index considers the IST price index variation, discounting a productivity factor previewed in the concession contract. Within each basket component, the rates had a maximum value, which could be adjusted to a percentage above the established index (up to 5.0% higher for the local basket and for the DLD basket). However, the application of a higher index to one of the items in the basket would require a balancing of the remaining items so as not to exceed the established limit for such basket.

The renewal of the concession contracts also established what parameters are used to adjust rates. After December 31, 2005, the IST, was implemented by Anatel as an index basket of existing public prices, became the official index to measure sector inflation and adjust rates. The IST is based on weighted indices which better represent variations in individual companies costs. For 2006, 2007, and 2008, the agency also elaborated a calculus model to the Transference Factor in order to reduce the readjustment levels to pass part of the productivity gains obtained from the companies to the users.

On the adjustment dates for the local and DLD baskets, the rate adjustments for network use are also approved. These rates apply when any networks are used by other telecommunications carriers. There is a rate charged per minute of use of our local network by other carriers (TU-RL) and another for use of our intercity network (TU-RIU).

From the year 2002 to the year 2006, our rates and the rates of other regional fixed-line companies have been adjusted downward, in real terms, as follows:

**K-factor annual productivity adjustments**

	2002	2003	2004	2005	2006
Fixed-line companies local (services)	1.0%	1.0%	1.0%	1.0%	1.13%
Fixed-line companies local (network)	10.0%	15.0%	20.0%	20.0%	1.13%
Fixed-line companies long-distance and intercity network	4.0%	4.0%	5.0%	5.0%	1.13%

We may also offer alternative plans in addition to the basic service plan. Such alternative plans must be submitted to Anatel for approval and are not subject to a price cap. Nevertheless, once set, prices may only be adjusted annually, based on the IST.

In the third year of concession, Anatel could have submitted us to the regime of free rating, provided that there is large-scale and effective competition among the service providers. Under this regime, the concessionaire can establish its own rates. In the event this regime is implemented, Anatel may reestablish the previous regime should arbitrary increases of profits by the carriers or practices considered harmful to the competition occur. To date, we have received no indication from Anatel that they intend to submit us to such a free rating regime.

Companies holding PCS licenses are allowed to freely price their wireless services, provided they are linked to existing service plans authorized by Anatel. Price caps are adjusted annually, based on the IGP-DI. After January 2006 the IST was adopted for concessions and Anatel is studying also to apply IST for authorizations annual adjustment. The interconnection rates, until July 2004, were also subject to price caps fixed by Anatel and adjusted on an annual basis. After that date, interconnection rates between PSTN and PCS networks may be negotiated directly between parties according with criteria established by Anatel. If the parties are unable to come to an agreement on the rates, Anatel can establish the values and open an arbitration process upon the request of any party.

For information on our current rates and service plans, see Item 4. Information on the Company Rates.

### *Revocation of a Concession*

Anatel may revoke the concession of any public regime telecommunications company upon the occurrence of any one of the following circumstances:

- an extraordinary situation in which the public interest is in jeopardy, during which time the Brazilian government may operate the public regime company. In such cases, the Brazilian government must be legislatively authorized to revoke the concession and the company must be indemnified for any losses incurred during the period in which the concession was revoked;
- contractual termination, either at the will of the company or at the will of the Brazilian government, upon an act or omission of the Brazilian government that renders the continued offering of the services excessively burdensome to the company;
- the occurrence of:
  - ◆ a split-up, spin-off, amalgamation, merger, capital reduction or transfer of the company's corporate power without Anatel's authorization;
  - ◆ the transfer of the concession without Anatel's authorization;
  - ◆ the dissolution or bankruptcy of the company;

an extraordinary situation where Brazilian government intervention, although legally possible, is not undertaken by the company since such intervention would prove to be inconvenient, unnecessary or resultant in unfair benefits for the company; or

  - ◆ failure to comply with universalization targets.

In the event that a concession is revoked, Anatel may occupy the company's premises and use its employees to continue providing telecommunications services.

### **Property, Plant and Equipment**

Our main equipment consists of transmission equipment, including Synchronous Digital Hierarchy systems and radio links, switching equipment, including local, tandem and transit telephone exchanges, metallic and fiber-optic cable networks, data communication equipment, network and systems and infrastructure, which include alternate and continue current and direct current supply equipment, motor-generator groups, air conditioning, towers, buildings and land surveillance.

Our properties are located in the States of Acre, Rondônia, Goiás, Tocantins, Mato Grosso, Mato Grosso do Sul, Paraná, Santa Catarina, Rio Grande do Sul, São Paulo, Rio de Janeiro, and Belo Horizonte, as well as in the Federal District. The buildings used by our management are primarily located in the capital cities of these states. At December 31, 2006, our operations used approximately 5,409 properties, of which 3,156 were owned by us and 2,253 were leased from third parties.

As of December 31, 2006, the net book value of our property, plant and equipment was approximately R\$7,565.1 million (which includes automatic switching, transmission and other equipment, buildings and other fixed assets net of accumulated depreciation and work-in-progress regarding the same).

**Environmental and Other Regulatory Matters**

We, like other Brazilian telephone companies, are subject to federal, state and municipal environmental legislation and regulation. Our failure to comply with applicable environmental laws could result in administrative, civil and criminal sanctions against us.

As part of our day-to-day operations, we regularly install ducts for wires and cables and erect towers for transmission antennae. We may be subject to federal, state and/or municipal environmental licensing requirements due to our installation of cables along highways and railroads, over bridges, rivers and marshes, and through farms, conservation units and environmental preservation areas, among other places. So far, we have been required to obtain environmental licenses for the installation of transmission towers and antennae in the municipality of Porto Alegre, the capital of the state of Rio Grande do Sul, with no material impact on our operations. However, there can be no assurances that other state and municipal environmental agencies will not require us to obtain environmental licenses for the installation of transmission towers and antennae in the future and that such a requirement would not have a material adverse effect on the installation costs of our network or on the speed with which we can expand and modernize our network.

We must also comply with environmental legislation on the management of solid wastes. According to CONAMA Resolution 237 of 1997, companies responsible for the treatment and final disposal of solid industrial wastes, special wastes and solid urban wastes are subject to environmental licensing. Should the waste not be disposed of in accordance with standards established by environmental legislation, the company generating such waste may be held jointly liable for any damage caused with the company responsible for treatment of the waste. In the States of Santa Catarina, Paraná and Mato Grosso, we have already implemented management procedures promoting the recycling of batteries, transformers and fluorescent lamps. During the current year those management practices will also be implemented in the other states.

In addition, we are subject to Anatel's requirements, which impose limits on the levels and frequency of the electromagnetic fields originating from our telecommunications transmissions stations.

We believe that we are in compliance with Anatel standards as well as with all applicable environmental legislation and regulations. We are currently not involved in any administrative or judicial proceeding involving material liability for environmental damage.

#### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

None.

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

The following discussion should be read in conjunction with our Consolidated Financial Statements and notes, which are included elsewhere in this Annual Report. Certain important features of the presentation of our Consolidated Financial Statements are described in the introduction to Selected Financial Data. See Item 3. Key Information Selected Financial Data.

##### **Overview of Results of Operations**

Over the last several years, we have focused on the following major initiatives:

- *Offer interregional and international long-distance services.* We have worked to increase our market share in our business of providing long-distance service. Since January 22, 2004 we have offered interregional and international long distance services, and we expect to be able to offer our existing corporate and residential clients more competitive and integrated plans and capture additional market share.
- *Strengthen our wireless telecommunications services.* Since September 27, 2004, we have offered wireless telecommunications services based on mobile technology. With the introduction of wireless services, we are



the only company in Region II to offer both wireline and wireless services and we continue to leverage this advantage to increase our brand awareness and overall market share.

- *Continue to integrate and acquire high technology network infrastructure in order to position ourselves as a market-leading Internet service provider.* Together, our submarine fiber optic cable system, our local fiber-optic network, and our Internet protocol provider, provide us with the state-of-the-art broadband infrastructure as well as local network capacity that will allow us to position ourselves as a market leader for Internet services to both residential and corporate clients.
- *Develop integrated voice, data and multimedia services for residential and corporate clients.* We have worked to offer integrated voice, data and multimedia products and services through our existing distribution channels as well as through new mobile phone stores, to provide our customers with a one-stop shopping environment for both residential and corporate clients.

We expect 2007 to be challenging, as we continue to work to keep pace with our competitors in Region II, enter new markets and improve our profitability. Our challenges include the following:

- *Meeting competition.* As a result of government regulations, our domestic and international long distance markets are increasingly open to competition from other service providers, and competitors have gained market share at our expense. We are actively pursuing a marketing strategy to attract and retain customers and develop our customer base, in particular our corporate client base.
- *Cost control.* To maintain our profitability in the increasingly competitive Brazilian telecommunications environment, we must continue to implement strategies to improve operating efficiency. We plan to do this by controlling bad debt expense, lowering interconnection costs through regulatory initiatives and targeted network build-out, making capital expenditures to address new markets, lowering our financing costs and operating costs and enhancing the productivity of our existing assets.
- *Changes in the competitive landscape due to new technology.* New technologies, such as voice over Internet Protocol (IP) and Next Generation Networks, have the potential to significantly transform the competitive landscape in the telecommunications business. Our long-term success will depend in part on our ability to adapt our business to these changes and take advantage of new technologies.

#### ***Rate Increases and Changes in Revenue from Network Services***

Rates for fixed-line telecommunications services are subject to comprehensive regulation. Our concession contract establishes a price-cap mechanism by which Anatel sets and adjusts rates on an annual basis. The price-cap mechanism consists of maximum rates established by Anatel that may be charged for the provision of services and weighted average rates for baskets of basic services. The basket of local services includes most of the services included in the basic service plan, such as installation charges, monthly subscription fees and switched local services (traffic). Subject to certain limits, the rates for individual services within the basket may be increased by up to 9.0% above the limit, so long as the weighted average rate for the entire basket does not exceed the limit. Other services covered by the maximum rate include long distance services, which are determined based on five rate categories that vary with the time of day and the distance between the origin and the call destiny, and network usage fees. For a further discussion of the application of prescribed rates to our individual services and average rates for baskets of services, see Item 4. Information on the Company Business Overview Our Rates.

*Rate Increases*

On July 11, 2006 and again on July 18, 2006, Anatel authorized rate readjustments as provided for in our concession contracts. These rate readjustments were equal to an average reduction of 0.42% on local services and 2.77% on domestic long distance services.

On July 1, 2005, Anatel authorized an increase in rates based on the IGP-DI index, in connection with local and long distance services and network usage, as provided for in our concession contract. These rate increases were equal to an average of 7.27% on local services and 2.94% on domestic long distance services. The maximum rates for international long distance calls were increased by 8.36% (basic plan).

Rate adjustments had a positive impact on our revenues for 2005 and 2006. See Net Operating Revenues. The following table sets forth the adjustments in rates in 2005 and 2006 for various services as adjusted by Anatel pursuant to the IGP-DI index.

	<b>July 3, 2005</b>	<b>July 14, 2006</b>
Local services basket	7.27%	(0.42)%
Installation	7.27%	28.10%
Residential subscription	7.25%	(0.42)%
Non-residential subscription	7.27%	2.18%
Trunk subscription	7.27%	9.06%
Pulses	7.27%	(0.42)%
Phone credits	7.37%	(0.42)%
Change of address	7.27%	32.21%
Local interconnection	(13.33)%	(19.46)%
Domestic long distance basket	2.94%	(2.77)%
Long distance interconnection	2.94%	(28.92)%

*Network Services*

We provide access to our network and lease certain network facilities to other telecommunications companies as part of our network service business. This generates revenues from:

- interconnection fees paid to us by mobile service providers and other telecommunications operators (principally Embratel and Intelig) for the use of our network;
- from telecommunications services provider companies for the cession of installation transmission, infrastructure and other equipment used in traffic transporting within their own internal networks; and
- the rental of our network, including local and long distance transmission, to other companies to establish Interconnection Points or Interconnection Points of Presence.

Interconnection fees are also reflected in our costs, as we pay interconnection fees for using other companies' networks to complete our clients' calls. To complete a fixed-to-mobile call, we pay an interconnection fee for the use of mobile networks (*VU-M*), which increased by 9.2%, in 2004, 4.5% in 2005 (*VU-M* for VC-1), and 4.5% in 2006 (*VU-M* for VC-2 and VC-3). To complete a fixed-to-fixed call, we also pay an interconnection fee for the use of local

networks (*TU-RL*), and an interconnection fee for the use of intercity networks (*TU-RIU*), which increased by 14.5% in 2004 and 2.9% in 2005, and decreased by 5.1% in 2006.

Although the growth of wireless telecommunications and increase in long distance usage volumes resulted in an increase in network services revenues from 2001 through 2003, our revenues have decreased in 2004, 2005 and 2006, in part due to an increase in competition among wireless telecommunications service providers. Any

adverse effect on our competitors' systems that in turn has a negative impact on their interconnection with our network could have an adverse effect on our financial condition and results of operations.

### ***Regulatory Factors***

Our operations are based on concessions granted by the Brazilian Government, which authorizes us to render local and long distance fixed line telephone services within and originating from Region II. It also requires the achievement of certain conditions related to the universalization of tariffs, service quality, network expansion and modernization and interconnection. Our business, including services rendered and tariffs charged, is subject to extensive regulation under Brazilian law. The Brazilian regulatory structure for telecommunications is under constant evolution. According to the Brazilian law, as a publicly held company, we must have Anatel's approval for the rates charged for our products and services. On December 22, 2005, Anatel and the publicly held telephone companies signed extensions of the concession contract for an additional 20 years, effective as of January 1, 2006.

The extensions to the concession contracts changed the rate model. The General Price Index - Internal Availability (IGP-DI) is no longer used to determine the annual readjustments in the rates charged by the telecommunications companies. This index was replaced by a specific index for the telecom sector, the Telecom Sector Index (IST), based on weighted indices which better represent variations in individual companies' costs. Private companies that are our peers in the industry, such as Global Village Telecom or Intelig, do not require Anatel's approval to define its rates and may unilaterally change the prices they charge for their services. As a consequence, Anatel's disapproval or delays in the approval of rate readjustments may have a negative impact in our operation and competitive position.

### ***Political and Economic Factors***

In 2002, various factors had a negative impact on the Brazilian economy, including uncertainties relating to the political and economic future of Brazil, and political and economic uncertainties of other South American countries, including Argentina and Venezuela. These factors led to increased unpredictability in the Brazilian markets, decreased ability to obtain credit, and a decrease in investor confidence in the Brazilian marketplace.

During a period of relative economic stability in the first half of 2002, the Brazilian Central Bank decreased the base interest rate (SELIC) to a level of 18.0% as of July 17, 2002. However, as a result of the deteriorating economic conditions and the internal political instability caused by the Brazilian presidential elections in the second half of 2002, the Central Bank increased the SELIC during the second half of 2002 to 25.0% on December 18, 2002. During 2002, GDP increased by 1.5%.

In 2003, the continued political and economic uncertainty in Brazil led the Brazilian Central Bank to raise the SELIC to 25.5% on January 22, 2003 and further to 26.5% on February 19, 2003. The base interest fell from a high of 26.5% to 16.5% at the end of 2003 due to the improving political situation in Brazil, growth in the global economy and investors' perception of the Brazilian market.

Notwithstanding a certain amount of economic instability from 2000 to 2002, the economic policies initiated by the new government have increased stability in the market, leading to an appreciation of the *real* in 2003 by 18.2% to R\$2.8892 per US\$1.00 as of December 31, 2003.

The economic and political climate in Brazil became slightly more stable in 2004. Municipal elections distributed the political powers of the country more evenly, and the approval by the Federal Senate of the provisional measure that gave the President of the Brazilian Central Bank Minister status was identified by the Brazilian government as the first step for the independence of the Central Bank. Economic recovery and continued growth in exports contributed to a decrease in country-risk. Although pressured by the increase in crude oil prices and the economic recovery

experienced in the year, inflation was kept under control.

In 2005, the Brazilian GDP grew by 2.3%, sustained primarily by the economic recovery and continued growth in exports, generating a record balance in Brazil's Trade Balance. The IPCA inflation rate was 5.69% in

2005, and the country's interest rate remained at elevated levels throughout the year, closing at 18.0% on December 31, 2005.

The exchange rate was influenced by periods of economic uncertainty resulting from political instability during the year. The exchange rate depreciated to R\$3.20 per US\$1.00 in May 2004, from R\$2.89 per US\$1.00 in December 2003, but appreciated gradually thereafter to close at R\$2.65 per US\$1.00 on December 31, 2004, to R\$2.34 per US\$1.00 on December 31, 2005, and to R\$2.14 per US\$1.00 on December 31, 2006.

In 2006, Brazil's economy ended with growth close to 3.0%, below initial expectations, which had estimated a Gross Domestic Product (GDP) of approximately 3.5%. The reason for this underperformance is that the systematic increase of the public expenditures generated a greater fiscal load, which, in 2006, surpassed the 37.4% of the GDP registered in 2005.

This elevated fiscal load contributed to a reduction in infra-structure investments. Market studies estimate that, for a greater level of economic development, the ratio between investment and GDP should be ideally approximately 26.0%. In September, this ratio was 20.8% in Brazil.

Furthermore, the reduction in the exchange rate (US dollar vs. Brazilian Real) is affecting export competition in some sectors of the economy, causing an increasing replacement of domestic production with imports. In 2006, the Real maintained its value against the US dollar, which ended the year quoted at R\$2.138, a 9.5% appreciation in comparison to 2005.

On the other hand, the country's economy has produced positive results with respect to inflation, interest rates and commercial surplus. The annual inflation measured by the National Index of Consumer Prices (IPCA - Índice de Preços ao Consumidor Amplo) reached 3.14% in 2006, the smallest levels in the latest years. The interest rates ended 2006 at 13.25%, with a diminishing trend, yet it is still high in comparison to other emerging countries. The commercial trade balance maintained a surplus of US\$ 46 billion, 2.8% above the volume registered in 2005.

In 2006, an increase in employee salaries was detected, along with a reduction in unemployment, which reached 8.4% at the year's end. The increased salary is significant because it directly impacts income and consumption.

This scenario has led Brasil Telecom to work with an estimate of moderate economic growth for 2007, of between 3.4% and 4.0%. This estimate, in line with market projection and based on the International Bank for Reconstruction and Development's Economic Perspective Report, is dependent upon stable inflation, at the level of December 2006, and on the maintenance of the Brazilian macroeconomic fundamentals, regardless of external instability factors generated by the continuous crisis in the Middle East and by the results of the American economy. The following table shows the GDP growth, the inflation rate, the dollar exchange rate devaluation (appreciation) and the SELIC rate for the three-year period ended December 31, 2006.

	<b>Year ended December 31</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
GDP growth <sup>(1)</sup>	4.9	2.3	3.7
IGP - DI Inflation Rate <sup>(2)</sup>	12.1	1.2	3.8
IGP - M Inflation Rate <sup>(2)</sup>	12.4	1.2	3.8
IPCA Inflation rate <sup>(3)</sup>	7.6	5.7	3.1
dollar exchange rate devaluation / (appreciation) <sup>(4)</sup>	(8.1)	(13.4)	(8.7)
SELIC <sup>(4)</sup>	17.8	18.0	13.3

- (1) Source: IBGE
- (2) Source: Fundação Getúlio Vargas
- (3) Source: Consumer Price Index IBGE
- (4) Source: Brazilian Central Bank



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

Our current cost of financing is not materially exposed to exchange rate risk. At December 31, 2006, approximately 20.7% of our indebtedness, or R\$1,026.1 million, was exposed to exchange rate risk (dollars, Japanese Yens and *Cesta de Moedas*), not considering swap adjustments. At December 31, 2006, we protected approximately 53.2% of our indebtedness exposed to exchange rate risk. For the year ended December 31, 2006, loss on foreign currency and monetary restatement amounted to approximately R\$55.0 million, due to the appreciation of the *real* against the dollar. We also face foreign exchange risk because a significant portion of our equipment costs, such as costs relating to switching centers and software used for upgrading network capacity, are denominated in dollars. Historically, approximately 47.9% our total capital expenditures have been dollar denominated. See Item 11. Quantitative and Qualitative Disclosures About Market Risk Quantitative Information About Market Risk Exchange Rate Risk.

We are exposed to interest rate risk as a consequence of our floating rate debt. At December 31, 2006, 98.5% of our *reais*-denominated interest-bearing liabilities bore interest at floating rates, not including swap adjustments. We have not entered into derivative contracts or made other arrangements to protect against this risk. Accordingly, if market interest rates (principally the TJLP (the Brazilian federal long-term interest rate) and the CDI (the Brazilian Interbank deposit rate)) rise in the future, our financing expenses will increase. Furthermore, at December 31, 2006, approximately 46.7% of our foreign currency denominated debt bore interest at floating rates based on either LIBOR or LIBOR Yen, not including swap adjustments. At December 31, 2006, the six-month LIBOR was 5.44% per annum and the six-month LIBOR Yen was 0.15% per annum.

We use swap and forward exchange contracts, as well as foreign currency investments, to limit the risk of increases in our liabilities (expressed in *reais*) on our foreign currency debt as a result of currency fluctuations. The swap contracts consist of currency swaps under which an obligation denominated in foreign currency is exchanged for a real-denominated obligation bearing interest at the CDI rate. The gain (loss) of swap transactions recorded under the Corporate Law Method offsets the effect of exchange rate variations on our foreign currency indebtedness. The forward exchange contracts consist of agreements between us and financial institutions to exchange a certain amount of *reais* for US dollars at a future date.

### ***General Trends of the Telecommunications Services Industry***

In 1998, Brazil had approximately 20.0 million fixed-line telephones and by the end of 2006, there were 42.0 million. According to Anatel, wireless subscribers increased from 7.4 million in 1998 to 99.9 million in 2006. Since mid-2003, we have been observing stabilization in the growth of the fixed-line telecommunications services market, while the wireless telecommunications services segment of our industry continues to experience consistent growth.

We do not expect future material increases in the number of installed fixed-lines and revenues from basic fixed-line telecommunications services; however, we do expect to generate revenues from wireless telecommunications services. By owning both wireless and fixed-line telecommunications services networks, we expect to be able to minimize our interconnection costs for outgoing calls and maximize interconnection revenues from incoming calls. We also expect an increase in revenues from our data transmission services due to the increased demand for our ADSL and other data transmission services.

### ***Competitive Factors***

We are the leading provider of local fixed-line telecommunications services and intraregional fixed-line telecommunications services in our region. However, we face rapidly increasing competition from companies that already operate in our region, such as Embratel, Intelig and Global Village Telecom, and from companies which have

been given permission to operate in our region, such as Telemar, Telesp, Albra, TIM, Telmex do Brasil, TNL PCS S.A., CTBC Telecom and Sercomtel.

The entry of new competitors in the local market, the long distance market or the other markets in which we compete may have an adverse impact on our business, financial condition, results of operations or prospects.

The extent of any adverse effects on our results of operations and market share from competition will depend on a variety of factors that cannot now be assessed with precision, some of which are beyond our control. Among these factors are the technical and financial resources available to our competitors, their business strategies and capabilities, consolidation of competitors, prevailing market conditions, the regulations applicable to us and to any new entrants to the market, including those pertaining to providers of wireless telecommunications services, and the effectiveness of our efforts to be prepared for increased competition.

### ***Attainment of Anatel Certification***

On January 19, 2004, Anatel certified that we had met the universalization targets established in our concession contract. We were therefore authorized to provide interregional long-distance services throughout Brazil and international long-distance services, also from any point in the country. We also received authorization to offer local services outside our original concession area, to offer mobile services in our region and to offer corporate data services from any point in the country.

Telemar, Telesp and Embratel also received certifications to offer the same services, and therefore are able to compete directly with us. After obtaining our certification, we now have authorization to offer telecommunications services outside Region II and compete directly against Telemar, Telesp, Embratel and any other telecommunication providers in the market.

### ***US GAAP Reconciliation***

We prepare our Consolidated Financial Statements in accordance with Brazilian GAAP, which differ in certain significant respects from US GAAP. The following table sets forth a comparison of our net income (loss) and shareholders' equity in accordance with Brazilian GAAP and US GAAP as of the dates and for the periods indicated:

	<b>Year ended December 31</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Net income (loss) in accordance with:		<i>(Thousands of reais)</i>	
Brazilian GAAP	98,840	(303,671)	432,391
US GAAP	284,907	168,790	687,299
Shareholders' equity in accordance with:			
Brazilian GAAP	6,481,363	5,496,607	5,528,301
US GAAP	7,072,120	6,558,186	7,054,583

See Note 35 to our Financial Statements for a description of the principal differences between Brazilian GAAP and US GAAP as they relate to us, and a reconciliation of net income (loss) and shareholders' equity for the dates and periods indicated therein.

### ***Critical Accounting Policies***

Strict regulation from Anatel prevents us from implementing certain policies that could have the effect of reducing delinquency, such as service restrictions or limitations on the types of services provided based on a subscriber's credit record.

In preparing our consolidated financial statements, we have relied on estimates and assumptions derived from historical experience and various other factors that we deemed reasonable and relevant. Critical Accounting Policies are those that are important to the portrayal of our financial condition and results and utilize management's most difficult, subjective or complex judgments, estimates and assumptions. The application of these critical accounting policies often requires judgments made by our management regarding the effects of matters that are inherently uncertain on the carrying value of our assets and liabilities and the results of our operations. Our results of operation and financial condition may differ from those set forth in our consolidated financial statements, if our

actual experience differs from management's assumptions and estimates. The following is a discussion of our critical accounting policies, including some of the variables, assumptions and sensitivities underlying the estimates relating to:

- goodwill impairment;
- revenue recognition;
- allowance for doubtful accounts;
- depreciation of property, plant and equipment;
- valuation of property, plant and equipment;
- provisions for contingencies;
- deferred income taxes; and
- provision for pensions.

### ***Goodwill Impairment***

In connection with the Statement of Financial Accounting Standards No. 142, *Accounting for Goodwill and other Intangible Assets*, or SFAS 142, we are required to perform an assessment of whether there was an indication that goodwill is impaired as of the date of adoption. To accomplish this, we were required to identify our reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of January 1, 2002. We were required to determine the fair value of each reporting unit and compare it to the carrying amount of the reporting unit within six months of January 1, 2002. To the extent the carrying amount of a reporting unit exceeded the fair value of the reporting unit, we would be required to perform the second step of the transitional impairment test, as this would be an indication that the reporting unit goodwill may be impaired. Under Brazilian GAAP, the amount of goodwill and other intangible asset impairment, if any, is measured based on projected undiscounted future operating cash flows.

Under the terms of the operating concessions granted by the Federal Government, we are obliged to provide a certain minimum level of services over the entire area covered by its fixed-line operating licenses. Also, we do not possess discrete financial information that could allow a determination of assets and liabilities (and goodwill) allocation in a level below the entire fixed-line business segment and neither does it manage different areas of the concession as if they were separate businesses and has thus considered the entire fixed-line business to be one reporting unit. In viewing all its fixed-line assets and liabilities as one reporting unit and performing an initial assessment on this reporting unit as to whether there was an indication that goodwill is impaired, the second step of the impairment test was not required. For the internet segment we apply separated assessment for each report unit. We were not required to recognize an impairment loss under U.S. GAAP for any of the periods presented.

A determination of the fair value and the undiscounted future operating cash flows of our segment businesses (fixed-telephone, data transmission and Internet) requires management to make certain assumptions and estimates with respect to projected cash inflows and outflows related to future revenues and expenditures and expenses. These assumptions and estimates can be influenced by different external and internal factors, such as economic tendencies, industry trends, and interest rates, changes in our business strategies and changes in the type of services we offer to the market. The use of different assumptions and estimates could significantly change our financial statements. For

example, if we had used more conservative assumptions and estimates the expected future net cash flow may had lead us to recognize impairment charges on goodwill, which would have decreased our results of operations and shareholders' equity. In viewing all of our fixed-line assets and liabilities as one reporting unit and performing an initial assessment on this reporting unit including the assumptions and estimates that we

considered appropriate, we were not required to recognize any impairment loss under either US GAAP or Brazilian GAAP.

### ***Revenue recognition***

Under Brazilian GAAP and US GAAP, revenues are generally recognized on accrual basis. Revenues from customer calls are based on time used, according to Brazilian law, and are recognized when services are provided (fixed and mobile telephony). Services provided and not billed at the end of each month are estimated and recorded on accrual basis. Considering their high turnover and short average life, revenues from phone cards for public telephones are recorded as the cards are sold. Revenues from sales of mobile phones and accessories are recorded when the goods are delivered and accepted by the subscriber. Revenues from pre-paid mobile services are recognized based on the use of the respective credits. Revenues from activation and installation fees are recognized upon the activation of customer services. Revenue is not accounted for if there is an uncertainty as to its realization.

Under Brazilian GAAP, revenues from activation and installation fees are recognized upon activation of customer services. Under US GAAP, revenues and related taxes from activation and installation fees are deferred and amortized over five years, the estimated average customer life.

Under Brazilian GAAP revenues from public telephone phone cards are recognized when the cards are sold. Under US GAAP, revenues generated from sales of public telephone phone cards are recognized as such services are provided. For US GAAP, deferred revenues at each consolidated balance sheet date are determined based upon estimates of sold but unused public phone card credits outstanding as of each consolidated balance sheet date.

We consider revenue recognition to be a critical accounting policy, because of the uncertainties caused by different factors such as the complex information technology required, high volume of transactions, fraud and piracy, accounting regulations, management's determination of collectibility and uncertainties regarding 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 revenue recognition policy for US GAAP or for Brazilian GAAP.

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

Under Brazilian GAAP and US GAAP, we provide an allowance for doubtful accounts for accounts receivables for which recoverability is considered doubtful. We base our estimates on our historical collection experience and a review of the current status of all trade accounts receivable. This estimate considers the ratio of historical losses applied to the different categories of all outstanding amounts receivable from our customers. Additional allowance may be required in case the value of our estimated allowance for doubtful accounts differs from the amounts not actually collected due to a deterioration in the financial condition of our customers or otherwise.

### ***Depreciation of property, plant and equipment***

Under Brazilian GAAP and US GAAP, depreciation of property, plant and equipment is provided using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are shown in Note 17 to the Consolidated Financial Statements. Given the complex nature of our property, plant and equipment, the estimates of useful lives require considerable judgment and are inherently uncertain, due to rapidly changing technology and industry practices, which could cause early obsolescence of our property, plant and equipment. If we materially change our assumptions of useful lives and if external market conditions require us to determine the possible obsolescence of our property, plant and equipment, our depreciation expense, obsolescence

write-off and consequently net book value of our property, plant and equipment could be materially different.



### ***Valuation of property, plant and equipment***

In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, or SFAS 144, long-lived assets, such as property, plant, and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset. Under Brazilian GAAP, the recoverability of assets as mentioned above, if negative, would indicate the amount that would be considered impaired.

A determination of the fair value of an asset requires management to make certain assumptions and estimates with respect to projected cash inflows and outflows related to future revenues and expenditures and expenses. These assumption and estimates can be influenced by different external and internal factors, such as economic tendencies, industry trends, interest rates and changes in the marketplace. The use of different assumptions and estimates could significantly change our financial statements, for example if we had used more conservative assumptions and estimates the expected future net cash flow may have led us to recognize impairment charges on our property, plant and equipment, which would have decreased our results of operations and shareholders' equity. No impairment losses have been recognized for any of the periods presented.

### ***Provisions for contingencies***

Under Brazilian GAAP and US GAAP, provisions for contingencies are recognized for the amounts of probable losses based on legal advice from our in-house and external legal counsel and management's opinion of the outstanding contingent matters at the balance sheet date. We continually evaluate the provisions for contingencies based on changes in relevant facts, circumstances and events, such as judicial decisions, that may impact the estimates, which could have a material impact on our results of operations and shareholders' equity. While management believes that the current provision for contingencies is adequate, there can be no assurance that these factors will not change in the future.

### ***Deferred income taxes***

We compute and pay income taxes based on results of operations under Brazilian Corporate Law, which are significantly different from the Brazilian GAAP figures that are presented in our financial statements in this annual report. Please see note 2b and 2c for more detailed description of the differences between Brazilian Corporate Law and Brazilian GAAP. Under Brazilian GAAP and US GAAP, we recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review the deferred tax assets for recoverability and establish a valuation allowance if it is more likely than not that the deferred tax assets will not be realized, based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. When performing such reviews, we are required to make significant estimates and assumptions about future taxable income. In order to determine future taxable income, we need to estimate future taxable revenues and deductible expenses, which are subject to different external and internal factors, such as economic tendencies, industry trends, interest rates, changes in our business strategies and changes in the type of services we offer to the market. The use of different assumptions and estimates could significantly change our financial statements. For example, if we had used more conservative assumptions and estimates with respect to our expected future taxable income, we would be required to recognize valuation allowance charges on deferred income tax assets, which would decrease our results of operations and shareholders' equity. If we operate at a loss or are unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates, the time period within which the underlying temporary differences

become taxable or deductible, or any change in our future projections, we could be required to establish a valuation allowance against all or a significant portion of our deferred tax assets resulting in a substantial increase of our effective tax rate and a material adverse impact on our operating results.

***Provision for post-retirement benefits***

In relation to the post-retirement liabilities, we are required to make assumptions and estimates regarding interest rates, investment returns, levels of inflation for future periods, mortality rates and projected employment levels. The accuracy of these assumptions and estimates will determine whether we have created sufficient reserves for accrued pension and medical health care costs and the amount we are required to provide each year as our post-retirement benefit costs. These assumptions and estimates are subject to significant fluctuations due to different external and internal factors, such as economic trends, social indicators, our capacity to create new jobs and our ability to retain our employees. If these assumptions and estimates are not accurate, we may be required to review our provisions for pensions, which could materially reduce the results of our operations and shareholders' equity.

**New Accounting Pronouncements**

In October 2005, CVM issued the Resolution 488/05, which approves the IBRACON Pronouncement NPC 27 concerning Financial Statements Disclosure and Presentation. Its resolution establishes new rules to the classification of balances, especially regarding the segregation of assets in current and non-current groups, as well as pertaining to the latter, the creation of intangible assets subgroup. The Company adopted this resolution as of December 31, 2006 and reclassified the presentation of previously years to comply with its requirements.

In October 2005, CVM issued the Resolution 489/05, which approves the IBRACON Pronouncement NPC 22 concerning Provisions, Liabilities, Asset Contingences and Liabilities Contingences which states the presentation of contingences and the criterions to the classification of contingences. In compliance with this pronouncement, the amounts of judicial deposits linked to the provisions are presented net of the liabilities. The Company adopted this resolution in 2006 and reclassified the presentation of previously years to comply with its requirements.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, or SAB 108, regarding the effects of prior year misstatements in considering current year misstatements for the purpose of a materiality assessment. SAB 108 states that in the case of an error that has occurred and has been immaterial in a number of previous years, the cumulative effect should be considered when assessing the materiality of the error in the current year. If the cumulative effect of the error is material, then the current year statements, as well as prior year statements, should be restated. In the case of restated prior year statements, previously filed reports do not need to be amended, if the error was considered immaterial to the previous years financial statements. However the statements should be amended the next time they are filed. The effects of this guidance should be applied cumulatively to fiscal years ending on or after August 31, 2007. Additional disclosure should be made regarding any cumulative adjustments made in the current year financial statements. Our management does not expect any significant impact on our consolidated financial statements by applying this pronouncement.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statements No. 109, which clarifies the accounting for uncertainty in tax positions. This interpretation requires that we recognize in our consolidated financial statements, the impact of a tax position, if such position is more likely than not to be sustained upon examination, based on the technical merits of the position. FIN 48 will be effective for accounting periods from and after September 1, 2007. Our management is currently evaluating the impact that FIN 48 will have on our consolidated financial statements.

In September 2006, the FASB issued FAS 157, Fair Value Measurements. FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, FAS 157 does not require any new fair value measurements. However,

for some entities, the application of FAS 157 will change current practice. FAS 157 is effective for accounting periods from and after September 1, 2008. Our management is in the process of evaluating the impact of this standard on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106 and 132R ( *FAS 158* ). This

Statement requires an employer to recognize the over- or under-funded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through accumulated and other comprehensive income. FAS 158 also requires an employer to measure the funded status of a plan at its year-end. SFAS 158 is effective for years ending on or after December 15, 2006. We started to adopt FAS 158 in 2006 and registered some unrecognized items in other comprehensive income. The net effect on other comprehensive income was R\$148,404, net of taxes.

### Results of Operations for the Years Ended December 31, 2004, 2005 and 2006

The following discussion is based on and should be read in conjunction with our audited consolidated financial statements, as well as under the caption Summary Information. The data at December 31, 2004, 2005 and 2006 have been derived from our audited consolidated financial statements, prepared in accordance with Brazilian GAAP. Investors should note that financial statements prepared in accordance with Brazilian GAAP differ from financial statements prepared in accordance with Brazilian Corporate Law in the methodology used for the recognition of inflation. Pursuant to Brazilian GAAP our audited financial statements as of and for the years ended December 31, 2004, 2005 and 2006 no longer recognize the effects of inflation after January 1, 2001 and are not restated in constant *reais*. Brazilian GAAP when applied to us differs in certain important respects from US GAAP. See Note 35 to our Financial Statements for (i) a summary of the principal differences between Brazilian GAAP and US GAAP as they relate to us, and (ii) a reconciliation to US GAAP of shareholders' equity as of December 31, 2005 and 2006 and net income (loss) for each of the years ended December 31, 2004, 2005 and 2006.

The following table sets forth certain components of our net income (loss), as well as the percentage change from the prior year, for 2004, 2005 and 2006.

	Year ended December 31			Percentage Changes		
	2004	2005	2006	2004 - 2005	2005	2006
	(thousands of <i>reais</i> , except percentages)					
Net operating revenues	9,064,855	10,138,684	10,296,659	11.8		1.6
Cost of services and goods sold <sup>(1)</sup>	(6,158,836)	(6,525,898)	(6,466,463)	6.0		(0.9)
Gross profit	2,906,019	3,612,786	3,830,196	24.3		6.0
Operating expenses						
Selling expenses <sup>(1)</sup>	(1,105,628)	(1,656,242)	(1,470,642)	49.8		(11.2)
General and administrative expenses <sup>(1)</sup>	(1,017,502)	(1,264,741)	(1,314,119)	24.3		3.9
Other net operating income (expenses)	(61,198)	(626,306)	(262,134)	923.4		(58.1)
Operating income before net financial expenses	721,691	65,497	783,301	(90.9)		1,095.9
Net financial expenses	(579,514)	(596,239)	(289,662)	2.9		(51.4)
Operating income (loss)	142,177	(530,742)	493,639	N/A		N/A
Net non-operating income (expenses)	(112,073)	(149,024)	30,865	(33.0)		N/A

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Income (loss) before taxes and minority interests	30,104	(679,766)	524,504	N/A	N/A
Income and social contribution tax benefits	75,012	389,066	(95,035)	418.7	N/A
Income (loss) before minority interests	105,116	(290,700)	429,469	N/A	N/A
Minority interests	(6,276)	(12,971)	2,922	106.7	N/A
Net income (loss)	98,840	(303,671)	432,391	N/A	N/A

(1) Since 2005, the Company has classified employee s profit sharing costs as operating expenses (as an allocation among the related cost of services and goods sold, selling and general and administrative expenses), in compliance with stated by Brazilian Corporate Law. For the sake of a better presentation and comparability among the years, the year ended December 31, 2004 was reclassified, resulting in a decrease in operating income of R\$53,783.

**Net Operating Revenues**

We generate operating revenues from:

- local services, including monthly subscription charges, measured service charges, public telephones and additional services;
- long-distance services;
- mobile services;
- data transmission;
- network services, including interconnection and leasing high-capacity lines; and
- other services, including toll-free, call forwarding and caller ID devices.

Gross operating revenues are offset by value-added and other indirect taxes and discounts to customers. The composition of gross operating revenues by category of service is presented in our Financial Statements and discussed below before deduction of value-added and other indirect taxes. We do not determine net operating revenues for each category of revenue as we do not believe such information to be useful to investors.

The following table sets forth certain components of our consolidated net operating revenues, as well as the percentage change from the prior year, for 2004, 2005 and 2006.

	Year ended December 31			Percentage Changes	
	2004	2005	2006	2004-2005	2005-2006
Local services:	(thousands of <i>reais</i> , except percentages)				
Monthly subscription charges	3,199,525	3,516,562	3,517,369	9.9	0.0
Measured service charges <sup>(1)</sup>	3,685,840	3,613,698	3,337,509	(2.0)	(7.6)
Public telephones	478,805	496,766	540,610	3.8	8.8
Other	126,435	96,810	74,091	(23.4)	(23.5)
Total local services	7,490,605	7,723,836	7,469,579	3.1	(3.3)
Long-distance services:					
Intraregional <sup>(2)</sup>	2,393,997	2,626,464	2,464,387	9.7	(6.2)
Interregional and International	248,909	364,098	305,702	46.3	(16.0)
Total long-distance services	2,642,906	2,990,562	2,770,089	13.2	(7.4)
Data transmission	1,068,779	1,530,985	2,000,525	43.2	30.7
Network services	970,422	941,464	770,579	(3.0)	(18.2)
Mobile services	87,904	732,339	1,323,270	N/A	80.7
Other	502,826	768,053	777,276	52.7	1.2
Gross operating revenues	12,763,442	14,687,239	15,111,318	15.1	2.9
Value added and other indirect taxes	(3,579,541)	(4,219,054)	(4,285,952)	17.9	1.6

Discounts	(119,046)	(329,501)	(528,707)	176.8	60.5
Net operating revenues	9,064,855	10,138,684	10,296,659	11.8	1.6

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(1) Includes VC-1 charges.

(2) Includes VC-2 and VC-3 charges.

Net operating revenues increased 1.6% to R\$10,296.7 million in 2006 from R\$10,138.7 million in 2005. This growth in net revenues was principally due to: (i) a 30.7% increase in revenues from data transmission resulting



from a 29.9% increase in our ADSL accesses in service; and (ii) an increase in the mobile service revenues representing a 52.6% increase in our mobile client base in 2006 from 2005, or R\$1,323.3 million, an increase of R\$590.9 million in comparison to 2005.

Net operating revenues increased 11.8% to R\$10,138.7 million in 2005 from R\$9,064.9 million in 2004. This growth in net revenues was principally due to: (i) a 43.2% increase in revenues from data transmission resulting from an 89.3% increase in our ADSL accesses in service; (ii) an increase in the mobile service revenues representing a 255.6% increase in our mobile client base in 2005 from 2004, or R\$732.3 million, an increase of R\$644.4 million in comparison to 2004; and (iii) the rate adjustments authorized by Anatel in July 2005.

In 2006, we reclassified revenues related to monthly subscription and measured services charges from other revenues to local services. The years ended December 31, 2004 and 2005 were reclassified to be consistent with the 2006 presentation, resulting in a increase in local services revenues of R\$120,040 and R\$121,314, respectively.

#### *Revenues from Local Service*

Total revenues from local services decreased by 3.3% to R\$7,469.6 million in 2006 from R\$7,723.8 million in 2005. This decrease was primarily due to the decreasing penetration of fixed-line telecommunications services in our region, represented by a decrease in telephone density in our region to 19.4 lines in service per 100 inhabitants at December 31, 2006 from 22.3 lines in service per 100 inhabitants at December 31, 2005. The total number of active lines in service (total lines in service excluding blocked lines) decreased to 8.1 million at December 31, 2006 from 9.6 million at December 31, 2005. In addition, on July 14, 2006 Anatel authorized a 0.42% decrease in local services tariffs.

Total revenues from local services increased by 3.1% to R\$7,723.8 million in 2005 from R\$7,490.6 million in 2004. This increase was primarily due to rate adjustments despite the decreasing penetration of fixed-line telecommunications services in our region, represented by a decrease in telephone density in our region to 22.3 lines in service per 100 inhabitants at December 31, 2005 from 22.4 lines in service per 100 inhabitants at December 31, 2004. The total number of lines in service increased to 9.6 million at December 31, 2005 from 9.5 million at December 31, 2004.

#### *Monthly Subscription Charges*

Total revenues from monthly subscription charges remained stable at R\$3,517.4 million in 2006 as compared to R\$3,516.6 million in 2005. This stability is primarily due a rate decrease to residential clients of 0.42%, offset by a rate increase to non-residential clients of 2.18% .

Total revenues from monthly subscription charges increased by 9.9% to R\$3,516.6 million in 2005 from R\$3,199.5 million in 2004. This revenue growth is primarily due to a rate increase to residential and non-residential clients of 7.1% and 7.5%, respectively. The increase in monthly subscription charges was partially offset by our continued offering of alternative plans to clients who requested line cancellations in areas where we have idle capacity. These alternative plans were implemented for the purpose of retaining clients in these areas.

#### *Measured Service Charges*

Total revenues from measured service charges, which include charges for pulses used in excess of the fixed monthly allowance and charges for local fixed-line to mobile handsets, decreased by 7.6% to R\$3,337.5 million in 2006 from R\$3,613.7 million in 2005. This decrease was primarily due to a 7.7% decrease in revenues from local calls made from a fixed-line to mobile handsets ( VC-1 ), resulting from greater competition in the sector, where mobile operators are offering plans in which the cost of the mobile-mobile minute can be lower than the fixed-mobile minute.

Total billed pulses, which are the number of pulses that exceed the fixed monthly allowance, decreased by 9.5% to approximately 8.8 billion in 2006. A pulse represents an average of 2.5 minutes of call time. The number of billed pulses per average lines in service per month decreased to 81.3 in 2006, compared to 84.8 in 2005, reflecting lower overall economic growth during 2006, and is consistent with the industry-wide trend of fixed-to-

mobile substitution and increased use of our ADSL service instead of our dial-up connections. By not automatically disconnecting delinquent clients at switch centers with idle capacity, we were able to continue to realize revenues by blocking only outgoing calls, enabling such clients to continue to generate fees for network service usage on calls they were permitted to receive on their blocked lines.

Total revenues from measured service charges decreased by 2.0% to R\$3,613.7 million in 2005 from R\$3,685.8 million in 2004. This decrease was primarily due to a 3.7% decrease in revenues from local calls made from a fixed-line to mobile handsets, resulting from a greater competition in the sector, where mobile operators are offering plans in which the cost of the mobile-mobile minute can be lower than the fixed-mobile minute.

Total billed pulses decreased by 14.0% to approximately 9.3 billion in 2005. The number of billed pulses per average lines in service per month decreased to 84.8 in 2005, compared to 93.0 in 2004, reflecting our increasing penetration into lower income households. This decrease in billed pulses also reflects lower overall economic growth during 2005, and is consistent with the industry-wide trend of fixed-to-mobile substitution and increased use of our ADSL service instead of our dial-up connections. By not automatically disconnecting delinquent clients at switch centers with idle capacity, we were able to continue to realize revenues by blocking only outgoing calls, enabling such clients to continue to generate fees for network service usage on calls they were permitted to receive on their blocked lines.

#### *Public Telephones*

Total revenue from public telephones increased by 8.8% to R\$540.6 million in 2006 from R\$496.8 million in 2005. Despite the 3.7% decrease in the number of public phone credits to 5.26 billion credits in 2006 from 5.46 billion credits in 2005 and the 0.3% decrease in the number of public telephones in service to 277.9 thousand at December 31, 2006 from 296.9 thousand at December 31, 2005, this increase in our revenue from public phone credits was partially driven by an increase in public phone usage by prepaid mobile phone subscribers, because the rates charged for outgoing calls on fixed-line public telephones are lower than the rates charged on outgoing calls from prepaid mobile phones.

Total revenues from public telephones increased by 3.8% to R\$496.8 million in 2005 from R\$478.8 million in 2004, primarily due to the rate increase of 7.27%, as well as a 3.3% decrease in the number of public phone credits to 5.63 billion credits in 2005 from 5.82 billion credits in 2004. This increase in our revenue from public phone credits was partially driven by an increase in public phone usage by prepaid mobile phone subscribers, because the rates charged for outgoing calls on fixed-line public telephones are lower than the rates charged on outgoing calls from prepaid mobile phones. The increase in public telephone revenues was also due to a 0.3% increase in the number of public telephones in service to 296,900 at December 31, 2005 from 295,900 at December 31, 2004.

#### *Other Local Services*

Total revenues from other local services, which consist primarily of installation fees, address change and collect calls, decreased by 23.5% to R\$74.1 million in 2006 from R\$96.8 million in 2005, due to a decrease in the revenues from address changes and revenues from collect calls. Although there was an increase in the number of address changes to 434,630 in 2006 from 336,344 in 2005, the respective revenues decreased to R\$10.7 million in 2006 from R\$21.1 million in 2005. This reduction is a result of the decrease in the tariff for address changes, which suffered an average reduction of 75%. Revenues from collect calls decreased to R\$22.6 million in 2006 from R\$36.5 million in 2005, principally due to the increase of 9.2% in 2006 in the number of mobile lines in our region, according to Anatel estimates.

Total revenues from other local services decreased by 23.4% to R\$96.8 million in 2005 from R\$126.4 million in 2004, due to a decrease in the number of address changes and collect calls revenues. Address change revenues decreased to R\$21.1 million in 2005 from R\$26.8 million in 2004 primarily as a result of the decrease in the number

of address changes to 336,344 in 2005 from 375,837 in 2004. Revenues from collect calls decreased to

R\$36.5 million in 2005 from R\$49.8 million in 2004, principally due to the increase of 30.8% in 2005 in the number of mobile lines in our region, according to Anatel estimates.

#### *Revenues from Long-Distance Services*

At December 31, 2006, our revenues from long-distance services consisted primarily of intraregional (intrastate and interstate), interregional and international long-distance calls (both fixed-fixed and fixed-mobile).

#### *Intraregional Long-distance*

Our revenues from intraregional long-distance services decreased by 6.2% to R\$2,464.4 million in 2006 from R\$2,626.4 million in 2005. This decrease is due to: (i) a 2.77% tariff decrease in the domestic long distance basket price; (ii) a 7.3% and 20.8% traffic reduction in intra-sector and intra-regional calls, respectively. The decrease was offset by the increase in our estimated average market share to 90.7% from 90.6% in the intrastate segment, and to 85.8% from 84.1% in the interstate segment, due to our targeted and focused television, radio and newspaper advertising campaigns.

Our revenues from intraregional long-distance services increased by 9.7% to R\$2,626.4 million in 2005 from R\$2,394.0 million in 2004. This increase was due to: (i) a 4.4% increase in VC-2 minutes and a 71.2% increase in VC-3 minutes, which was fueled by the growth in the number of mobile subscribers in our region that use our CSC 14 in mobile calls, resulting in a combined increase in VC-2 and VC-3 fixed-mobile revenues to R\$1,261.2 million in 2005 from R\$916.8 million in 2004; (ii) the 2.9% average rate increase in the long-distance services basket in 2005; and (iii) the increase in our estimated average market share to 90.6% from 90.3% in the intrastate segment, and to 84.1% from 79.5% in the interstate segment, due to our targeted and focused television, radio and newspaper advertising campaigns.

#### *Interregional and International Long-distance*

Since January 2004, we have been authorized to provide interregional and international long distance services. Revenues from interregional and international long-distance services decreased by 16.0% to R\$305.7 million in 2006, from R\$364.1 million in 2005. The decrease in 2006 was primarily due to a 14.2% and 23.4% traffic reduction in interregional and international long distance, respectively. Our estimated market share in 2006 was 62.9% and 36.6% in the interregional and international segments, respectively.

Revenues from interregional and international long-distance services increased by 46.3% to R\$364.1 million in 2005, from R\$248.9 million in 2004. The increases in 2004 and 2005 were primarily due to the offering of interregional and international long-distance services on a national scale since January 2004. Our estimated market share in 2005 was 58.7% and 33.8% in the interregional and international segments, respectively.

#### *Revenues from Data Transmission*

Total revenues from data transmission, which include revenues from ADSL, ATM, DialNet, Vetor, Dedicated IP and other similar products increased by 30.7% to R\$2,000.5 million in 2006 from R\$1,531.0 million in 2005. This growth was due to a 29.9% increase in ADSL accesses and a 8.9% increase in ATM, Frame Relay or Dedicated IP. Total ADSL accesses in service were approximately 1.3 million on December 31, 2006 up from approximately 1.0 million on December 31, 2005, and generated average revenues per line of approximately R\$67.27 during 2006. In addition, the 29.9% increase in ADSL subscribers was driven by increased residential demand while the increase in IP and network accesses was due to increased corporate demand. Overall growth in all data transmission services was due to the expansion of our corporate client base and our ability to provide integrated solutions to our customers through targeted and focused marketing campaigns.



Total revenues from data transmission increased by 43.2% to R\$1,531.0 million in 2005 from R\$1,068.8 million in 2004. This growth was due to the 89.4% increase in the number of ADSL accesses in service to approximately 1.0 million on December 31, 2005 from 535.5 thousand accesses in service on December 31, 2004, which generated average revenues per line of approximately R\$74.2 during 2005, lower compared to the R\$89.5 observed in 2004 because of fast growth strategy of broadband access in 2005. In addition, the 40.8% increase in the number of IP accesses (Dedicated IP and IP Turbo) in service to 10,432 at December 31, 2005 from 7,408 at December 31, 2004 and the 28.0% increase in the number of network accesses (Frame Relay, ATM, Interlan and VETOR) in service to 24,998 at December 31, 2005 from 19,529 at December 31, 2004 also contributed to the higher revenues from data transmission over the period.

#### *Revenues from Network Services*

Revenues from network services are generated primarily from interconnection fees paid to us by other telecommunications operators for use of our network and, to a lesser extent, from fees generated from mobile service providers for the leasing of our transmission facilities, infrastructure and other equipment, and fees from the rental of our assets, such as points of presence, to other long-distance and mobile operators.

Total revenues from network services decreased by 18.2% to R\$770.6 million in 2006, from R\$941.5 million in 2005, due to our continued penetration of the interregional and international segments. Since we provide these services, we no longer receive interconnection fees from other telecommunications companies. Total revenues from interconnection fees consisted of R\$298.2 million from fixed-to-fixed traffic compared to R\$397.1 million in 2005, R\$143.9 million from mobile-to-fixed traffic compared to R\$236.6 million in 2005, and R\$328.4 million from leasing fees compared to R\$307.8 million in 2005.

Total revenues from network services decreased by 3.0% to R\$941.5 million in 2005, from R\$970.4 million in 2004, due to our continued penetration of the interregional and international segments. Since we provide these services, we no longer receive interconnection fees from other telecommunications companies. Total revenues from interconnection fees consisted of R\$397.1 million from fixed-to-fixed traffic compared to R\$468.0 million in 2004, R\$236.6 million from mobile-to-fixed traffic compared to R\$263.3 million in 2004 and R\$307.8 million from leasing fees compared to R\$239.1 million in 2004.

#### *Mobile Services*

In September 2004 we started offering mobile services through 14 Brasil Telecom Celular S.A., our subsidiary. Total revenues from mobile services reached R\$1,323.3 million in 2006, an 80.7% increase from R\$732.3 million in 2005, consisting of: (i) R\$286.2 million in sales of handsets and related equipment, up from R\$299.4 million in 2005; and (ii) R\$1,037.1 million derived from services, up from R\$433.0 million in 2005, composed primarily of: (a) monthly subscription charges, which accounted for R\$305.4 million at December 2006, up from R\$167.8 million at December 2005, (b) utilization charges which include charges for minutes used in excess of the mobile monthly allowances and accounted for R\$388.2 million at December 2006, up from R\$209.7 million at December 2005 and (c) interconnection charges which accounted for R\$300.1 million at December 2006, up from R\$43.2 million at December 2005. The increase in the interconnection charges was primarily due to the effects of Anatel's new regulation (full bill), which established that all calls among mobile operators would be charged (previously only the calls in which the difference in outgoing and incoming traffic was superior to 55%). By the end of 2006 we had approximately 3.38 million mobile subscribers, a 52.6% increase from the 2.21 million mobile subscribers at the end of 2005.

#### *Revenues from Other Services*

Other services consist primarily of supplementary and value-added services such as toll-free, call forwarding and caller ID, as well as Internet access services. Total revenues from other services increased by 1.2% to R\$777.3 million in 2006 from R\$768.1 million in 2005. Revenues from supplementary and value-added services increased by 8.7% to

R\$367.6 million in 2006 from R\$338.1 million in 2005. This growth was due to increased advertising campaigns promoting value added services as part of our strategy to increase average revenue per line. We are also the leader in the Brazilian Internet market, having generated 42.4 billion minutes of usage in 2006, with 1.4 million subscribers paying for services including broadband access and value-added services.



Total revenues from other services increased by 52.7% to R\$768.1 million in 2005 from R\$502.8 million in 2004. Revenues from supplementary and value-added services increased by 12.3% to R\$338.1 million in 2005 from R\$301.0 million in 2004. This growth was due to increased advertising campaigns promoting value added services as part of our strategy to increase average revenue per line. We are also the leader in the Brazilian Internet market, having generated 38.7 billion minutes of usage in 2005, with 916,000 subscribers paying for services including broadband access and value-added services.

#### *Charges Against Gross Operating Revenues*

##### *Value-added and Other Indirect Taxes.*

As already mentioned, the principal taxes deducted from gross operating revenues are state value added taxes ICMS, the federal social contribution taxes, PIS and COFINS, and the telecommunications contributions, FUST and FUNTTEL. We collect these taxes from our customers and transfer them to the appropriate governmental entities. At this point, please note that on January 1, 2006, we have been charged a Public Price for the Right of Exploration of Telecommunication Services known as the PPDEST. PPDEST is a new tax instituted by the Anatel Resolution no. 386 dated November 3, 2004 and it is a fixed value that must be paid by us at the moment of the issuance by Anatel of the Act that authorizes the exploration of the telecommunication services.

The total amount of value-added and other taxes increased by 1.6% to R\$4,286.0 million in 2006 from R\$4,219.1 million in 2005. The rate of growth in value-added and other taxes reflects the rate of growth in our gross operating revenue during the period and the change in revenue mix, as there is less tax applicable to certain services, such as interconnection services.

The total amount of value-added and other taxes increased by 17.9% to R\$4,219.1 million in 2005 from R\$3,579.5 million in 2004. The rate of growth in value-added and other taxes reflects the rate of growth in our gross operating revenue during the period and the change in revenue mix, as there is less tax applicable to certain services, such as interconnection services.

##### *Discounts*

Discounts are generally divided into rebates on: (i) pre-paid telephone cards (typically having commissions of approximately 10.0% over the face amount sold), (ii) local wireline calls, (iii) long-distance calls, and (iv) intelligent network services (such as caller ID, call forwarding and conference calling). Discounts reached R\$528.7 million in 2006, compared to R\$329.5 million in 2005 and R\$119.0 million in 2004.

##### *Cost of Services*

Total cost of services decreased by 0.9% to R\$6,466.5 million in 2006 from R\$6,525.9 million in 2005. Our cost of services decreased primarily as a result of (i) a decrease in third party services, which decreased by 2.5% to R\$3,025.9 million in 2006 from R\$3,102.8 million in 2005, and (ii) a 17.6% decrease in the cost of mobile handsets and accessories to R\$294.7 million in 2006 from R\$357.7 million in 2005. This decrease in third party services was largely due to the reduction in interconnection costs. As a percentage of net operating revenues, cost of services decreased to 62.8% in 2006 from 64.4% in 2005.

Total cost of services increased by 6.2% to R\$6,525.9 million in 2005 from R\$6,158.8 million in 2004. Our cost of services increased primarily as a result of an increase in the cost of third-party services, which increased by 4.8% to R\$3,102.8 million in 2005 from R\$2,959.7 million in 2004. This increase in costs was largely due to the implementation of certain of our mobile operations, including call centers and sales commissions. However, as a percentage of net operating revenues, cost of services decreased to 64.4% in 2005 from 67.8% in 2004, primarily due to reductions in personnel costs and relatively stable materials costs.



The following table sets forth certain components of our cost of services, as well as the percentage change from the prior year, for 2004, 2005 and 2006.

	Year ended December 31			Percentage Changes	
	2004	2005	2006	2004 - 2005	2005 - 2006
Cost of Services:	(thousands of <i>reais</i> , except percentages)				
Depreciation and amortization	(2,498,734)	(2,278,511)	(2,306,553)	(8.8)	1.2
Personnel	(136,363)	(160,721)	(193,021)	17.9	20.1
Mobile handsets and accessories	(113,642)	(357,680)	(294,727)	214.7	(17.6)
Materials	(66,613)	(73,871)	(72,394)	10.9	(2.0)
Services	(2,959,656)	(3,102,827)	(3,025,924)	4.8	(2.5)
Other	(383,828)	(552,288)	(573,844)	43.9	3.9
Total cost of services	(6,158,836)	(6,525,898)	(6,466,463)	6.0	(0.9)

#### *Depreciation and Amortization*

Total depreciation and amortization costs increased by 1.2% to R\$2,306.6 million in 2006 from R\$2,278.5 million in 2005, through a decrease in lines installed to 10.4 million at December 31, 2006 from 10.8 million at December 31, 2005.

Total depreciation and amortization costs decreased by 8.8% to R\$2,278.5 million in 2005 from R\$2,498.7 million in 2004, through an increase in lines installed to 10.8 million at December 31, 2005 from 10.7 million at December 31, 2004. This decrease is due to the fact that certain of our assets are completely depreciated and we do not have to book these specific values.

#### *Personnel*

Total personnel costs increased by 20.1% in 2006 to R\$193.0 million from R\$160.7 million in 2005. This increase in personnel costs was primarily due to labor expenses related to the downsizing in our workforce announced in February 2006, an increase in our employees' profit share and to the collective labor agreement. At December 31, 2006, we had approximately 5,835 employees, a decrease from 6,872 employees at December 31, 2005.

Total personnel costs increased by 17.9% in 2005 to R\$160.7 million from R\$136.4 million in 2004. This increase in personnel costs was primarily due to an increase in our number of employees, an increase in our employees' profit share and to the collective labor agreement. At December 31, 2005, we had approximately 6,872 employees, an increase from 6,680 employees at December 31, 2004.

#### *Material*

Total costs related to materials, such as plastic phone cards and materials for network maintenance (such as cables), decreased by 2.0% to R\$72.4 million in 2006 from R\$73.9 million in 2005. This decrease in material costs was primarily due to a reduction in the issuance of pre-paid phone cards.

Total costs related to materials, such as plastic phone cards and materials for network maintenance (such as cables), increased by 10.9% to R\$73.9 million in 2005 from R\$66.6 million in 2004. This increase in material costs was primarily due to the growth in usage of prepaid phone cards.

*Services*

The cost of third party services decreased by 2.5% to R\$3,025.9 million in 2006 from R\$3,102.8 million in 2005. This decrease in costs is largely due to a 7.1% reduction in interconnection costs.

The cost of third party services increased by 4.8% to R\$3,102.8 million in 2005 from R\$2,959.7 million in 2004. This increase in costs is largely due to implementation of certain of our mobile operations like call centers service and sales commissions.

Interconnection costs decreased to approximately 14.0% of gross revenues, or R\$2,114.9 million in 2006, from approximately 15.5%, or R\$2,275.8 million, in 2005. This decrease was due to higher mobile penetration and by the usage of BrT GlobeNet's services, which assured the necessary autonomy to carry its own international traffic of voice, data and Internet protocol. In addition to the 45.0% fixed-to-mobile rate readjustment the interconnection costs presented a R\$161.0 million decrease from 2005, reflecting our mobile economies.

Interconnection costs decreased to approximately 15.5% of gross revenues, or R\$2,275.8 million in 2005 from approximately 18.0% or R\$2,297.5 million, in 2004. This decrease was due to higher mobile penetration and the fixed-to-mobile rate increase, mostly in VC-1. Besides the 45.0% fixed-to-mobile rate readjustment the interconnection costs presented a R\$21.6 million decrease from 2004, reflecting our mobile economies.

#### *Other Costs of Service*

Other costs of service, which primarily include fees paid for the rental of equipment and infrastructure, insurance and a fee imposed by Anatel on providers of telecommunications services for the inspection of switching stations and wireless terminals, referred to as *Taxa de Fiscalização de Telecomunicações*, or FISTEL, increased by 3.9% to R\$573.8 million in 2006 from R\$552.3 million in 2005.

Other costs of service increased by 43.9% to R\$552.3 million in 2005 from R\$383.8 million in 2004.

#### *Gross Profit*

Our gross profit increased in 2006 by 6.0% to R\$3,830.2 million from R\$3,612.8 million in 2005, as a result of a reduction in cost of services and an increase in net operating revenues. As a percentage of net operating revenues, gross profit increased to 37.2% in 2006 from 35.6% in 2005.

Our gross profit increased in 2005 by 24.3% to R\$3,612.8 million from R\$2,906.0 million in 2004, as a result of an increase in our net operating revenues in 2005. As a percentage of net operating revenues, gross profit increased to 35.6% in 2005 from 32.1% in 2004.

#### *Operating Expenses*

Total operating expenses, which include selling expenses, general and administrative expenses and other net operating expenses, decreased by 14.1% to R\$3,046.9 million in 2006 from R\$3,547.3 million in 2005. This decrease was primarily a result of the decrease in selling expenses in the period, as discussed below.

Total operating expenses increased by 62.4% to R\$3,547.3 million in 2005 from R\$2,184.3 million in 2004. This increase was primarily a result of the increase in selling expenses and general and administrative expenses in the period, as discussed below.

The following table sets forth certain components of our operating expenses, as well as the percentage change from the prior year, for 2004, 2005 and 2006.

Year ended December 31			Percentage Changes	
2004	2005	2006	2004 - 2005	2005- 2006

Operating expenses:

(thousands of *reais*, except percentages)

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Selling expenses	(1,105,628)	(1,656,242)	(1,470,642)	49.8	(11.2)
General and administrative expenses	(1,017,502)	(1,264,741)	(1,314,119)	24.3	3.9
Other net operating expenses (income)	(61,198)	(626,306)	(262,134)	N/A	(58.1)
Total operating expenses	(2,184,329)	(3,547,289)	(3,046,895)	62.4	(14.1)

*Selling Expenses*

Total selling expenses decreased 11.2% to R\$1,470.6 million in 2006 from R\$1,656.2 million in 2005. The decrease was primarily due to third party services, which decreased R\$154.5 million in 2006, largely due to a 35.9% reduction in marketing and advertising.

Bad debt and provisions for doubtful accounts decreased 14.5% in 2006 despite the increase in gross revenues. As a percentage of gross revenues, bad debt and provisions for doubtful accounts decreased to 2.5% of gross revenues in 2006 from 3.1% in 2005. This reduction in bad debt and provisions for doubtful accounts as a percentage of gross revenues reflects our continued focus on measures to control bad debt, such as the introduction of alternative plans to mitigate credit risk.

Total selling expenses increased 49.8% to R\$1,656.2 million in 2005 from R\$1,105.6 million in 2004. A large portion of this increase can be explained partially by the fact that we operated our mobile business for 12 months in 2005, as opposed to only 2 months in 2004. This increase was due primarily to:

- (i) a 71.2% increase in expenses for salaries and bonuses relating to our sales personnel, with a portion this variation explained by a change in the booking of profit sharing which, in 2004, was booked after EBITDA, by the Collective Labor Agreement in effect as of January 2005, which implicated an average salary readjustment of 6.0% and by increase in the number of employees;
- (ii) a 37.2% increase in expenses regarding call center services primarily in the mobile segment and readjustment of contracts in October 2005;
- (iii) a 26.4% increase in expenses regarding commissions to sales representatives and stores, and increase in our sales spots due to the increase of sales in Christmas;
- (iv) a 9.2% increase of bad debt and provisions for doubtful accounts partially connected with the correspondent increase in revenues and the fact that in December 2005, Brasil Telecom made additional provisions amounting to R\$74.0 million regarding risks of losses in clients bills subject to co-billing procedures; and
- (v) a 74.1% increase in advertising and marketing expenses explained by the mobile operation, which, in 2005 amounted to R\$128.1 million, against R\$24.2 million in 2004.

Bad debt and provisions for doubtful accounts increased 9.2% in 2005 due to our increase in gross revenues. However, as a percentage of gross revenues, bad debt and provisions for doubtful accounts remained stable at 3.1% of gross revenues for 2005 in comparison to 2004. This stability in bad debt and provisions for doubtful accounts as a percentage of gross revenues reflects our continued focus on measures to control bad debt, such as the introduction of prepaid phone cards to mitigate credit risk.

*General and Administrative Expenses*

Total general and administrative expenses increased 3.9% to R\$1,314.1 million in 2006 from R\$1,264.7 million in 2005. The increase was primarily due to an increase of R\$45.8 million in depreciation and amortization.

As a percentage of net operating revenues, general and administrative expenses rose to 12.8% in 2006 from 12.5% in 2005.

Total general and administrative expenses increased 24.3% to R\$1,264.7 million in 2005 from R\$1,017.5 million in 2004. In general and administrative expenses, a large portion of this increase can be explained partially



by the fact that we operated our mobile business for 12 months in 2005, as opposed to only two months in 2004. The increase was primarily due to:

- (i) a 38.8% increase in expenses for salaries and bonuses relating to our personnel, which may be explained by a change in the booking of profit sharing which, in 2004, was booked after EBITDA, by the Collective Labor Agreement in effect as of January 2005, which implemented an average salary readjustment of 6.0% and by an increase in the number of employees;
- (ii) an increase in legal and corporate consulting expenses;
- (iii) an increase in expenses from information technology equipment depreciation; and
- (iv) an increase in expenses for regular office services, such as security, cleaning and maintenance, attributable to the expansion of our mobile operations.

As a percentage of net operating revenues, general and administrative expenses rose to 12.5% in 2005 from 11.2% in 2004.

*Other Net Operating Expenses (Income)*

In 2006, total other net operating expenses amounted to R\$262.1 million, a 58.1% reduction in comparison to R\$626.3 million in 2005. This result is primarily due to:

- (i) R\$237.5 million reduction in provisions and administrative costs for Pension Funds; and
- (ii) R\$127.9 million increase in recovery of taxes and recovered expenses.

Total other net operating expenses increased from R\$61.2 million in 2004 to R\$626.3 million in 2005. This increase in expenses resulted primarily from:

- (i) provisions for contingencies, of which, R\$198 million is related to social security and labor- related legal proceedings, as well as administrative proceedings, and R\$77 million is related to a write-off of tax credits, in particular of the ICMS (Value Added) tax levied on supplies used in the maintenance of our fixed telephone plant and on electric energy consumption;
- (ii) a R\$171 million supplement to the provision for pension fund liabilities as a result of the adoption of a revised mortality table (UP94 with two-year grievance and separated by gender), which better corresponds to current expectation of longevity of participants of sponsored plans.
- (iii) a R\$39.4 million increase in interconnection costs due to the decision rendered by Anatel which altered the calculation basis of FUST (Fund for the Universalization of Telecommunications Services).

***Operating Income (Loss) Before Net Financial Expenses***

Our total operating income before net financial expenses increased by 1,095.9% to an income of R\$783.3 million in 2006 from an income of R\$65.5 million in 2005. As a percentage of net operating revenues, operating income before net financial expenses increased to 7.6% in 2006 from 0.65% in 2005.

Our total operating income before net financial expenses decreased by 90.9% to an income of R\$65.5 million in 2005 from an income of R\$721.7 million in 2004. As a percentage of net operating revenues, operating income before net financial expenses decreased to 0.65% in 2005 from 8.0% in 2004.

### ***Net Financial Expenses***

Total net financial expenses represent the net effect of interest income, interest expense and exchange rate and monetary restatement gain and loss.

In 2006, our net financial expenses decreased 51.4% to R\$289.7 million from R\$596.2 million in 2005 primarily as a result of:

- a 46.8% reduction of swap contracts in foreign currency, to R\$136.5 million in 2006 from R\$256.8 million in 2005 due to the appreciation of the Real in comparison to the Yen, which represented, in 2006, an effect of 23.5% in BrT's Receives position, against 9.5% in 2005;
- a reduction of R\$94.7 million in loans in foreign currency referring to the appreciation of the Real against the US dollar and the Yen.

In 2005, our net financial expenses increased 2.9% to R\$596.2 million from R\$579.5 million in 2004 primarily as a result of:

- an extraordinary adjustment related to monetary updates in the amount of approximately R\$60.2 million;
- a 4.4% decrease in our interest expense, to R\$822.7 million in 2005 from R\$860.7 million in 2004 (of which approximately 16.4% (R\$134.9 million) was paid to Brasil Telecom Participações S.A., our parent company) as a result of lower interest rates in Brazil in 2005 compared to 2004, which decreased the cost of our *real* denominated indebtedness, as the average CDI in 2005 was 15.1% as compared to 16.2% in 2004; and
- an increase in our interest income to R\$664.7 million in 2005 from R\$493.3 million in 2004, primarily as a result of the increase in average cash balances to R\$2,063.9 million in 2005 from R\$1,931.8 million in 2004.

### ***Operating Income (Loss)***

Our total operating income (loss) totaled R\$493.6 million in 2006 as opposed to a loss of R\$530.7 million in 2005, primarily as a result of a 6.0% increase in gross profits, a 14.1% decrease in operating expenses and a 51.4% decrease in net financial expenses. As a percentage of net operating revenues, operating income increased to 4.8% in 2006 as opposed to a loss of 5.2% in 2005.

Our total operating income (loss) decreased to a loss of R\$530.7 million in 2005 from an income of R\$142.2 million in 2004, primarily as a result of a 24.3% increase in gross profits offset by a 62.4% increase in operating expenses and a 2.9% increase in net financial expenses. As a percentage of net operating revenues, operating loss decreased to 5.2% in 2005 from an income of 1.6% in 2004.

### ***Net Non-Operating Expenses***

Net non-operating expenses consist principally of equipment disposal in connection with the modernization of our network.

Total net non-operating expenses reverted to an income of R\$30.9 million in 2006 from expenses of R\$149.0 million in 2005. Net non-operating expenses are comprised mainly of the amortization of goodwill we acquired as a result of the merger with CRT in December 2000. Goodwill amortization for CRT totaled R\$7.8 million for the year ended December 31, 2006 (See note 8 to our audited consolidated financial statements).

Total net non-operating expenses increased by 33.0% to R\$149.0 million in 2005 from R\$112.1 million in 2004. Net non-operating expenses are comprised mainly of the amortization of goodwill we acquired as a result of

the merger with CRT in December 2000. Goodwill amortization for CRT totaled R\$126.0 million for the year ended December 31, 2005. (See note 8 to our audited consolidated financial statements).

***Income (Loss) Before Taxes and Minority Interests***

Our income (loss) before taxes and minority interests reverted to an income of R\$524.5 million in 2006 from a loss of R\$679.8 million in 2005 primarily as a result of the increase in operating loss and net non-operating expense. As a percentage of net operating revenues, income before taxes and minority interests reverted to an income of 5.1% in 2006 from a loss of 6.7% in 2005.

Our income (loss) before taxes and minority interests decreased to a loss of R\$679.8 million in 2005 from an income of R\$30.1 million in 2004 primarily as a result of the increase in operating loss and net non-operating expense. As a percentage of net operating revenues, income (loss) before taxes and minority interests increased to 6.7% in 2005 from a loss of 0.3% in 2004.

***Income and Social Contribution Tax Benefits (Expenses)***

Income and social contribution tax benefits reverted to a loss of R\$95.0 million in 2006 from an income of R\$389.1 million in 2005, due to an increase in income before taxes and minority interest of R\$524.5 million in 2006 from a loss of R\$679.8 million in 2005.

Income and social contribution tax benefits increased by 418.8% to R\$389.1 million in 2005 from R\$75.0 million in 2004, due to the increase in loss before taxes and minority interest of R\$679.8 million in 2005 from an income of R\$30.1 million in 2004.

***Minority Interests***

In 2006, we allocated R\$2.9 million of gain to minority shareholders, originating from their stakes in iG Cayman, Opynia Cayman and Agência o Jornal da Internet.

In 2005, we allocated R\$13.0 million of loss to minority shareholders, originating from their stakes in iBest and iG.

In 2004, we allocated R\$6.3 million of gain to minority shareholders, originating from their stakes in iBest and iG.

***Net Income (Loss)***

Our net income reverted to an income of R\$432.4 million in 2006 from a loss of R\$303.7 million in 2005, as a result of the increase in operating income and reduction of net non-operating expenses. As a percentage of net operating revenues, net income reverted to 4.2% in 2006 from a loss of 3.0% in 2005.

Our net income (loss) decreased to a loss of R\$303.7 million in 2005 from an income of R\$98.8 million in 2004, as a result of the increase in operating loss and net non-operating expenses. As a percentage of net operating revenues, net loss decreased to a loss of 3.0% in 2005 from income of 1.1% in 2004.

***Information per Business Segment***

Information per business segment is presented in relation to our Company and our subsidiaries' business, which was identified based on their performance and management structure, as well as the internal management information.

The operations carried out among the business segments presented were based on conditions equivalent to the market.



The income by segment, as well as the equity items presented, takes into consideration the items directly attributable to the segment, also taking into account those which can be allocated on a reasonable basis.

**Company reportable segments as of December 31, 2006**

	<b>Fixed Telephony and Data Transmission</b>	<b>Mobile Telephony</b>	<b>Internet</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net operating revenue	9,419,265	1,247,377	299,542	(669,525)	10,296,659
Gross income (loss)	3,649,832	71,294	153,978	(43,666)	3,831,438
Operating income (loss) before financial revenues (expenses)	1,321,772	(477,353)	(61,177)	59	783,301

**Company reportable segments as of December 31, 2005**

	<b>Fixed Telephony and Data Transmission</b>	<b>Mobile Telephony</b>	<b>Internet</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net operating revenue	9,734,282	699,848	513,187	(808,633)	10,138,684
Gross income (loss)	3,823,126	(259,403)	175,403	(123,944)	3,615,182
Operating income (loss) before financial revenues (expenses)	906,350	(847,864)	6,998	13	65,497

**Company reportable segments as of December 31, 2004**

	<b>Fixed Telephony and Data Transmission</b>	<b>Mobile Telephony</b>	<b>Internet</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net operating revenue	9,065,390	78,982	269,345	(348,861)	9,064,856
Gross income (loss)	3,375,506	(68,427)	70,067	(140,302)	3,236,844
Operating income (loss) before financial revenues (expenses)	1,309,298	(173,303)	(15,709)	-	1,120,286

**Fixed Telephony and Data Transmission**

	Year ended December 31,			Percent change	
	2004	2005	2006	2005-2004	2006-2005
<b>Gross Operating Revenue</b>	<b>12,699,485</b>	<b>13,924,898</b>	<b>13,653,447</b>	<b>9.6</b>	<b>(1.9)</b>
<b>Deductions from Gross Revenue</b>	<b>(3,634,095)</b>	<b>(4,190,616)</b>	<b>(4,234,182)</b>	<b>15.3</b>	<b>1.0</b>
<b>Net Operating Revenue</b>	<b>9,065,390</b>	<b>9,734,282</b>	<b>9,419,265</b>	<b>7.4</b>	<b>(3.2)</b>
<b>Cost of Services Rendered and Goods Sold</b>	<b>(5,689,884)</b>	<b>(5,911,156)</b>	<b>(5,769,433)</b>		
<b>Gross Income</b>	<b>3,375,506</b>	<b>3,823,126</b>	<b>3,649,832</b>	<b>13.3</b>	<b>(4.5)</b>

<b>Operating Expenses, Net</b>	<b>(2,066,208)</b>	<b>(2,916,776)</b>	<b>(2,328,060)</b>	<b>41.2</b>	<b>(20.2)</b>
Sale of Services	(1,102,190)	(1,227,199)	(986,621)	11.3	(19.6)
General and Administrative Expenses	(932,444)	(1,079,120)	(1,123,975)	15.7	4.2
Management Compensation	(7,214)	(9,196)	(7,767)	27.5	(15.5)
Other Operating Expenses	(24,360)	(601,261)	(209,697)	N.A.	(65.1)
<b>Operating Income Before Financial Revenues (Expenses)</b>	<b>1,309,298</b>	<b>906,350</b>	<b>1,321,772</b>	<b>(30.8)</b>	<b>45.8</b>

*Operating revenues*

Gross operating revenues decreased 1.9% to R\$13,653.4 million at December 31, 2006 from R\$13,924.9 million at December 31, 2005. This decrease was due to a 4.0% decrease in local services revenues and 5.9% decrease in intraregional long-distance services, partially compensated by a 18.4% increase in data transmission revenues.

Gross operati