

PORTUGAL TELECOM SGPS SA  
Form 20-F  
June 30, 2005

[QuickLinks](#) -- Click here to rapidly navigate through this document

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 20-F**

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

OR

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

For the fiscal year ended December 31, 2004

OR

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

Commission file number 1-13758

---

**PORTUGAL TELECOM, SGPS, S.A.**

(Exact name of Registrant as specified in its charter)

**Republic of Portugal**

(Jurisdiction of incorporation or organization)

**Av. Fontes Pereira de Melo, 40, 1069-300 Lisboa Codex, Portugal**

(Address of principal executive offices)

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<br/>on which registered</b> |
|--|--|
| American Depositary Shares, each representing one ordinary share, nominal value €1 per share | New York Stock Exchange                              |
| Ordinary shares, nominal value €1 each   | New York Stock Exchange*                             |

---

\*  
Not for trading but only in connection with the registration of American Depositary Shares.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

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 the annual report.

|   |               |
|---|---------------|
| Ordinary shares, nominal value €1 per share | 1,166,484,550 |
| Class A shares, nominal value €1 per share  | 500           |

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 which financial statement item the registrant has elected to follow.

Item 17  Item 18

---

---

---

## TABLE OF CONTENTS

|  |     |
|--|-----|
| <b>CERTAIN DEFINED TERMS</b>   | 3   |
| <b>PRESENTATION OF FINANCIAL INFORMATION</b>   | 3   |
| <b>FORWARD-LOOKING STATEMENTS</b>  | 3   |
| <b>PART I</b>  | 5   |
| ITEM 1 IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS                         | 5   |
| ITEM 2 OFFER STATISTICS AND EXPECTED TIMETABLE                                       | 5   |
| ITEM 3 KEY INFORMATION   | 5   |
| ITEM 4 INFORMATION ON THE COMPANY  | 20  |
| ITEM 5 OPERATING AND FINANCIAL REVIEW AND PROSPECTS                                  | 87  |
| ITEM 6 DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES                                    | 118 |
| ITEM 7 MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS                             | 133 |
| ITEM 8 FINANCIAL INFORMATION   | 135 |
| ITEM 9 THE OFFER AND LISTING   | 142 |
| ITEM 10 ADDITIONAL INFORMATION   | 143 |
| ITEM 11 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK                   | 157 |
| ITEM 12 DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES                       | 165 |
| <b>PART II</b>   | 166 |
| ITEM 13 DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES                              | 166 |
| ITEM 14 MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS | 167 |
| ITEM 15 CONTROLS AND PROCEDURES  | 168 |
| ITEM 16A AUDIT COMMITTEE FINANCIAL EXPERT  | 169 |
| ITEM 16B CODE OF ETHICS  | 170 |
| ITEM 16C PRINCIPAL ACCOUNTANT FEES AND SERVICES                                      | 171 |
| ITEM 16D EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES                  | 172 |
| ITEM 16E PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS      | 173 |
| <b>PART III</b>  | 174 |
| ITEM 17 FINANCIAL STATEMENTS   | 174 |
| ITEM 18 FINANCIAL STATEMENTS   | 174 |
| ITEM 19 EXHIBITS   | 174 |

### CERTAIN DEFINED TERMS

Unless the context otherwise requires, the term "*Portugal*" refers to the Republic of Portugal, including the Madeira Islands and the Azores Islands; the term "*Portuguese Government*" refers to the government of the Republic of Portugal and, where the context requires, includes the Portuguese state; the term "*Parliament*" refers to the Assembly of the Republic of Portugal, the legislative body of the Portuguese state; the term "*EU*" refers to the European Union; the term "*EC Commission*" refers to the Commission of the European Communities; the terms "*United States*" and "*U.S.*" refer to the United States of America; the term "*Portugal Telecom*" refers to Portugal Telecom, SGPS, S.A.; and unless indicated otherwise, the terms "*we*," "*our*" or "*us*" refer to Portugal Telecom and its consolidated subsidiaries.

### PRESENTATION OF FINANCIAL INFORMATION

We publish our financial statements in Euro, the single European currency adopted by certain participating member countries of the European Union, including Portugal, as of January 1, 1999. Unless otherwise specified, references to "Euros," "EUR" or "€" are to the Euro. References herein to "U.S. dollars," "\$" or "US\$" are to United States dollars. References to "Escudos" or "PTE" are to Portuguese Escudos. References to "Real," "Reais" or "R\$" are to Brazilian Reais. Certain Euro amounts have been translated into U.S. dollars at specified rates. Unless otherwise indicated, U.S. dollar equivalent information for amounts in Euro is based on the noon buying rate in the City of New York for cable transfers in Euros as certified for United States customs purposes by the Federal Reserve Bank of New York on June 22, 2005. For convenience and comparability, figures previously stated in Escudos have been converted to figures in Euros based on the fixed Escudo/Euro exchange rate of PTE 200.482 = €1.00. We are not representing that the Euro or US\$ amounts shown herein could have been or could be converted into US\$ or Euros, as the case may be, at any particular rate or at all. See "*Item 3 Key Information Exchange Rates*" for further information regarding the rates of exchange between Euros and U.S. dollars.

### FORWARD-LOOKING STATEMENTS

This Form 20-F includes, and documents incorporated by reference herein and future public filings and oral and written statements by our management may include, statements that constitute "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. These statements are based on the beliefs and assumptions of our management and on information available to management at the time such statements were made. Forward-looking statements include, but are not limited to: (a) information concerning possible or assumed future results of our operations, earnings, industry conditions, demand and pricing for our products and other aspects of our business under "*Item 4 Information on the Company*," "*Item 5 Operating and Financial Review and Prospects*" and "*Item 11 Quantitative and Qualitative Disclosures About Market Risk*"; and (b) statements that are preceded by, followed by or include the words "believes," "expects," "anticipates," "intends," "is confident," "plans," "estimates," "may," "might," "could," "would," the negatives of such terms or similar expressions.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Although we make such statements based on assumptions that we believe to be reasonable, there can be no assurance that actual results will not differ materially from our expectations. Many of the factors that will determine these results are beyond our ability to control or predict. We do not intend to review or revise any particular forward-looking statements referenced in this Form 20-F in light of future events or to provide reasons why actual results may differ. Investors are cautioned not to put undue reliance on any forward-looking statements.

Any of the following important factors, and any of those important factors described elsewhere in this or in other of our SEC filings, among other things, could cause our results to differ from any results that might be projected, forecast or estimated by us in any such forward-looking statements:

material adverse changes in economic conditions in Portugal or Brazil;

exchange rate fluctuations in the Brazilian Real and the U.S. dollar;

risks and uncertainties related to national and supranational regulation;

increased competition resulting from the liberalization of the telecommunications sector in Portugal and Brazil;

the success of our mobile operations in Brazil through our joint venture with Telefónica Móviles;

the development and marketing of new products and services and market acceptance of such products and services; and

the adverse determination of disputes under litigation.

**PART I**

**ITEM 1 IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

We are not required to provide the information called for by Item 1.

**ITEM 2 OFFER STATISTICS AND EXPECTED TIMETABLE**

We are not required to provide the information called for by Item 2.

**ITEM 3 KEY INFORMATION**

**Selected Consolidated Financial Data**

The selected consolidated balance sheet data as of December 31, 2003 and 2004 and selected consolidated statement of income and cash flow data for each of the years ended December 31, 2002, 2003 and 2004 have been derived from our audited consolidated financial statements included herein. The selected consolidated balance sheet data as of December 31, 2000, 2001 and 2002 and selected consolidated statement of income and cash flow data for each of the years ended December 31, 2000 and 2001 have been derived from our audited consolidated financial statements not included herein.

We prepare our audited consolidated financial statements in accordance with Portuguese GAAP, which differs in certain significant respects from U.S. GAAP. See Notes 36, 37 and 38 to our audited consolidated financial statements for an explanation of the differences between Portuguese GAAP and U.S. GAAP. We have provided, in the information below, amounts in accordance with U.S. GAAP of operating revenues, operating income, net income, earnings per share, total assets, total liabilities and shareholders' equity for all periods and dates for which we have provided information.

The information set forth below is qualified by reference to, and should be read in conjunction with, our audited consolidated financial statements and the notes thereto and also "*Item 5 Operating and Financial Review and Prospects*" included in this Form 20-F.

During 1998, we acquired voting control of Telesp Celular Participações S.A., or TCP, the controlling shareholder of Telesp Celular S.A., or Telesp Celular, a mobile telecommunications operator in the Brazilian state of São Paulo. During 1999 and 2000, we increased our economic interest in TCP to 13.92% and Telesp Celular became the wholly-owned operating subsidiary of TCP. In June 2000, we conducted a tender offer in Brazil for ordinary shares in TCP. As a result of the tender offer, we increased our economic interest in TCP to 29.92%. On November 7, 2000, TCP completed a capital increase in which we subscribed for additional shares in TCP, and, upon acquisition of such shares, our economic interest in TCP increased to 36.20%. In November 2000, after we exchanged with Telefónica our minority interest in Telesp Fixa (the wireline operator in the Brazilian state of São Paulo controlled by Telefónica) for an additional interest in TCP, we increased our economic interest in TCP further to 41.23%, our voting interest to 85.06% and our ownership of TCP's preferred shares to 17.7%. TCP completed a rights offering in September 2002, in which we subscribed to a total of 247,224 million common shares and 326,831 million preferred shares, thereby increasing our economic interest in TCP to 65.12%, our voting interest to 93.7% and our ownership of TCP's preferred shares to 49.8%. In October 2002, in connection with our agreements with Telefónica Móviles, S.A., or Telefónica Móviles (Telefónica's mobile telecommunications subsidiary), for the formation of Brasilcel (the 50/50 joint venture with Telefónica Móviles for mobile operations in Brazil), which operates under the brand name Vivo as of April 2003 and is referred to as Vivo elsewhere in this Form 20-F, we sold a 14.68% stake in TCP to Telefónica Móviles. On December 27, 2002, we transferred the rest of our interest in TCP to Vivo. We now hold, jointly with Telefónica Móviles, an indirect interest in TCP, as well as in the other Brazilian mobile telecommunications companies previously held directly by Telefónica Móviles. See "*Item 4 Information on the Company Our Businesses Brazilian Mobile Business*" and "*Item 4 Information on the Company Strategic Alliances Alliance with Telefónica*".

Our financial statements for 2000 and 2001 fully consolidate the results of TCP in accordance with Portuguese GAAP. As a result of the transfer of our interest in TCP to Vivo on December 27, 2002 and our acquisition of a 50% ownership interest in Vivo as of that date, our consolidated balance sheet data as of December 31, 2002, 2003 and 2004 proportionally consolidates 50% of Vivo's assets and liabilities. Our consolidated statement of income and cash flow data for the year ended December 31, 2002 includes the full consolidation of TCP's income and cash flows. Our consolidated statement of income and cash flow data for the years ended December 31, 2003 and 2004 proportionally consolidates 50% of Vivo's income and cash flows.

In February 2001, TCP acquired an 83% indirect economic interest in Global Telecom (corresponding to 49% of the voting rights), a mobile telecommunications company operating in the Brazilian states of Paraná and Santa Catarina. On December 27, 2002, TCP purchased the remaining 51% of the voting shares of the three holding companies that own Global Telecom and as a result holds a 100% indirect economic interest in Global Telecom. Our consolidated results of operations for the year ended December 31, 2002 presented below reflect the results of operations of Global Telecom based on the equity method of accounting. Global Telecom's assets and liabilities as of December 31, 2002, 2003 and 2004 are reflected in our consolidated balance sheet through our proportional consolidation of Vivo. Global Telecom's income and cash flows for the years ended December 31, 2003 and 2004 are reflected in our consolidated statement of income and cash flows through our proportional consolidation of Vivo's income and cash flows.

On April 25, 2003, TCP acquired a controlling interest in Tele Centro Oeste Participações, S.A., or TCO, a mobile telecommunications operator in the Midwestern and Northern regions of Brazil. As a result, TCO's assets and liabilities as of December 31, 2003 and 2004 are reflected in our consolidated balance sheets as of those dates through our proportional consolidation of Vivo. TCO's income and cash flows from May through December 2003 and for the year ended December 31, 2004 are reflected in our consolidated statement of income and cash flows for the years ended December 31, 2003 and 2004, respectively, through our proportional consolidation of Vivo's income and cash flows.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Information provided in U.S. dollars for the year ended December 31, 2004 has been calculated on the basis of the Euro/U.S. dollar exchange rate on June 22, 2005 of €0.8244 = US\$1.00. See "Presentation of Financial Information" and "Exchange Rates".

|   | Year Ended December 31, |         |         |         |         |         |
|---|-------------------------|---------|---------|---------|---------|---------|
|   | 2004                    | 2004    | 2003    | 2002    | 2001    | 2000    |
|   | US\$                    | EUR     | EUR     | EUR     | EUR     | EUR     |
| <b>STATEMENT OF PROFIT AND LOSS DATA:</b>                   |                         |         |         |         |         |         |
| <b>Amounts in accordance with Portuguese GAAP</b>           |                         |         |         |         |         |         |
| <b>Operating revenues:</b>                                  |                         |         |         |         |         |         |
| Services rendered   | 6,399.9                 | 5,276.1 | 5,056.5 | 4,950.9 | 4,976.3 | 4,329.8 |
| Sales of merchandise and products                           | 748.4                   | 617.0   | 583.5   | 492.0   | 613.5   | 684.7   |
| Telephone directory   | 157.4                   | 129.8   | 136.1   | 139.1   | 136.8   | 131.7   |
| Total operating revenues                                    | 7,305.7                 | 6,022.9 | 5,776.1 | 5,582.0 | 5,726.6 | 5,146.2 |
| <b>Operating costs and expenses:</b>                        |                         |         |         |         |         |         |
| Wages and salaries  | 905.1                   | 746.2   | 705.9   | 694.8   | 668.6   | 578.1   |
| Post retirement benefits                                    | 168.0                   | 138.5   | 222.9   | 183.2   | 140.7   | 103.4   |
| Costs of telecommunications                                 | 669.9                   | 552.2   | 587.1   | 622.9   | 715.1   | 470.7   |
| Depreciation and amortization                               | 1,161.3                 | 957.3   | 954.0   | 962.8   | 956.2   | 1,021.5 |
| Subsidies   | (18.3)                  | (15.1)  | (20.6)  | (31.5)  | (36.8)  | (38.1)  |
| Maintenance and repairs                                     | 145.0                   | 119.6   | 126.5   | 129.2   | 120.1   | 105.7   |
| Own work capitalized  | (108.6)                 | (89.5)  | (74.5)  | (114.0) | (179.3) | (133.9) |
| Raw materials and consumables                               | 83.0                    | 68.4    | 74.0    | 97.2    | 139.1   | 97.3    |
| Costs of products sold                                      | 721.3                   | 594.7   | 550.2   | 462.7   | 619.8   | 658.0   |
| Telephone directories                                       | 105.4                   | 86.9    | 90.4    | 92.0    | 89.2    | 87.1    |
| Marketing and publicity                                     | 228.9                   | 188.7   | 141.9   | 108.8   | 142.0   | 157.5   |
| Concession rent   |                         |         |         | 16.3    | 12.7    | 20.8    |
| Other general and administrative                            | 1,305.1                 | 1,075.9 | 966.5   | 925.6   | 998.9   | 848.9   |
| Provision for doubtful receivables, inventories & other     | 208.3                   | 171.7   | 130.8   | 132.8   | 130.7   | 188.6   |
| Other net operating income                                  | (81.6)                  | (67.3)  | (90.0)  | (45.3)  | (45.3)  | (51.9)  |
| Taxes other than income taxes                               | 152.8                   | 126.0   | 97.1    | 77.8    | 87.1    | 95.7    |
| Total operating costs and expenses                          | 5,645.6                 | 4,654.3 | 4,462.4 | 4,315.3 | 4,558.8 | 4,209.4 |
| <b>Operating income</b>                                     | 1,660.1                 | 1,368.6 | 1,313.7 | 1,266.7 | 1,167.8 | 936.8   |
| Other expenses, net   | 399.7                   | 329.5   | 249.5   | 520.9   | 1,086.0 | 419.6   |
| Work force reduction program costs                          | 207.2                   | 170.8   | 314.1   | 53.7    | 183.9   | 252.7   |
| Extraordinary items   | 106.0                   | 87.4    | 52.8    | 38.6    | 258.6   | (492.2) |
| <b>Income before income taxes</b>                           | 947.1                   | 780.8   | 697.3   | 653.5   | (360.7) | 756.7   |
| Provision for income taxes                                  | (217.3)                 | (179.1) | (377.9) | (337.1) | (174.6) | (258.6) |
| <b>Consolidated net income before minority interests</b>    | 729.9                   | 601.7   | 319.5   | 316.4   | (535.3) | 498.1   |
| Loss (income) applicable to minority interests              | (123.2)                 | (101.6) | (79.2)  | 74.6    | 342.7   | 42.3    |
| <b>Consolidated net income</b>                              | 606.7                   | 500.1   | 240.2   | 391.1   | (192.6) | 540.3   |
| Operating income per ordinary share, A share and ADS(1)     | 1.42                    | 1.17    | 1.05    | 1.01    | 0.93    | 0.78    |
| Earnings per ordinary share, A share and ADS(1)             | 0.52                    | 0.43    | 0.19    | 0.31    | (0.15)  | 0.45    |
| Cash dividends per ordinary share, A share and ADS(1)(2)(3) | 0.42                    | 0.35    | 0.22    | 0.16    | 0.10    |         |
| Share capital   | 1,414.9                 | 1,166.5 | 1,254.3 | 1,254.3 | 1,254.3 | 1,201.8 |



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

**Amounts in accordance with U.S. GAAP**

|  |         |         |         |           |         |         |
|--|---------|---------|---------|-----------|---------|---------|
| Operating revenues   | 5,650.7 | 4,658.5 | 4,460.0 | 6,007.7   | 6,042.8 | 5,199.9 |
| Operating income as restated(4)  | 1,019.0 | 840.7   | 723.1   | 383.2     | 696.1   | 395.8   |
| Net income before change in accounting principles as restated(4)                   | 618.5   | 509.9   | 145.5   | 1,315.3   | 208.1   | 66.8    |
| Cumulative effect of a change in accounting principles SAB 101                     |         |         |         |           |         | (126.7) |
| Cumulative effect of a change in accounting principles SFAS 133                    |         |         |         |           | (57.5)  |         |
| Cumulative effect of a change in accounting principles SFAS 142                    |         |         |         | (1,038.9) |         |         |
| Cumulative effect of a change in accounting principles SFAS 143                    |         |         | (7.4)   |           |         |         |
| Cumulative effect of a change in accounting principle subscriber acquisition costs | (29.3)  | (24.2)  |         |           |         |         |
| Net income after change in accounting principles as restated(4)                    | 589.2   | 485.7   | 138.2   | 276.4     | 150.6   | (59.8)  |
| Earnings per ordinary share, A share and ADS as restated(4)(5)                     | 0.49    | 0.40    | 0.11    | 0.22      | 0.12    | (0.05)  |
| Diluted net income per share as restated(4)(6)                                     | 0.47    | 0.39    | 0.11    | 0.21      | 0.12    | (0.05)  |

- (1) Based on 1,201,750,000 ordinary and A shares issued in the year ended December 31, 2000, 1,254,285,000 ordinary and A shares issued in the years ended December 31, 2001, 2002 and 2003 and 1,166,485,050 ordinary and A shares issued in the year ended December 31, 2004.
- (2) Dividends for the year ended December 31, 2000 were not paid.
- (3) Cash dividends per ordinary share, A share and ADS for the years ended December 31, 2001, 2002, 2003 and 2004 in US\$ were US\$0.09, US\$0.17, US\$0.28 and US\$0.42 respectively.
- (4) Operating income and net income for the years ended December 31, 2000 and 2001 have been restated to include the effect of the reduction in the reported amortization expense for the translated carrying value of goodwill in Portugal Telecom's investment in TCP.
- (5) Based on the weighted average number of shares as of the date given and taking into account the number of shares issued pursuant to capital increases and all treasury shares, there were 1,091,826,182 shares for the year ended December 31, 2000, 1,228,392,386 shares for the year ended December 31, 2001, 1,253,880,328 shares for the year ended December 31, 2002, 1,249,778,188 shares for the year ended December 31, 2003 and 1,210,976,939 shares for the year ended December 31, 2004.
- (6) The weighted average number of shares is computed as a weighted average as of the date given and taking into account the number of shares from the exchangeable bonds issued on December 6, 2001, assuming conversion of the bonds into ordinary shares. For the years ended December 31, 2000, 2001, 2003 and 2004, the effects of the exchangeable bonds have been excluded from the calculation of diluted earnings per share since they would be antidilutive.

**December 31,**

|  | 2004 | 2004 | 2003 | 2002 | 2001 | 2000 |
|--|------|------|------|------|------|------|
|  | US\$ | EUR  | EUR  | EUR  | EUR  | EUR  |

**CASH FLOW DATA:**

**Amounts in accordance with Portuguese GAAP**

|                                      |         |           |           |           |           |           |
|--------------------------------------|---------|-----------|-----------|-----------|-----------|-----------|
| Cash flows from operating activities | 2,447.5 | 2,017.8   | 2,334.0   | 2,092.3   | 1,475.4   | 1,357.6   |
| Cash flows from investing activities | 757.5   | (624.5)   | (459.5)   | (1,009.6) | (2,528.5) | (2,343.2) |
| Cash flows from financing activities | 2,410.8 | (1,987.5) | (1,654.1) | (486.1)   | 1,839.9   | 1,131.0   |

December 31,

|   | 2004     | 2004     | 2003     | 2002     | 2001     | 2000     |
|---|----------|----------|----------|----------|----------|----------|
|   | US\$     | EUR      | EUR      | EUR      | EUR      | EUR      |
| <b>BALANCE SHEET DATA:</b>                        |          |          |          |          |          |          |
| <b>Amounts in accordance with Portuguese GAAP</b> |          |          |          |          |          |          |
| Current assets                                    | 5,661.1  | 4,667.1  | 5,039.7  | 4,850.9  | 3,628.1  | 2,032.6  |
| Investments, net                                  | 524.8    | 432.6    | 448.1    | 376.4    | 2,000.3  | 1,295.3  |
| Fixed assets, net                                 | 4,928.2  | 4,062.9  | 4,268.0  | 4,575.8  | 5,491.3  | 5,446.2  |
| Intangible assets post retirement benefits        |          |          |          |          | 761.9    | 495.0    |
| Intangible assets other, net                      | 3,897.2  | 3,212.9  | 3,150.1  | 2,968.7  | 4,934.4  | 3,878.8  |
| Other non-current assets, net                     | 713.3    | 588.0    | 652.0    | 954.3    | 820.3    | 68.3     |
| Total assets                                      | 15,724.6 | 12,963.4 | 13,557.8 | 13,726.1 | 17,636.3 | 13,216.2 |
| Current liabilities                               | 4,589.0  | 3,783.1  | 3,354.5  | 2,958.0  | 3,240.0  | 3,154.2  |
| Long-term debt                                    | 4,447.1  | 3,666.2  | 4,555.6  | 5,219.1  | 5,428.3  | 2,815.2  |
| Accrued post retirement liability                 | 1,540.4  | 1,269.9  | 1,256.0  | 1,061.5  | 1,810.0  | 1,488.0  |
| Deferred income post retirement benefits          |          |          |          |          | 23.0     | 26.2     |
| Other non-current liabilities                     | 1,162.5  | 958.4    | 806.8    | 929.1    | 1,748.2  | 257.4    |
| Total liabilities                                 | 11,738.9 | 9,677.6  | 9,973.0  | 10,167.6 | 12,249.5 | 7,741.0  |
| Net assets  | 3,985.7  | 3,285.8  | 3,584.8  | 3,558.5  | 5,386.7  | 5,475.2  |
| Minority interests                                | 704.8    | 581.0    | 644.0    | 447.2    | 1,220.0  | 1,113.1  |
| Total shareholders' equity                        | 3,280.9  | 2,704.8  | 2,940.8  | 3,111.3  | 4,166.8  | 4,362.1  |
| Number of ordinary shares                         | 1,166.5  | 1,166.5  | 1,254.3  | 1,254.3  | 1,254.3  | 1,201.7  |
| Share Capital(1)                                  | 1,414.9  | 1,166.5  | 1,254.3  | 1,254.3  | 1,254.3  | 1,201.7  |
| <b>Amounts in accordance with U.S. GAAP</b>       |          |          |          |          |          |          |
| Total assets as restated(2)                       | 14,391.9 | 11,864.7 | 11,764.3 | 12,554.2 | 16,747.8 | 14,534.6 |
| Total liabilities as restated(2)                  | 12,089.9 | 9,967.0  | 9,562.1  | 10,167.9 | 11,902.5 | 9,019.4  |
| Total shareholders' equity as restated(2)         | 1,987.5  | 1,638.5  | 1,999.0  | 2,343.7  | 3,736.5  | 4,191.8  |

(1) As of the dates indicated, Portugal Telecom did not have any redeemable preferred stock.

(2) Assets, liabilities and shareholders' equity as of December 31, 2001 and 2000 have been restated to include the effect of translation of goodwill in TCP and the minimum pension liability adjustment.

### Exchange Rates

#### *Euro*

Effective January 1, 1999, Portugal joined ten other member countries of the European Union in adopting the Euro as the common currency. During the transition period between January 1, 1999 and December 31, 2001, the Escudo remained legal tender in Portugal as a denomination of the Euro, and public and private parties paid for goods and services in Portugal using either the Euro or the Escudo. On January 1, 2002, the Euro entered into cash circulation, and from January 1, 2002 through February 28, 2002, both the Euro and the Escudo were in circulation in Portugal. From March 1, 2002, the Euro became the sole circulating currency in Portugal.

For the years ended December 31, 2002, 2003 and 2004 the majority of our revenues, assets and expenses were denominated in Euro, although a significant portion of our assets and liabilities are denominated in Brazilian Reals. We have published our audited consolidated financial statements in Euro and our shares trade in Euro on the Euronext Lisbon Stock Exchange. Our financial results could be affected by exchange rate fluctuations in the Brazilian Real. See "*Item 5 Operating and Financial Review and Prospects Exchange Rate Exposure to the Brazilian Real*".

Our future dividends, when paid in cash, will be denominated in Euros. As a result, exchange rate fluctuations have affected and will affect the U.S. dollar amounts received by holders of ADSs on conversion of such dividends by The Bank of New York as the ADS depository. The Bank of New York converts dividends it receives in foreign currency into U.S. dollars upon receipt, by sale or such other manner as it has determined, and distributes such U.S. dollars to holders of ADSs, net of The Bank of New York's expenses of conversion, any applicable taxes and other governmental charges. Exchange rate fluctuations may also affect the U.S. dollar price of the ADSs on the New York Stock Exchange.

The following tables show, for the period and dates indicated, certain information regarding the U.S. dollar/Euro exchange rate. The information is based on the noon buying rate in the City of New York for cable transfers in Euro as certified for United States customs purposes by the Federal Reserve Bank of New York. On June 22, 2005, the Euro/U.S. dollar exchange rate was €0.8244 per US\$1.00.

| Year ended December 31, | Average Rate(1)       |
|-------------------------|-----------------------|
|                         | (EUR per<br>US\$1.00) |
| 2000                    | 1.0873                |
| 2001                    | 1.1217                |
| 2002                    | 1.0561                |
| 2003                    | 0.8786                |
| 2004                    | 0.8022                |

(1) The average rate is calculated as the average of the noon buying rates on the last day of each month during the period.

| Period            | High               | Low    |
|-------------------|--------------------|--------|
|                   | (EUR per US\$1.00) |        |
| December 31, 2004 | 0.7400             | 0.7317 |
| January 31, 2005  | 0.7707             | 0.7658 |
| February 28, 2005 | 0.7557             | 0.7530 |
| March 31, 2005    | 0.7745             | 0.7681 |
| April 30, 2005    | 0.7763             | 0.7704 |
| May 31, 2005      | 0.8123             | 0.8008 |

None of the 25 member countries of the European Union has imposed any exchange controls on the Euro.

**Brazilian Real**

Although the majority of our revenues, assets and expenses are denominated in Euros, most of the revenues, assets and expenses from our Brazilian investments are denominated in Brazilian Reais. Consequently, exchange rate fluctuations between the Euro and the Brazilian Real affect our revenues.

There are two principal legal foreign exchange markets in Brazil: the commercial rate exchange market and the floating rate exchange market. Most trade and financial foreign-exchange transactions are carried out on the commercial rate exchange market. These transactions include the purchase or sale of shares or payment of dividends or interest with respect to shares. Foreign currencies may only be purchased through a Brazilian bank authorized to operate in these markets. In both markets, rates are freely negotiated but may be influenced by Central Bank intervention. In 1999, the Central Bank placed the commercial rate exchange market and the floating rate exchange market under identical operational limits, which led to a convergence in the pricing and liquidity of both markets. Since February 1, 1999, the floating market rate has been the same as the commercial market rate, and the system relying on the foreign exchange rate band has been eliminated. However, there is no guarantee that these rates will continue to be the same in the future. Despite the convergence in pricing and liquidity of both markets, each market continues to be regulated separately.

The Brazilian government may impose temporary restrictions on the conversion of Reais into foreign currencies and on the remittance to foreign investors of proceeds from their investments in Brazil. Brazilian law permits the government to impose these restrictions whenever there is a serious imbalance in Brazil's balance of payments or reason to foresee a serious imbalance.

The following tables show, for the periods and date indicated, certain information regarding the Real/U.S. dollar exchange rate. On June 22, 2005, the Real/U.S. dollar exchange rate was R\$2.3760 per US\$1.00. The information is based on the noon buying rate in the City of New York for cable transfers in Brazilian Reais as certified for United States customs purposes by the Federal Reserve Bank of New York.

| Year ended December 31, | Average<br>Rate(1)    |
|-------------------------|-----------------------|
|                         | (R\$ per<br>US\$1.00) |
| 2000                    | 1.8333                |
| 2001                    | 2.3507                |
| 2002                    | 2.9886                |
| 2003                    | 3.0565                |
| 2004                    | 2.9175                |

(1) The average rate is calculated as the average of the noon buying rates on the last day of each month during the period.

| Period            | High               | Low    |
|-------------------|--------------------|--------|
|                   | (R\$ per US\$1.00) |        |
| December 31, 2004 | 2.6563             | 2.6520 |
| January 31, 2005  | 2.6495             | 2.6085 |
| February 28, 2005 | 2.6185             | 2.5831 |
| March 31, 2005    | 2.6883             | 2.6520 |
| April 30, 2005    | 2.5538             | 2.5235 |
| May 31, 2005      | 2.4230             | 2.3650 |

**Escudo**

As of January 1, 2002, we ceased to use the Escudo. For the years ended December 31, 2001, 2002, 2003 and 2004 the majority of our revenues, assets and expenses were denominated in Euros. As



a result, revenues, assets and expenses for years prior to 2001 have been translated from Escudos into Euros. All figures previously stated in Escudos have been converted to figures in Euro based on the fixed Escudo/Euro exchange rate, established on January 1, 1999, of PTE 200.482 per €1.00 or approximately €0.005 per PTE 1.00. See " Euro".

### **Risk Factors**

#### ***The Portuguese Government Holds All of Our A Shares Which Afford It Special Approval Rights***

All of our A shares are held by the Portuguese government. Under our articles of association, as the holder of all of our A shares, the Portuguese government may veto a number of actions of our shareholders, including the following:

election of one-third of the directors, including the chairman of the board of directors;

authorization of a dividend in excess of 40% of our distributable net income in any year;

capital increases and other amendments to our articles of association;

issuance of bonds and other securities;

authorization for a shareholder that is engaged in an activity in competition with us to hold more than 10% of our ordinary shares;

altering our general objectives, strategy or policies; and

defining our investment policies, including the authorization of acquisitions and disposals.

#### ***An ADS Holder May Face Disadvantages Compared to an Ordinary Shareholder When Attempting to Exercise Voting Rights***

Holders of our ADSs may instruct the depositary to vote the ordinary shares underlying the ADSs. For the depositary to follow the voting instructions, it must receive them on or before the date specified in our voting materials. The depositary must try, as far as practical, subject to Portuguese law and our articles of association, to vote the ordinary shares as instructed. In most cases, if the ADS holder does not give instructions to the depositary, it may vote the ordinary shares in favor of proposals supported by Portugal Telecom's board of directors, or, when practicable and permitted, give a discretionary proxy to a person designated by us. We cannot be certain that ADS holders will receive voting materials in time to ensure that they can instruct the depositary to vote the underlying ordinary shares. Also, the depositary is not responsible for failing to carry out voting instructions or for the manner of carrying out voting instructions. This means that ADS holders may not be able to exercise their right to vote and there may be nothing they can do if their ordinary shares or other deposited securities are not voted as requested.

#### ***A Growing Percentage of Our Revenue Is Derived From Businesses That Are Subject to Rapid and Sometimes Unpredictable Changes in Technology and to Increasing Competition***

During 2004, approximately 64.7% of our consolidated revenues were derived from businesses other than our wireline business in Portugal. These businesses include mainly mobile telecommunications in Portugal and Brazil and multimedia services in Portugal.

We believe that the development of mobile telecommunications and multimedia services presents our company with appreciable growth opportunities. However, the success of our mobile telecommunications and multimedia businesses is subject to rapid and sometimes unpredictable changes in technology and to increasing competition. These businesses also may have unforeseen capital



requirements and shifts in customer preferences and demographics. Our business and financial results could suffer:

if we fail to compete effectively in these new businesses and markets;

if we fail to adapt on a timely and efficient basis to changes in technology;

if we cannot attract and retain employees with the requisite skill level necessary to manage these new businesses; or

if customer usage does not increase, or if it declines or evolves away from the technologies and businesses in which we are investing.

***Burdensome Regulation in an Open Market May Put Us at a Disadvantage to Our Competitors***

The Portuguese electronic communication sector is now fully open to competition. However, many regulatory restrictions and obligations are still imposed on us. The Portuguese telecommunications regulator, ANACOM, is conducting a market analysis to determine the regulatory obligations that should be imposed on operators with significant market power in the provision of electronic communications as a result of the European Commission Recommendation on relevant product and service markets within the electronic communication sector subject to "ex ante" regulation. In all of the markets analyzed, the Portugal Telecom group has been found by ANACOM to have significant market power and consequently is subject to regulatory restrictions and obligations. These obligations and restrictions have not been imposed on other telecommunications operators and service providers. The substantial resources we must commit to fulfill these obligations could adversely affect our ability to compete. See "*Item 4 Information on the Company Regulation Portugal*".

***Regulation of Our Interconnection Rates Could Give Other Service Providers an Unfair Competitive Advantage***

European Union and Portuguese regulations require us to allow other telecommunications operators to use our network to connect their networks to ours and to terminate calls for them. We are also required to connect our networks to the networks of other service providers and to terminate calls for them. We believe the interconnection rates should reflect the cost of operating our network in Portugal. The Portuguese regulatory authorities may, however, set our rates at levels comparable to rates in certain other EU countries, where interconnection rates are lower than the current rates in Portugal. See "*Item 4 Information on the Company Regulation Portugal*".

***The Portuguese Government Could Terminate Our Wireline Concession and Licenses***

We provide a significant number of services under a Concession granted to us by the Portuguese government and under licenses (that will be converted into "general authorizations" and "individual rights" following publication of law 5/2004, which will implement the new EU regulatory framework for electronic communications networks and services in Portugal) granted to us by ANACOM. See "*Item 4 Information on the Company Regulation Portugal*". The Concession runs until 2025, with provisions for renewal. The Portuguese government can revoke the Concession after 2010, if it considers the revocation to be in the public interest. It can also terminate our Concession at any time if we fail to comply with our obligations under it. The Portuguese government can also terminate our licenses under certain circumstances. If the Portuguese government took such action, we would not be able to conduct the activities authorized by the Concession or the relevant licenses. This loss would eliminate an important source of our revenues.



***Regulatory Investigations and Litigation May Lead to Fines or Other Penalties***

We are regularly involved in litigation and regulatory inquiries and investigations involving our operations. ANACOM, the Portuguese telecommunications regulator, the European Commission and the Autoridade da Concorrência, the Portuguese competition authority, can make inquiries and conduct investigations concerning our compliance with applicable laws and regulations. Current inquiries and investigations include several preliminary investigations by the Autoridade da Concorrência relating to alleged anti-competitive practices in our wireline and multimedia businesses. See "*Item 4 Information on the Company Regulation Portugal Regulatory Institutions*" and "*Item 8 Financial Information Legal Proceedings Regulatory Proceedings*".

If we are found to be in violation of applicable laws and regulations in this or other regulatory inquiries and investigations, or in litigation proceedings, which are currently pending against us or which may be brought against us in the future, we may become subject to penalties, fines, damages or other sanctions. Any adverse outcome could have a material adverse effect on our operating results or cash flows.

***EU Regulation Regarding Abuse of Dominant Position Could Adversely Affect our Businesses***

On June 8, 2005, Portugal Telecom was informed through the press that Sonae.com, a competing telecommunications operator in Portugal, had filed a complaint against it with the European Commission, alleging abuse of dominant position in the Portuguese market under article 82 of the EU Treaty. We have not yet been served with the complaint. According to press reports, the complaint appears to relate specifically to our provision of both cable television and fixed line services, respectively, through our subsidiaries, PT Multimédia and PT Comunicações. Sonae.com has requested that the European Commission require us to separate our cable television and fixed line telecommunications operations. We believe that steps already taken to operate our cable television business in Portugal through PT Multimédia, which is a separate legal entity that has a separate Board of Directors and independent shareholders, should satisfy the requirements of relevant EU regulations, including article 82 of the EU Treaty, as implemented in Portugal. However, there can be no assurance that the European Commission will not require us to change the current ownership structure or existing operational arrangements between PT Multimédia and other companies of the Portugal Telecom group in response to Sonae.com's complaint or subject us to other penalties, fines, damages or sanctions. Because Sonae.com's complaint is at a very preliminary stage of review at the European Commission, and we do not know what the potential time frame will be for resolution of this issue, we cannot predict what the impact could be on our results of operations. We believe that Portugal Telecom has complied with relevant laws and has not abused its position in the markets where it operates. See "*Item 8 Financial Information Legal Proceedings Regulatory Proceedings*".

***Competition From Mobile Telephony and From Other Wireline Operators Could Significantly Reduce Our Fixed Telephone Revenues***

During 2004, approximately 35.3% of our consolidated revenues were derived from services provided by our wireline business in Portugal. As a result of the substitution of mobile for fixed telephone services, combined with the increase in competition from other wireline operators, we have experienced, and may continue to experience, erosion of market share of both access lines and of outgoing domestic and international traffic. The number of active mobile telephone cards in Portugal has overtaken the number of wireline main lines. Some of our wireline customers are using mobile services as an alternative to wireline telephone services. Mobile operators can by-pass our international wireline network by interconnecting directly with wireline and mobile networks either in our domestic network or abroad. Competition is also forcing down the prices of our wireline telephone services for long distance and international calls. Lowering our international call prices has caused a significant decline in our revenues from international wireline telephone services.

The decrease in wireline traffic and lower tariffs resulting from competition could significantly harm our overall revenues. See "Item 4 Information on the Company Competition Competition Facing our Wireline Business".

***The Broadband Market in Portugal is Highly Competitive and It May Become More Competitive in the Future***

At the end of 2004, we had 695,000 broadband subscribers (380,000 asymmetric digital subscriber lines, or ADSL, and 315,000 through cable modems), which represented a growth of 78% over the number of broadband subscribers at the end of 2003. Some of our competitors have been improving their commercial offer in broadband Internet, with most of them offering triple-play bundled packages (voice telephony, broadband Internet and pay-TV subscription). We believe that with competition in Internet broadband access intensifying, and with the development of existing technologies such as broadband wireless access, or BWA, and universal mobile telecommunications service, or U-TMS, we may face loss of market share in the broadband market, which could result in a loss of subscribers and eventually a loss in revenues.

***The Development of Voice over Internet Protocol Services May Reduce Our Voice Telephony Revenues***

As existing Voice over Internet Protocol, or VoIP, technology develops and new technologies emerge, competition from VoIP services is likely to intensify. VoIP has a significantly more advantageous cost structure when compared to Public Switched Telephony Networks, or PSTN. Currently, some VoIP-based providers are able to offer cost-free calls between VoIP users, as well as call prices to PSTN and mobile networks at significant discounts to our tariffs. Competition from VoIP-based operators is likely to increase price pressure on voice tariffs and reduce wireline traffic, which could harm significantly our voice telephony revenues.

***Increased Competition in the Portuguese Mobile Markets May Result in Decreased Tariffs and Loss of Market Share***

We operate in the highly competitive Portuguese mobile telecommunications market. As competition continues to intensify, our mobile business may lose market share, and we may reduce our tariffs for these services further or introduce new packages at significant discounts to our current tariffs.

We believe that our existing mobile competitors, Vodafone and Optimus, a subsidiary of Sonae.com, will continue to market their services aggressively. In June 2005, Optimus introduced a virtual operator "Rede 4" in response to our new offer "Uzo" at a significant discount to our new tariffs. Although both Uzo and Rede 4 are divisions of TMN and Optimus, respectively, they are both positioned commercially as independent operators, targeting low-cost subscribers.

In addition, the commercial introduction in Portugal of third generation mobile services could heighten competition and reduce the potential profitability of providing third generation services. Moreover, ANACOM may open the mobile market to mobile virtual network operators, or MVNOs, which do not have their own network infrastructure and thus would not have the fixed cost burdens facing our current GSM and UMTS services. Competition from companies providing wireless local-area network, or WLAN, services, which can deliver wireless data services more cheaply than UMTS in concentrated areas, may also affect the market and pricing for third generation services.

***PT Multimédia's Success Depends on Its Ability to Offer New Products and Services and to Keep Up with Advances in Technology***

PT Multimédia has introduced and continues to introduce new products and services, such as high speed Internet access via cable and TV services, including improving channel offer and introducing

services through digital signal transmission. PT Multimédia expects to market and sell such products and services effectively. If it is not successful, its business, financial position and results of operations may be harmed. In addition, PT Multimédia cannot be sure that there will be adequate demand for its system upgrades or new product and service offerings. Because technology changes very rapidly, it is not possible to ensure that the technology PT Multimédia uses or will use in offering its products and services will not be rendered obsolete by new and superior technology. In addition, many of the new products and services that PT Multimédia intends to offer may also be offered by its competitors. Therefore, these new products and services may fail to generate revenue or attract and retain the level of customers that we currently anticipate.

***PT Multimédia is Subject to Competition in Each of Its Business Areas, which is Expected to Intensify***

PT Multimédia faces competition in all its business areas. As existing technology develops and new technologies emerge, competition is likely to intensify in all these areas, particularly with regard to products and services related to subscription TV and Internet. PT Multimédia's cable and satellite TV services face competition from broadband local loop access based on BWA. In January 2005, Jazztel, a direct competitor of Portugal Telecom's wireline business, launched a commercial offer through BWA in the geographical areas where it operates. Video over ADSL is also expected to be a competitor of PT Multimédia's television services. In June 2005, Novis, a direct competitor of Portugal Telecom's wireline business, announced it may launch an IP television offer that would compete with PT Multimédia's television services. Terrestrial digital television, for which an auction for the granting of a license was originally scheduled for March 2005 but due to the several political changes in Portugal was postponed, will be a direct competitor of PT Multimédia's subscription TV business. ANACOM has announced its interest in launching a new auction but has not announced a date for this auction. In its audiovisuals business, PT Multimédia also faces competition at the film distribution, film rights marketing and film screening levels. If PT Multimédia is unable to compete successfully, its business, financial position and results of operations could be significantly harmed.

***We Are Exposed to Exchange Rate and Interest Rate Fluctuations***

We are exposed to exchange rate fluctuation risks mainly due to the significant level of our investments in Brazil. These investments are not hedged against exchange rate fluctuations. We are required to make adjustments to our equity on our balance sheet in response to fluctuations in the value of foreign currencies in which we have made investments. For example, as of December 31, 2004, cumulative foreign currency transaction adjustments related to investments in Brazil were negative €2,204.0 million. Further devaluations in the Brazilian Real could result in further negative adjustments. See "*Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Equity*" and "*Item 5 Operating and Financial Review and Prospects Exchange Rate Exposure to the Brazilian Real*".

The majority of the debt of our Brazilian subsidiaries is either Real-denominated or has been swapped into Reais, and exposure to exchange rate fluctuations is not significant.

We are also exposed to interest rate fluctuation risks. We have entered into financial instruments to reduce the impact on our earnings of an increase in market interest rates, but there can be no assurance that such instruments will continue to reduce the impact of interest rate fluctuations in the future or that these financial instruments will prevent unexpected and material fluctuations of interest rates from having any material adverse effect on our earnings.

***An Economic Crisis in Brazil Could Reduce Expected Returns on Our Brazilian Investments***

A material portion of our business, prospects, financial condition and results of operations is dependent on general economic conditions in Brazil. In particular, it depends on economic growth and

its impact on demand for telecommunications and other related services. The major factors that could have a material adverse effect on our investments and results of operations in Brazil, including Vivo, are:

*Adverse political and economic conditions.* The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. The Brazilian government has utilized salary and price controls, currency devaluation and foreign exchange controls as tools in its previous attempts to stabilize the Brazilian economy and control inflation. Changes in the government's exchange control policy, or in general economic conditions in Brazil, could have a material adverse effect on the results of our operations in Brazil. Deterioration in economic and market conditions in other countries (mainly in other Latin American and emerging market countries) may adversely affect the Brazilian economy and our business.

*Devaluation of the Real and increases in interest rates.* The Brazilian currency has historically experienced frequent devaluations. The Real devalued against the Euro by 1.1% in 2000, by 12.8% in 2001 and by 81.4% in 2002. During 2002, the Real underwent significant devaluation due in part to political uncertainty in connection with the elections and the global economic slowdown. In the period leading up to, and after, the general election in 2002, there was substantial uncertainty relating to the policies that the new government would pursue, including the potential implementation of macroeconomic policies that would differ significantly from those of the prior administration. This uncertainty resulted in a loss of confidence in the Brazilian capital markets, and the continued devaluation of the Real. The Real appreciated during 2003 and 2004 against the Euro by 1.29% and 1.36%, respectively. Any substantial negative reaction to the policies of the Brazilian government could have a negative impact, including devaluation. The devaluation of the Real could negatively affect the stability of the Brazilian economy and accordingly could negatively affect the profitability and results of our operations. It would also increase costs associated with financing our operations in Brazil. In addition, a devaluation of the Real relative to the U.S. dollar may increase the costs of imported products and equipment. Our operations in Brazil rely on imported equipment and, as a result of such devaluation, such equipment would be more expensive to purchase.

As the majority of our debt issued in Brazil is denominated in or swapped into Real, a devaluation of this currency against the Euro could decrease our total debt, although this impact could be offset by the differential between Euro and Real interest rates.

During 2004, the Brazilian Central Bank tightened its monetary policy to contain inflationary pressures resulting from high international prices for oil and other commodities, and increased the SELIC basic interest by 125 bp in the second half of 2004 to 17.75% at year end. An increase in interest rates could negatively affect our profitability and results of operations and would increase the costs associated with financing our operations in Brazil. In addition, an increase would raise our interest costs because most of the interest on our debt is floating, primarily in relation to Real-denominated debt, which floats based on the commercial rate exchange market.

*Inflation in Brazil.* Brazil has historically experienced extremely high rates of inflation. Inflation, as well as governmental measures put in place to combat inflation, have had a material adverse effect on the Brazilian economy. Since the implementation of the Real Plan in 1994, the rate of inflation has been substantially lower than in previous periods. However, inflationary pressures persist, and actions taken in an effort to curb inflation, coupled with public speculation about possible future governmental actions, have contributed to economic uncertainty in Brazil and heightened volatility in the Brazilian securities market. The general price index, or the IGP-DI (the Índice Geral de Preços Disponibilidade Interna), an inflation index developed by the Fundação Getúlio Vargas, a private Brazilian economic organization, reflected inflation of 7.6% in 2004 compared to 9.3% in 2003 and to 26.4% in 2002. If Brazil continues to experience significant inflation, Vivo may be unable to increase service rates to its

customers in amounts that are sufficient to cover its increasing operating costs, and its business may be adversely affected, which could in turn have an adverse effect on our results of operations.

***Our Strategy of Enhancing Our Mobile Operations in Brazil Through Our Joint Venture With Telefónica Móviles May Not Be Successful***

The successful implementation of our strategy for our mobile operations in Brazil depends on the development of our mobile services joint venture company with Telefónica Móviles. On December 27, 2002, we and Telefónica Móviles transferred our direct and indirect interests in Brazilian mobile operators to the mobile services joint venture company, Brasilcel, operating under the brand name Vivo, with headquarters in the Netherlands.

As in any joint venture, it is possible that Telefónica Móviles and we will not agree on Vivo's strategy, operations or other matters. Any inability of Telefónica Móviles and us to operate Vivo jointly could have a negative impact on Vivo's operations, which could have a negative impact on our strategy in Brazil and could have a material adverse effect on our results of operations. In addition, we cannot be sure that Vivo will be able to take advantage of its position in the Brazilian market to increase the scope and scale of its operations or that any anticipated benefits of the joint venture will be realized. See "*Item 4 Information on the Company Strategic Alliances Alliance with Telefónica*".

***Regulation May Have a Material Adverse Effect on Vivo's Results***

Our mobile business in Brazil is subject to extensive regulation, including certain regulatory restrictions and obligations relating to licenses, competition, taxes and rates (including interconnection rates) applicable to mobile telephone services. Changes in the regulatory framework in the mobile telecommunications sector may have a negative impact on Vivo's revenues and results of operations. Moreover, Vivo's operating subsidiaries are restricted from increasing some of the rates that they charge for services provided even if the devaluation of the Real and an increase of interest rates by the Brazilian government increase their costs. Such circumstances may limit Vivo's flexibility in responding to market conditions, competition and changes in its cost structure, which could have a material adverse effect on its results of operations and in turn adversely affect our results of operations.

***The Conditions Applying to Vivo's Subsidiaries Under the SMP Licensing Regime May Result in Reducing Our Revenues and Results of Operations***

In September 2000, ANATEL, the Brazilian telecommunications regulator, introduced a new mobile services licensing regime, referred to as the SMP regime. The SMP regime permits existing mobile service providers operating under concessions to migrate to the SMP regime and become SMP license holders. Each of Vivo's subsidiaries has migrated to the SMP regime and now holds a SMP license instead of their previous concessions.

The SMP regime imposes restrictions on the provision of wireline services. As a result of the restrictions, because ANATEL considers Vivo's subsidiaries to be affiliated with Telefónica, which provides wireline long distance services in the state of São Paulo and was awarded a license to provide such services nationwide, ANATEL will not award a wireline long distance license to any of Vivo's subsidiaries. As a result, Vivo's subsidiaries no longer receive revenues from wireline long distance services but receive revenues from interconnection fees paid by wireline long distance operators for wireline long distance traffic originating and terminating on their networks. The interconnection fees do not fully compensate, however, for the loss of wireline long distance revenues, and this has had a negative impact on the overall revenues of Vivo's subsidiaries.

Under the SMP regime, an SMP mobile operator will pay for the use of another SMP mobile operator's network in the same authorization area only if the traffic carried from the first operator to the second exceeds 55% of the total traffic exchanged between them (known as a partial "Bill & Keep")

regime). In that case, only those calls that have surpassed the 55% level will be subject to payment for network usage. This rule was meant to be valid until June 30, 2005, after which a full "Bill & Keep" regime was expected to be applied whereby no payments would be required for network usage between SMP networks, regardless of the amount of traffic. However, ANATEL has not yet reached a final determination on the interconnection regime applicable after June 30, 2005. If ANATEL opts for a full "Bill & Keep" regime and if the traffic Vivo's subsidiaries terminate for other SMP mobile operators exceeds the traffic other SMP mobile operators terminate for Vivo's subsidiaries, Vivo's, and consequently our, revenues and results of operations may be adversely affected. See "*Item 4 Information on the Company Regulation Brazil SMP Regulation*".

***Interconnection Negotiations May Not Result in Sufficiently Remunerative Revenues for Terminating Calls on the Mobile Networks of Vivo's Subsidiaries and May Negatively Affect our Revenues and Results of Operations***

Under the new SMP regime, interconnection fees for the termination of calls on mobile networks will be determined through commercial negotiations between Vivo's subsidiaries and other telecommunications operators. If the parties do not reach an agreement, the matter will be determined through arbitration, which will be conducted by ANATEL. Vivo's interconnection fees should have been revised pursuant to the new regime in February 2005, but the parties have not yet reached a final agreement through commercial negotiations. Prior to the introduction of the new regime, the interconnection fees for termination of calls on mobile networks were determined by ANATEL. See "*Item 4 Information on the Company Regulation Brazil SMP Regulation*".

Vivo faces the following risks under the new regime: (i) delays in reaching a final agreement between the parties could lead to delays in implementation of interconnection fee adjustments, and (ii) because the final outcome on fees is dependent on the relative bargaining power between Vivo and the other companies, Vivo may receive less revenues than under the previous regime. Because a significant number of mobile subscribers use prepaid mobile services and generally receive more calls than they make, Vivo's subsidiaries derive an important part of their revenues from the interconnection fees paid to them by the wireline operators for traffic originating on wireline networks and terminating on the subsidiaries' mobile networks. If the interconnection fees are reduced, operating revenues may be negatively affected as a result.

***Vivo Faces Substantial Competition in Each of its Markets that may Reduce its Market Share and Harm our Financial Performance***

Since the opening of the Brazilian market for mobile telecommunications services to competition in 1998, several licenses have been granted for mobile telecommunications services in the areas where Vivo's subsidiaries operate. The introduction of the SMP regime has further increased the number of licensees, which has intensified competition. There has been consolidation in the Brazilian telecommunications market, and we believe this trend may continue. Consolidation may result in increased competitive pressures within the market, for example if financially stronger companies are better positioned to compete with Vivo's subsidiaries or if some brand names become better known than others. Vivo's subsidiaries may be unable to respond adequately to pricing and other competitive pressures resulting from consolidation, which would adversely affect their businesses, financial conditions and results of operations. The level of competition from wireline service providers is also increasing. Failure by Vivo's subsidiaries to compete successfully could result in them losing market share and revenues. For more information about the various bands of licenses granted for mobile services in Vivo's coverage areas and competing operators, see "*Item 4 Information on the Company Competition Competition Facing Vivo in Brazil*".

**ITEM 4 INFORMATION ON THE COMPANY**

**Overview**

Portugal Telecom's legal and commercial name is Portugal Telecom, SGPS, S.A. Portugal Telecom is a limited liability holding company, organized as a *Sociedade Gestora de Participações Sociais* under the laws of the Republic of Portugal. The company was originally incorporated as Portugal Telecom, S.A., a *sociedade anónima* in June 1994. Our principal offices are located at Avenida Fontes Pereira de Melo, 40, 1069-300 Lisboa, Portugal. Our telephone number is +351 21 500 1701 and our facsimile number is +351 21 355 6623. Portugal Telecom's agent for service of process in the United States is CT Corporation System at 111 Eighth Avenue, New York, New York 10011. Our home page is located at [www.telecom.pt](http://www.telecom.pt). The information on our website is not part of this report. The website address is included as an indicative textual reference only.

We provide telecommunications and multimedia services in Portugal and Brazil. Our service offering covers a full range of:

wireline services, which include fixed line telephone services for retail and wholesale customers, leased lines, interconnection, distribution of programming for TV and radio broadcasters, Internet access, data and business solutions, portal and e-commerce services;

mobile telecommunications services, such as voice, data and Internet-related services;

multimedia services, such as cable and satellite television services and TV programming, film distribution and screening, newspaper publishing and distribution, radio programming and Cable Internet; and

sales of telecommunications equipment.

In Portugal, we are the leading provider of all of these services. The provision of wireline services in Portugal continues to account for a larger proportion of our revenues (35.3% during 2004) as compared to revenues derived from any other line of business in our group. In Brazil, we have a leading position in the mobile market. To strengthen our position in the Brazilian mobile telecommunications market, we entered into a strategic alliance with Telefónica Móviles, the Spanish telecommunications company, pursuant to which we created, on December 27, 2002, a new mobile telecommunications services company in Brazil, Brasilcel, which was rebranded Vivo on April 8, 2003. See " *Our Businesses Brazilian Mobile Business*", below.

We are focusing our efforts on market segments and businesses that have the potential for high growth, and we are positioning our company as the leading integrated supplier of a full range of telecommunications services in Portugal. We derive an increasing share of our revenues from mobile services in Portugal and Brazil, and from new services in fast-growing businesses in Portugal, such as multimedia and Internet services.

The telecommunications market is increasingly characterized by new technological developments resulting in new opportunities and risks for telecommunications operators, the growth in demand for Internet-related services and the increasing use of information technology in telecommunications services. Our objectives are to:

continue to leverage our experience as the leading provider of wireline, mobile and multimedia services in Portugal;

maintain the growth of our customer base and service portfolio, by introducing new products and services and further improving quality of service levels;

capitalize on our leading position in the Portuguese market to preserve the profitability and cash flow of our wireline and mobile businesses;

exploit new growth opportunities in service areas, such as multimedia and Internet services in Portugal; and

continue to pursue opportunities for growth in the mobile business in Brazil, through Vivo.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

For information regarding our current and historic principal capital expenditures and divestitures, see "Item 5 Operating and Financial Review and Prospects - Capital Investment and Research and Development".

### Our Businesses

#### Business Units

Our market is characterized by increasing competition and rapid technological change. Portugal Telecom's business unit subsidiaries are held by Portugal Telecom in its role as holding company. We have integrated different functions across the board, with particular emphasis on information systems (PT Sistemas de Informação, or PT SI), research and development capabilities (PT Inovação), back office activities (PT PRO), central purchasing capabilities (PT Compras) and call center operations (PT Contact). In addition, in April 2004 we created Portugal Telecom Investimentos Internacionais Consultoria Internacional, S.A., or PT II, to manage all of our international businesses. See "Item 5 Operating and Financial Review and Prospects - Overview Our Business Reorganization and Revenue Reporting Categories".

The diagram below presents our different businesses as of December 31, 2004, which takes into account the internal reorganization of our businesses we initiated in 2003 and completed in the first quarter of 2004.

- 
- (1) Providing wireline services in Portugal, including our fixed telephone service, Internet access services, wholesale services and data and business solutions services.
  - (2) In our discussion of this business segment below, we have provided a diagram of the organizational structure of Vivo.
  - (3) Providing multimedia services in Portugal, including cable operations through TV Cabo, audiovisuals services through Lusomundo Audiovisuals and Lusomundo Cinemas, and media services through Lusomundo Serviços and Lusomundo Media, which PT Multimédia agreed to dispose of on February 28, 2005, subject to the approval of the Portuguese competition authority. See "Multimedia Business", below. In our discussion of this business segment below, we have provided a diagram of the different businesses operating under PT Multimédia Serviços de Telecomunicações e Multimédia, SGPS, S.A., or PT Multimédia.
  - (4) Various international investments, managed through PT II, including global telecommunications operators in Cabo Verde Islands, São Tomé e Príncipe Islands and Macao, mobile operators in Morocco and Angola, and other investments in various countries.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

(5)

Various instrumental companies providing services to Portugal Telecom group companies, including PT Sistemas de Informação (information systems), PT Inovação (research and development), PT PRO (shared services), PT Compras (central purchasing) and PT Contact (call centers).

The following table sets forth the operating revenues of each of our major business lines, on a standalone basis, for the years ended December 31, 2002, 2003 and 2004:

|  | 2002    | 2003    | % Increase<br>of Item | 2004    | % Increase<br>of Item |
|--|---------|---------|-----------------------|---------|-----------------------|
| <b>Wireline Business</b>                     | 2,441.1 | 2,287.9 | (6.3)%                | 2,266.3 | (0.9)%                |
| Retail                                       | 1,477.8 | 1,410.2 | (4.6)%                | 1,383.8 | (1.9)%                |
| Wholesale                                    | 442.0   | 444.8   | 0.6%                  | 442.0   | (0.6)%                |
| Data and Corporate                           | 235.7   | 235.9   | 0%                    | 242.0   | 2.6%                  |
| Directories                                  | 139.1   | 136.1   | (2.5)%                | 129.7   | (4.7)%                |
| Sales  | 35.1    | 37.0    | 5.7%                  | 37.6    | 1.7%                  |
| Other  | 111.4   | 23.9    | (78.5)%               | 31.2    | 30.5%                 |
| <b>Domestic Mobile Business</b>              | 1,474.8 | 1,522.6 | 3.2%                  | 1,588.3 | 4.3%                  |
| Services                                     | 1,332.7 | 1,384.1 | 3.9%                  | 1,440.2 | 4.1%                  |
| Sales  | 142.0   | 138.5   | (2.5)%                | 148.1   | 6.9%                  |
| <b>Brazilian Mobile Business</b>             | 1,218.1 | 1,361.5 | 11.8%                 | 1,503.0 | 10.4%                 |
| Services                                     | 1,049.1 | 1,093.8 | 4.3%                  | 1,183.4 | 8.2%                  |
| Sales  | 169.0   | 267.7   | 58.4%                 | 319.6   | 19.4%                 |
| <b>Multimedia Business</b>                   | 622.8   | 684.3   | 9.9%                  | 729.8   | 6.6%                  |
| Pay TV and Cable Internet                    | 367.8   | 432.8   | 17.7%                 | 495.4   | 14.5%                 |
| Audiovisuals                                 | 110.7   | 107.7   | (2.7)%                | 80.0    | (25.8)%               |
| Media  | 144.2   | 143.8   | (0.2)%                | 154.0   | 7.1%                  |
| Other  | 0       | 0       | n.a.                  | 0.5     | n.a.                  |
| <b>Other Businesses</b>                      | 346.0   | 404.8   | 17.0%                 | 440.8   | 8.9%                  |
| <b>Eliminations in consolidation</b>         | (520.8) | (485.0) | 6.9%                  | (505.3) | (3.8)%                |
| <b>Total consolidated operating revenues</b> | 5,582.0 | 5,776.1 | 3.5%                  | 6,022.9 | 4.3%                  |

**Wireline Business**

Our wireline business consists of the three operating companies, PT Comunicações, PT Prime and PT.com, which provide the following services on our wireline network:

retail, including fixed line telephone services and Internet access services to residential and small office home office customers;

wholesale, including leased lines, transmission of television and radio signals and interconnection services;

data and corporate, including data communications, leased lines to major clients, network managing and outsourcing; and

other wireline services, including our directories business and sales of telecommunications equipment.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

PT Comunicações holds and operates our fixed line network, providing fixed line telephone services, wholesale services, directories and sales of telecommunications equipment. PT Comunicações provides fixed line telephone services pursuant to a Concession granted to us by the Portuguese government and transferred to PT Comunicações pursuant to Decree Law 219/2000. On December 11, 2002, PT Comunicações entered into a definitive agreement to acquire full ownership of the basic telecommunications network from the Portuguese government for €365 million, which included the

2002 Concession rental payment of €16.6 million. Since then, PT Comunicações has owned the basic telecommunications network.

PT Prime offers corporate customers in Portugal data and corporate services through a "one-stop-shop" for a variety of flexible, efficient and innovative solutions using information technology, telecommunications, Internet and outsourcing. Until October 6, 2003, we held 87.5% of the share capital of PT Prime. SIBS, a Portuguese entity operating the ATM network and the inter-bank payment system in Portugal, held the remaining 12.5%, which we acquired on that date for €39 million.

PT.com is the leading Internet company in Portugal, operating as an Internet access service provider using our fixed line network and in portal and related activities through sapo.pt, Portugal's leading Internet portal. PT.com was formed as PT Multimédia.com, or PTM.com, in March 2000 by PT Multimédia to aggregate all of its Internet activities focused on the residential and small and medium-sized enterprise markets. On October 17, 2002, we entered into an agreement with PT Multimédia to acquire its 100% interest in PTM.com. The sale of PT Multimédia's Internet business to us was intended to encourage the continued growth of our broadband businesses and increase the loyalty of fixed line subscribers, while providing a single platform for investment and development of on-line services and content for the Portugal Telecom group. The results from our services provided through PTM.com, renamed PT.com in November 2004, have been included in our wireline business segment since 2003. We have adjusted our results for years prior to 2003 to include PT.com's results in our wireline business segment, as opposed to our PT Multimédia business segment. See "Item 5 Operating and Financial Review and Prospects Overview Our Business Reorganization and Revenue Reporting Categories".

**Fixed Line Network.** We, through PT Comunicações and PT.com, maintained approximately 4.4 million telephone and ADSL access lines in service at December 31, 2004, excluding external supplementary lines, direct extensions and active multiple numbers. We break our fixed line network down into traditional main lines (PSTN), ISDN lines and asymmetric digital subscriber lines (ADSL) lines. Because of their large capacity, we count ISDN lines, which transmit voice and data at higher rates than analog lines, as equivalent to either two or up to 30 (depending on whether they are basic or primary ISDN lines) traditional main lines. Using this counting convention, total main lines included approximately 783 thousand equivalent ISDN lines. We offer high-speed Internet access through ADSL lines. As of December 31, 2004, we had 420 thousand ADSL lines, of which 380 thousand were attributable to our ADSL retail business (which is operated by PT.com), and 3,948 thousand PSTN/ISDN lines, of which 79% were residential/small office home office clients, 16% business and the remainder mainly payphones, wholesale lines and other.

The following table shows the number of our main lines by category.

|   | As of December 31, |       |       |       |       |
|---|--------------------|-------|-------|-------|-------|
|   | 2000               | 2001  | 2002  | 2003  | 2004  |
| Fixed line main lines in service (thousands)        |                    |       |       |       |       |
| Traditional main lines                              | 3,650              | 3,501 | 3,317 | 3,224 | 3,165 |
| ISDN main line equivalents                          | 653                | 800   | 826   | 813   | 783   |
| ADSL  | 0                  | 3     | 53    | 188   | 420   |
| Total   | 4,303              | 4,304 | 4,196 | 4,225 | 4,368 |
| PSTN/ISDN fixed line main lines per 100 inhabitants | 41.9               | 42.3  | 41.9  | 41.2  | 40.6  |
| Public pay phones (thousands)                       | 47.7               | 45.5  | 43.8  | 41.4  | 47.3  |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Over past years, PT Comunicações has made significant investments to meet subscriber demand for lines and to modernize our fixed line network. As a result, the number of PSTN/ISDN lines per 100 inhabitants almost doubled from 20.9 fixed line main lines at the end of 1989 to approximately 40.6 fixed line main lines at the end of 2004.

In September 1999, the number of active mobile cards (the mobile equivalent of main lines) overtook the number of fixed line main lines in Portugal, and traffic that once was transmitted in whole or in part on our fixed line network is being carried on our mobile network or on the network of other mobile operators. We are addressing this trend by encouraging increased use of our fixed line network for other data services.

During 2003, PT Comunicações focused its attention on attracting new wireline customers through a campaign entitled "Rediscover the Fixed Business". PT Comunicações offered its wireline customers a large portfolio of modern and innovative products and services. During 2004, PT Comunicações focused on customer retention and loyalty in order to turn around the wireline business. The aggressive rollout of ADSL was central to this strategy. Throughout 2004, new broadband products and offers were launched, including the launch of one of the first broadband prepaid offers in Europe and the revamping of the ADSL product brand, Sapó ADSL.

All of our local switches in Portugal have been digital since 1999. Digital technology is used on all long distance and trunk connections. This level of digitalization of our fixed line network permits us to market and provide network-based value-added services, such as call waiting, call forwarding and voice mail, resulting in increased line usage. By the end of December 2004, PT Comunicações was providing approximately 1,099 voicemail boxes.

Our fixed line network includes ISDN lines, which transmit voice and data at higher rates than analog lines. We, through PT Comunicações, have offered ISDN services commercially since 1994. PT Comunicações offers a basic-rate service, which provides two communications channels. It also offers a primary-rate service which provides up to 30 communications channels. At the end of December 2004, PT Comunicações had 267,173 subscribers to its basic-rate ISDN service and 8,278 subscribers to its primary-rate ISDN service.

The following chart sets forth the number of ISDN equivalent main lines at the end of each of the last five years:

### ISDN Lines

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

By the end of 2004, ISDN lines represented 19.8% of our total equivalent fixed line main lines, as compared with 20.1% one year before. The conversion of traditional main lines to ISDN lines results in increased quality of service, and PT Comunicações' ISDN subscribers tend to produce higher levels of usage per line than traditional main line subscribers.

We, through PT Comunicações, have started to deploy higher-speed ADSL lines. PT Comunicações launched ADSL service on a wholesale basis in Lisbon and Oporto in 2002, covering 98.9% and 99.2% of those cities, respectively. Throughout the remainder of 2002, ADSL services were made available in the rest of Portugal, increasing total coverage throughout Portugal to 95% at the end of 2004. In addition, through PT.com we launched a plug & play solution ADSL service in the third quarter of 2002, targeting residential customers, and a tailor-made service developed for small office home office and small and medium-sized enterprise customers.

PT Comunicações had 0.2 billing complaints per 1,000 bills and 9.7 reported faults per 100 main lines in the year ended December 31, 2004. The percentage of faults repaired in less than 12 working hours was 77.7% in 2004, compared with 74.5% in 2003. PT Comunicações offers residential customers detailed billing on request without extra charge.

*Traffic.* Total traffic originating on the network has been decreasing since 2002. The chart below sets forth the rate of growth or decrease of traffic originated on our fixed line network.

### Total Growth of Originated Traffic

The following table shows the breakdown of fixed line traffic originated on our fixed line network among mobile, Internet and data and other domestic and international traffic for the periods indicated.

#### Year ended December 31,

|                 | 2000                |       | 2001                |       | 2002                |       | 2003                |       | 2004                |       |
|-----------------|---------------------|-------|---------------------|-------|---------------------|-------|---------------------|-------|---------------------|-------|
|                 | Millions of minutes | (%)   | Millions of minutes | (%)   | Millions of minutes | (%)   | Millions of minutes | (%)   | Millions of minutes | (%)   |
| Domestic        | 8,933               | 53.7  | 7,431               | 43.0  | 6,480               | 39.6  | 5,841               | 40.1  | 5,236               | 42.8  |
| International   | 413                 | 2.5   | 411                 | 2.4   | 402                 | 2.5   | 382                 | 2.6   | 372                 | 3.0   |
| Fixed-to-Mobile | 1,290               | 7.8   | 1,215               | 7.0   | 1,119               | 6.8   | 1,023               | 7.0   | 918                 | 7.4   |
| Internet        | 5,630               | 33.8  | 6,920               | 40.0  | 6,581               | 40.3  | 5,023               | 34.5  | 3,151               | 25.3  |
| Other           | 379                 | 2.2   | 1,319               | 7.6   | 1,758               | 10.8  | 2,294               | 15.8  | 2,673               | 21.5  |
| Total           | 16,645              | 100.0 | 17,296              | 100.0 | 16,340              | 100.0 | 14,563              | 100.0 | 12,440              | 100.0 |

During 2004, Internet-related traffic accounted for approximately 25% of the total traffic originated on the fixed line network, compared with 34% during 2003. According to an administrative decision by ANACOM, the Portuguese telecommunications regulator, of February 21, 2001, PT Comunicações changed its billing structure for Internet service and established a new access regime for

ISPs, which we refer to as the Reference Offer for Internet Access. This billing structure accommodates two different types of pricing methods. Under the first method, ISPs pay a call origination charge to PT Comunicações, and, if the ISPs request that PT Comunicações invoice customers on their behalf, they also pay PT Comunicações the corresponding charge for the invoicing service. Under the second method, PT Comunicações charges the ISPs a wholesale flat rate and the ISPs bill their own customers. On September 23, 2003, ANACOM decided that data traffic and Internet traffic should be included in our Reference Interconnection Offer. Accordingly, PT Comunicações now offers two access regimes to ISPs: (i) the Reference Offer for Internet Access, which includes the two pricing methods described above, and (ii) the Reference Interconnection Offer, which includes a pricing method based on call origination. On March 16, 2004, ANACOM issued a new administrative decision regarding the billing structure for our Reference Interconnection Offer. As a result, the call origination pricing arrangements between PT Comunicações and ISPs are now ruled by two different billing regimes. The primary differences between the two billing regimes relate to origination prices, the manner in which ISP infrastructures are connected to PT Comunicações' wireline network and billing arrangements. The regime introduced in March 2004 has lower origination charges, involves the use of leased lines and does not require PT Comunicações to maintain billing arrangements with ISPs. The ISPs determine which billing regime will apply to their arrangements to connect with PT Comunicações' wireline network. For additional information, see "*Regulation Portugal Interconnection Internet Access*".

PT Comunicações is required to provide carrier selection to its customers on all kinds of traffic. See "*Regulation Portugal Number Portability and Carrier Selection*". Carrier selection, excluding non-geographical services, such as number translation services, has not yet resulted in large-scale reduction in its traffic.

Except for customer pre-selection and Internet traffic, PT Comunicações accounts for traffic originating on our network in its fixed line telephone services unit. Traffic originating on other networks but terminating on our network is allocated to its wholesale unit. PT Comunicações allocates the revenue billed to customers to its fixed line telephone retail service revenue.

*Marketing.* Our wireline business, through PT Comunicações, is increasing marketing efforts towards customer loyalty and promoting increased usage of our wireline telephone services.

Promotional Efforts and Market Analysis. PT Comunicações has increased its promotional and marketing campaigns. It wants the public, and particularly its customers, to recognize that it provides better service and more attractive billing packages than its competitors. PT Comunicações is aggressively promoting the sale of products and services targeted to specific customers, in line with its "resegmentation of customers" policy implemented in 2004 through:

the successful promotion of a special pricing package named "PT Preços para Si", which was launched in 2003, and the launch of new pricing packages based on the principles of simplicity, liberty and discount, named "PT Minutos Diários", "PT Simples", "PT Economia", "PT Liberdade" and "PT Mix", which have sold more than 947 thousand packages in 2004;

the launch of new equipment, such as Siemens Gigaset C100, Fusitju Enjoy, PT Decibel, Kit Home Guard and Kit Power Max, allowing access to new facilities, such as "Homesecurity";

"Rede ADSL PT", which involves the wholesale offer of ADSL to ISPs. During 2004, total ADSL lines grew 123% and represented 9.6% of PT Comunicações' fixed line main lines, compared to 4.5% in 2003;

the launch and promotion of innovative products and services and special pricing packages, such as "Campanha Primavera", "Dia dos Namorados Pack Para Ti" and "Agame já o seu lugar no Euro 2004";

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

the "PC for All" project aimed at increasing PC penetration in Portugal, which bundled affordable PCs with consumer finance and through which we provided broadband access to the majority of schools in Portugal in 2004; and

the launch of an interactive public phone, called "Webphone PT", providing Internet access, e-mail and SMS services.

Internet customers can also profit from special programs created by PT Comunicações that provide special conditions for access and use of PT Comunicações' network. PT Comunicações also sells higher-speed Internet access, including ADSL services, to take advantage of the growing use of Internet services in Portugal and of the group's various Internet-related services.

PT Comunicações uses market research programs to evaluate customer satisfaction and service quality and to help develop products. PT Comunicações focuses its marketing on different segments of its residential and business market. It has a state-of-the-art billing and customer information system and a marketing information database that combines usage and other data.

Targeted Subscriber Packages. PT Comunicações has targeted its products and pricing packages to specific segments of the retail market, such as family groups and small and medium-sized enterprises.

Customer Care. To provide support and marketing services to its residential and business customers, PT Comunicações has developed a network of regional organizations and retail service centers. In addition, it has separate call centers dedicated to increasing services to its residential and business customers. The call centers are interconnected and cover the whole country. This system allows PT Comunicações' customer service representatives to access the history of customers' telephone use and commercial dealings with PT Comunicações.

Increased Selling Efforts. PT Comunicações has developed its distribution network through its retail service centers and agents such as supermarkets and other retail outlets. Its customer support system enables it to develop strategies to sell new and expanded services to its customers. In addition, PT Comunicações is expanding its telemarketing activities, addressing both residential and small and medium-sized enterprise marketing segments and developing more proactive and closer relationships with its customers.

### **Retail**

Fixed Line Telephone Services. We provide public fixed line telephone services in Portugal to retail customers, primarily through our subsidiary PT Comunicações. This business area provided €1,261.2 million, €1,330.3 million and €1,417.6 million to our wireline operating revenues during 2004, 2003 and 2002, respectively. We distinguish between two principal sources of revenue in the provision of fixed telephone services:

*Fixed charges*, including network access charges based on a monthly line rental and an initial installation fee, as well as a monthly fee from pricing packages.

*Traffic*, including charges for the use of our fixed line network based on rates dependent on amount and type of usage.

We divide traffic into domestic and international traffic. Domestic traffic includes domestic telephone services provided by PT Comunicações directly to subscribers that originate or terminate calls on our fixed line network. International traffic includes international telephone services provided by PT Comunicações directly to users that originate calls on our fixed line network.

Since January 1, 2000, public switched fixed line telephone services in Portugal have been fully open to competition. As a result of the introduction of competition, combined with the substitution of



mobile for fixed-line services, we have experienced, and may continue to experience, increased erosion of market share of both access lines and of outgoing domestic and international traffic. See " *Competition Competition Facing Our Wireline Business*".

*Fixed Charges.* PT Comunicações' fixed charges to domestic fixed line telephone subscribers include a one-time installation charge and a monthly line rental fee. These fixed charges provided €670.3 million, €647.5 million and €629.1 million to our wireline operating revenues during 2004, 2003, and 2002, respectively.

As at December 31, 2004, the installation charge to our subscribers was €71.83. The standard line rental fee was €12.66 per month for standard lines and €25.20 per month for ISDN basic lines, in each case excluding value-added tax.

The chart below illustrates changes in PT Comunicações' prices and fees from 2000 through 2004. All prices are in Euros and exclude VAT.

#### Fixed Fees for Fixed Line Telephone Services(1)

|                       | As at December 31, |       |       |       |       |
|-----------------------|--------------------|-------|-------|-------|-------|
|                       | 2000               | 2001  | 2002  | 2003  | 2004  |
| Installation fee      | 77.69              | 74.41 | 71.83 | 71.83 | 71.83 |
| Line rental per month | 12.08              | 12.27 | 11.85 | 12.3  | 12.66 |

(1)

Amounts rounded to nearest hundredth.

*Traffic.* Traffic contributed €590.9 million, €682.8 million and €788.5 million to our wireline operating revenues during 2004, 2003, and 2002, respectively. Measured in minutes, total fixed line retail traffic originating on our fixed line network decreased by 14.6% during 2004, compared with 2003. The decrease was primarily due to the continuing effects of mobile substitution and the migration of heavy dial-up Internet users to ADSL.

*Domestic.* Domestic traffic contributed €514.7 million, €593.0 million and €668.7 million to PT Comunicações' operating revenues in 2004, 2003 and 2002, respectively.

*Prices.* On January 1, 2000, PT Comunicações introduced a system for charging its customers on a per-second basis, after a time credit included in the initial call price. PT Comunicações has three domestic tariffs: local, regional and national. Between the end of 2000 and the end of 2004, weighted average prices for domestic fixed line telephone services decreased by 1.6% per year in nominal terms. Compared with 2003, over the course of 2004, domestic prices decreased a further 0.76% in nominal and annual terms. See " *Regulation Portugal Pricing of Wireline Services*".

The chart below illustrates changes in PT Comunicações' prices from 2000 through 2004. The call prices from 2000 through 2004 are for a three-minute call at peak rates in 2004 constant prices. All prices are in Euros and exclude VAT.

#### Principal Prices for Domestic Fixed Line Telephone Services(1)

|                      | As at December 31, |      |      |      |      |
|----------------------|--------------------|------|------|------|------|
|                      | 2000               | 2001 | 2002 | 2003 | 2004 |
| Local call prices    | 0.13               | 0.12 | 0.12 | 0.12 | 0.13 |
| Regional call prices | 0.31               | 0.24 | 0.23 | 0.21 | 0.16 |
| National call prices | 0.42               | 0.35 | 0.33 | 0.29 | 0.20 |

(1)

Amounts rounded to nearest hundredth.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The average annual reduction in 2004 for the basket of prices was about 0.76% in nominal terms. PT Comunicações' pricing structure has come more into line with pricing structures in the rest of the EU over the last ten years. The following table compares our estimates of average domestic services prices per minute, excluding VAT, for a three-minute call at peak rates in the EU with average prices in Portugal in effect at December 31, 2004.

### Principal Prices for Domestic Fixed Line Telephone Services: EU and Portugal

|                      | As of December 31, 2004 |                  |          |
|----------------------|-------------------------|------------------|----------|
|                      | EU<br>Average(1)        | EU<br>Average(2) | Portugal |
| Local call prices    | 0.10                    | 0.11             | 0.13     |
| Regional call prices | 0.19                    | 0.18             | 0.16     |
| National call prices | 0.20                    | 0.19             | 0.20     |

(1) The average including all 25 member states of the EU.

(2) The average including only the previous 15 member states of the EU.

To increase its price competitiveness, PT Comunicações is promoting innovative differentiated pricing plans for market segments. For example, it offers various plans specially designed for business customers as well as other plans for residential customers. PT Comunicações also offers a prepaid card and pricing plans suited for Internet users, as well as plans aimed at the development of education and the information society. In addition, in 2004, PT Comunicações launched three new pricing plans: (i) the "simplicity plan," which charges a single price for all fixed-to-fixed calls; (ii) the weekend flat rate plan; and (iii) the off-peak weekday plan.

*International.* PT Comunicações estimates that operating revenues from international fixed line telephone services were €76.3 million in 2004 compared with €89.8 million in 2003 and €119.8 million in 2002. Revenues from international fixed line telephone services come primarily from charges to its individual and business subscribers in Portugal for outgoing calls. PT Comunicações must pay a portion of these charges to other international operators whose facilities carry the calls. Over the past two years, PT Comunicações' revenues from international fixed line telephone services decreased as a result of decreases in international traffic and prices for outgoing international calls. PT Comunicações expects these decreases to continue.

*Accounting Rates.* Historically, the amount of incoming traffic has been significantly greater than the amount of outgoing traffic. As a result of this imbalance, PT Comunicações receives higher payments from other international telecommunications operators than it pays out to these operators. PT Comunicações negotiates the amount of the payments with these operators periodically.

In recent years, the billing rates among operators have been declining steadily, both for incoming and outgoing traffic. PT Comunicações estimates that, on an aggregate basis in Euros, termination rates for international traffic at the end of 2004 decreased by a weighted average of approximately 2.0% for incoming traffic and decreased by 0.4% for outgoing traffic as compared to the end of 2003.

With the opening of the Portuguese market to competition on January 1, 2000, international telecommunications operators are now able to provide services directly in Portugal. They can lease lines from PT Comunicações or obtain international lines from other operators and then interconnect with our fixed line network. The revenues PT Comunicações receives from such services are interconnection fees and thus fall into the wholesale business category of our wireline business. As a result, while PT Comunicações' share of the international market has declined, increases in our wholesale business have, to a substantial extent, offset this decline.

*Prices.* PT Comunicações sets traffic charges for international fixed line telephone services in a number of different groups of countries. Within each group, it charges different prices according to the time of day and the day of the week that the customer makes the call.

Between the end of 2000 and the end of 2004, PT Comunicações experienced aggregate reductions in real terms of 8.3% in international traffic prices.

The table below shows changes in prices for our international fixed line telephone services to selected destinations since 2000. The prices for 2000 through 2004 are peak rate prices per minute on the basis of a three minute call, set at 2004 constant prices. They are in Euros and exclude VAT.

**Selected Prices for the International Services(1)**

|                             | As of December 31, |      |      |      |      |
|-----------------------------|--------------------|------|------|------|------|
|                             | 2000               | 2001 | 2002 | 2003 | 2004 |
| EU(2)                       | 0.29               | 0.28 | 0.27 | 0.27 | 0.27 |
| Other European countries(3) | 0.67               | 0.63 | 0.61 | 0.61 | 0.61 |
| United States               | 0.30               | 0.29 | 0.28 | 0.28 | 0.28 |
| Canada                      | 0.30               | 0.29 | 0.28 | 0.28 | 0.28 |
| Brazil                      | 0.67               | 0.59 | 0.57 | 0.57 | 0.57 |

(1) Euro amounts rounded to nearest hundredth.

(2) Including Switzerland.

(3) Excluding Norway and Iceland.

**ADSL Services and ISPs.** PT.com is the leader in providing Internet access in Portugal. As at December 31, 2004, PT.com had approximately 380 thousand ADSL retail customers, which represented an overall increase of 136% over the previous year. PT.com also offers dial-up paid and free Internet access services. The number of hours of subscriber use in 2004 decreased by 46% to 13 million hours compared to 23 million hours in 2003, reflecting the increasing penetration of broadband in Portugal.

**Application Service Provider (ASP).** PT.com also provides ASP services in Portugal. These activities include remote applications services, web hosting and web design services to small and medium-sized enterprises. PT.com had approximately 2,784 thousand customers for its ASP business at December 31, 2004.

**Wholesale**

Our wireline business' wholesale services, which are provided primarily through PT Comunicações, consist of:

domestic and international interconnection telephone services that we provide to other telecommunications service providers in Portugal, including other companies in our group;

leasing of national and international lines to other telecommunications service providers and Portuguese cable television operators, including other companies in our group;

provision of ADSL on a wholesale basis to other ISPs, including other companies within the Portugal Telecom group;

transmission of television and radio signals for major broadcast television companies in Portugal;

narrowband Internet access origination services, which we provide to ISPs, including other companies within the Portugal Telecom group; and

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

other services provided to telecommunications service providers and operators, such as local loop unbundling and IP international connectivity.

Wholesale services provided €442.0 million, €444.8 million and €441.9 million to our wireline operating revenues in 2004, 2003 and 2002, respectively.

*Traffic.* Interconnection and narrowband Internet access traffic comprises about 49.7% of our wholesale business in terms of revenues. The service providers who purchase interconnection services include fixed and mobile network operators, telephony and data communications service providers, Internet service providers, value-added service providers and service providers whose international calls are terminated on or carried by PT Comunicações. Providing interconnection services means allowing third parties to connect their networks to our network, and vice versa. This interconnection is necessary, for example, to allow calls or data signals that originate on another network to terminate on our network, and vice versa. PT Comunicações has interconnection rates for call termination, call origination, transits and international interconnection. In 2004, interconnection rates per minute for call termination included local transit rates equal to €0.007, single transit rates equal to €0.01 and double transit rates equal to €0.0149, each based on a three-minute call made during peak hours. PT Comunicações published the latest version of its reference offer for unbundled access to our local loops on December 16, 2004, and since then has made available to its competitors, where technical and space conditions are available, all of the local switches, 101 of which are co-located. See "*Regulation Portugal Unbundling of the Local Loop*" and "*Regulation Portugal Number Portability and Carrier Selection*".

Wholesale traffic is generated by the interconnection portion of our wholesale business, which decreased by 89.5% in 2004 compared with 2003. This decrease was primarily due to a decrease in Internet traffic, which was partially compensated for by increases in indirect access traffic. The following table sets forth the total amount of wholesale domestic traffic on our fixed line network during the period 2000 through 2004.

### Wholesale Domestic Traffic (millions of minutes)

|               | Year ended December 31, |               |               |               |              |
|---------------|-------------------------|---------------|---------------|---------------|--------------|
|               | 2000                    | 2001          | 2002          | 2003          | 2004         |
| Mobile        | 1,172                   | 1,061         | 998           | 959           | 912          |
| Internet      | 5,630                   | 6,916         | 6,581         | 5,023         | 3,151        |
| International | 1,138                   | 1,343         | 1,420         | 1,318         | 1,413        |
| Other         | 594                     | 2,336         | 2,831         | 3,008         | 3,753        |
| <b>Total</b>  | <b>8,534</b>            | <b>11,656</b> | <b>11,830</b> | <b>10,308</b> | <b>9,229</b> |

The traffic figures for mobile include fixed-to-mobile, mobile-to-fixed and mobile-to-mobile traffic between different networks.

We estimate that international wholesale mobile traffic accounted for approximately 44% of the Portugal Telecom group's total outgoing international traffic and approximately 37% of total incoming international traffic in 2004. We estimate that, in 2003, these percentages were approximately 43% and 36%, respectively.

*Leased Lines.* We lease lines to other telecommunications providers for fixed, mobile and data communications services, including our other subsidiaries and competitors. Since 1996, we have been leasing lines to resellers who offer voice services to corporate networks and closed user groups. Leased line services involve making a permanent point-to-point connection with dedicated and transparent capacity between two geographically separate points.

Our Concession requires us to provide leased lines to third parties. ANACOM defined a minimum set of leased lines as including 2-wire and 4-wire traditional lines and 64 kbit/s to 34 Mbit/s digital lines. We are also providing higher capacity 140 Mbit/s and above digital lines to third parties in Portugal.

The three current mobile telephone operators in Portugal, which include our subsidiary TMN, Vodafone Portugal and Optimus, are among our wireline business' largest leased line customers. Our wireline business leases lines to TMN and TV Cabo on a basis that does not discriminate against other customers.

*Prices.* The net prices and fees we receive from providing access to our fixed line network on a wholesale basis are less per minute than those we charge for domestic and international fixed line telephone services.

Domestic interconnection revenue per minute for calls terminated on our network declined by 12.2% in nominal terms in 2004 compared with 2003. International interconnection revenue per minute declined by 10.6% in nominal terms in 2004 compared with 2003. In accordance with EU and Portuguese regulation, PT Comunicações' interconnection prices are cost-oriented and non-discriminatory.

### *Data and Corporate*

Our data and corporate services, within our wireline business, are provided by PT Prime to top corporate and business customers that have a need for complex telecommunications solutions. It offers those customers data and business solutions, such as:

low speed data communications

digital leased lines

broadband data and metroLAN solutions

networking and systems integration solutions

Internet-related services and applications including Intranet and Extranet services

interactive systems and related applications

outsourcing of telecommunications application systems

consultancy services

Web design and site management

fixed line and mobile convergence services

business-to-business e-commerce

housing and hosting solutions, including application service provider, or ASP, and enterprise resource planning, or ERP

telephone services using Internet protocol

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

PT Prime is the leading supplier of the full range of these services in Portugal. Data and corporate operating revenues contributed €242.0 million, €235.9 million and €235.7 million to our wireline operating revenues in 2004, 2003 and 2002, respectively.

*Services.* PT Prime is one of the focal points for our group's interface with business customers in Portugal for our data, Internet, fixed line, mobile and outsourcing services. PT Prime has developed a full range of telecommunications services, and it integrates these services, as well as other services within the group, such as fixed line services and domestic mobile services, to provide its customers with



packaged groups of services. In addition, PT Prime has its own license to provide a full range of telecommunications and related services in Portugal. By combining its communications capabilities with its software-based integrated systems and applications, PT Prime can offer integrated voice, data and image solutions, virtual private networks, convergence solutions, consultancy and outsourcing. We believe that PT Prime is the main service provider in Portugal capable of offering customers a full range of integrated and customized services rather than stand-alone services. Despite increasing competition, overall demand for data and corporate services has been increasing. As a result of competition, PT Prime has reduced its prices for leased lines and data services.

PT Prime is able to respond to the changing needs of its customers as quickly as new entrants in the Portuguese market do and to pursue and form strategic partnerships to take advantage of opportunities in domestic and international markets. It offers its services in partnership with leading operators and service providers such as Telefónica, British Telecom, Equant and Infonet. It uses systems and networks in partnership with Siemens, Alcatel, Cisco Systems, Newbridge, Motorola, Nortel Networks and Matra/EADS Telecom.

PT Prime leases lines and broadband capacity to large businesses for data communications and other private uses and provides related services. It also provides integrated voice and data services to corporate customers. It offers X.25/X.32 synchronous services and X.28 asynchronous services and other switched and non-switched data communications services, such as frame relay, virtual private networks over IP for data communications, broadband services, security/firewall services and VSAT satellite communications services. In addition, it offers a new range of data, voice and Internet services, such as Intranet, Extranet and managed services, including "voice over IP". It is using IP-based solutions to improve interconnections between companies and their employees and between customers and commercial partners through remote access, and exploring virtual private network capabilities. These solutions enable customers to integrate voice, video and data services in a flexible cost-effective manner with add-on capacity. The offering of web contact centers solutions represents an evolution of the classic call center for customers.

PT Prime provides a range of broadband solutions to corporate customers. The type of solution depends on the type (voice, data or image), volume, priority level and stability of information flow required by its customers.

PT Prime also provides reporting services targeted to special customers to control service level agreements and the overall performance of the network.

In addition, PT Prime is outsourcing corporate networks and services for our group's customers. For example, PT Prime operates and manages the SIBS network, as well as the corporate networks of its strategic partners, Caixa Geral de Depósitos, Banco Espírito Santo and CTT. PT Prime delivers international seamless services aimed at multinational customers in association with Telefónica, British Telecom, Infonet and Equant.

PT Prime has entered into a partnership with Casa da Moeda, CTT and SIBS to create a company called Multicert, with PT Prime, Casa da Moeda and CTT each holding a 20% stake and SIBS holding the remaining 40%. Multicert provides digital certificates and communications security services to both consumer and business segments.

*Networks.* PT Prime network services use their own switched and access points in customer premises and their own network and lines leased from our fixed line network. PT Prime provides its services over the largest IP backbone in Portugal, leasing the necessary fixed line capacity from PT Comunicações. It has points of presence in all major cities throughout Portugal. This broadband data transmission network provides high capacity, flexibility and security. It can progressively incorporate current voice and data infrastructures at lower costs than alternative networks. PT Prime also provides

high speed Internet access through ADSL. PT Prime leases the necessary fixed line capacity from PT Comunicações. PT Prime supplies full IP and broadband connectivity for our whole group.

Revenues from services that offer leased lines of PT Comunicações are typically divided between PT Prime's own direct billings to its customers and our leased line revenues from our wholesale business. Revenues from our group's fixed line voice services for corporate customers are not reflected in PT Prime's revenues, as they are included under Retail.

*Systems Integration.* PT Prime offers an integrated range of telecommunications and information technology services to the business market. PT Prime's goal is to service all of its customers' telecommunications needs and to leverage the traditional offering of products and services from our group.

PT Prime has a strong and competitive position in the development of information technology solutions where communications are an integral part of the services provided. To reinforce its position as a leader in this area, PT Prime is pursuing a partnership strategy with the main information technology suppliers in the market, particularly software and hardware providers. PT Prime is also exploring synergies arising from its relationship with our subsidiary PT SI, the information systems arm of our group.

To support these new services and to respond to the increasing demand of e-business integrators, PT Prime developed a Corporate Internet Data Center. This facility allows it to provide services, such as co-location, sophisticated web hosting, ISP services, data storage and ASP services.

PT Prime also offers services focused on the integrated management of networks ranging from local area networks, or LANs, to software applications, including PC management.

*Marketing and Customer Care.* PT Prime is focusing significant resources on marketing and customer care. Account managers are being given clear incentives to meet and exceed sales targets. PT Prime is upgrading its sophisticated customer relationship management platform, or CRM, to increase focus on market and Internet efficiency.

PT Prime is seeking to compete in Portugal on the basis of the quality of its services as well as its position as the leading supplier of integrated telecommunications and IT services. PT Prime is pricing its various service offerings on the basis of the volume of traffic, the duration of service agreements and the scope of the services offered to each customer.

PT Prime offers its customers services available from other companies in our group. Our subsidiary PT.com, for example, provides significant support for product development and the marketing of Internet and ADSL access.

PT Prime uses customer care capabilities that were developed for PT Comunicações. To maximize customer loyalty, PT Prime is developing systems that provide integrated assessments of customer profiles, based on a CRM system. We believe that to reinforce its competitiveness, PT Prime must change and optimize its processes and focus the entire organization on its customers more effectively.

#### ***Other Wireline Services***

Other wireline services include primarily our directories business and sales of telecommunications equipment.

*Directories.* Operating revenues from our directories business amounted to €129.7 million in 2004, €136.1 million in 2003 and €139.1 million in 2002. We subcontract to Páginas Amarelas (an associated company 25% owned by us) for the publication and distribution of telephone directories throughout Portugal in return for an annual payment of approximately 64% of its gross revenues from the sale of

advertising space. Currently, the provision of yellow page directory services is not subject to significant competition.

*Sales of Telecommunications Equipment.* Revenues from sales of telecommunications equipment amounted to €37.6 million in 2004, €37.0 million in 2003 and €35.1 million in 2002, including the sale of handsets, modems and other telecommunications equipment.

### Domestic Mobile Business

TMN, our Portuguese mobile operating company, is the leading provider of mobile voice, data and Internet services in Portugal in terms of the number of active mobile telephone cards connected to its network and by revenues, margins and profits.

TMN contributed €1,588.3 million, €1,522.6 million and €1,474.8 million to our domestic mobile business operating revenues in 2004, 2003 and 2002, respectively. Mobile services have undergone extraordinary growth in recent years in Portugal. At December 31, 2004, there were approximately 95 active mobile telephone cards per 100 Portuguese inhabitants. This was more than the number of wireline main lines per 100 Portuguese inhabitants at December 31, 2004, which was 40%, according to ANACOM.

The table below provides statistical information relating to TMN.

|  | As of December 31, |       |       |       |       |
|--|--------------------|-------|-------|-------|-------|
|  | 2000               | 2001  | 2002  | 2003  | 2004  |
| <b>TMN Portugal</b>  |                    |       |       |       |       |
| Number of subscribers (thousands)  | 2,939              | 3,905 | 4,426 | 4,887 | 5,053 |
| Subscribers growth per annum (%)   | 39                 | 33    | 13    | 10    | 3     |
| Number of subscribers per 100 inhabitants (including competitors' subscribers) | 65.0               | 77.2  | 81.9  | 89.8  | 95    |
| Estimated market share by number of subscribers (%) <sup>(1)</sup>             | 44.1               | 49.0  | 51.9  | 52.3  | 50.7  |
| Churn rate (%) <sup>(2)</sup>  | 26.1               | 23.5  | 25.3  | 23.5  | 27.7  |
| Number of employees  | 1,019              | 1,194 | 1,192 | 1,109 | 1,133 |

(1)

Source: ANACOM and TMN.

(2)

TMN defines the "churn rate" as the percentage of TMN mobile subscribers that end their use of TMN's mobile services either by terminating their service or by changing their mobile handset and card number without terminating their existing TMN service. Generally, a pre-paid card can receive or send calls for a period of three months after the last recharge, depending upon the pre-paid service. After this period, if the card is not recharged, it can only receive calls for an additional three months. After this second three-month period, provided the pre-paid card receives one paid call over the course of the next month, then the pre-paid card is allowed to receive calls for an additional month. This will continue, as long as the pre-paid card continues to receive at least one paid call a month, for a maximum of six months. Once the card ceases to receive paid calls, or after the end of six months, it becomes non-active.

*Services.* TMN provides GSM mobile telephone services. GSM is a European and worldwide mobile telephone standard using digital technology. Through roaming agreements, TMN's subscribers can use GSM to make and receive mobile calls throughout Europe and in many other countries.

TMN provides GSM services in the 900 MHZ and 1800 MHZ band spectrums. TMN began to offer GSM 1800 services in May 1998 in addition to the GSM 900 service it already offered. TMN's strategy has been to use GSM 1800 services to offer an increased number of channels in high traffic

density areas. Dual-band handsets, which select available channels from each frequency band, enable users to benefit from the wider range of available channels.

TMN paid spectrum fees in 2002, 2003 and 2004 of €29 million, €30 million and €29 million, respectively, for the use of its 900 MHz and 1800 MHz GSM network. These spectrum fees are recorded as an operating expense under "taxes other than income taxes" in our financial statements.

At the end of 2000, the Portuguese government opened a tender for four licenses for third generation mobile services, also known as universal mobile telecommunications services, or UMTS. TMN received one of these licenses and paid an up-front fee of €100 million. Licenses were also awarded to Oniway, a new entrant in the Portuguese mobile market, Vodafone Portugal and Optimus. However, subsequent to an agreement with the other three mobile operators in Portugal, including TMN, Oniway decided not to participate in the provision of third generation mobile services and as a result requested that the Portuguese government repeal the license granted to it in December 2000. The Portuguese government granted this request by ministerial order on January 13, 2003. The other three recipients of third generation licenses, including TMN, requested that the additional frequency that had been allocated to Oniway be reallocated to them. This request was granted by a special ministerial order in January 2003. See "*Regulation Portugal Summary of Our Concession and Existing Licenses Third Generation Mobile Services Licenses*". Under the agreement entered into with Oniway referred to above, TMN, Vodafone Portugal and Optimus agreed to pay Oniway an amount of €33 million each for certain intangibles held by Oniway related to UMTS launch preparations upon the reallocation to them of the frequency that had been allocated to Oniway.

We expect the development of third generation services to require additional investments. TMN made direct investments of €12.4 million in 2001, €38 million in 2002, €67.2 million in 2003 and €51 million in 2004 in building out its third generation services. In 2004, the investments made by TMN in connection with UMTS represented more than 30% of its total capital expenditures in 2004.

ANACOM reviewed the situation regarding the availability of handsets and related software for UMTS services during the third quarter of 2002 and initially postponed the mandatory initiation of third generation services for all holders of UMTS licenses until December 31, 2003. In February 2004, ANACOM issued a decision requiring the initiation of third generation services in 2004. However, UMTS license holders were not required to initiate UMTS services commercially until June 30, 2004. On April 19, 2004, TMN became the first mobile operator to launch UMTS in Portugal, with a service that allows customers to make video calls. The 3G handsets function both on GSM/GPRS and UMTS, allowing customers to use all the voice, multimedia and data services already offered by TMN. For data access exclusively, TMN also offers a 3G access card. TMN is providing initial UMTS coverage in the largest cities in Portugal, and is in the process of expanding this coverage to cover the whole of Portugal.

During 2002, 2003 and 2004, TMN continued to introduce new products and services in Portugal, such as:

"Euro 2004TMN I9", the first pre-paid access to a wide range of services and contents (May 2004);

third generation video call centers and videomail;

the installation of UMTS networks in every town where the European football championship took place (May 2004);

"Travel Mate" and "City Guide", which are targeted at foreign users who visit Portugal (June 2004);

"MMS Funny" in partnership with Unisys, which allows customers to send pre-formed video multimedia messages and personalize them with the sender's voice;

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

"Wayfinder", a GPS based system;

DIX, a new solution for the visually impaired;

"TMN Multi" and "TMN Familiar", which offer discount packages to groups;

Wireless access protocol, or WAP, services, including "Bolsa on-line" (providing share price information), together with sapo.pt;

"MyTMN", personalized internet and data services which offer text messaging, WAP and voice-based services that can be customized by each subscriber;

the first SMS InterWorking agreement, an interconnection agreement (February 2002);

"DataXpress", a wireless data compressed transmission service using GPRS technology (April 2002);

first public demonstration of mobile video telephony service, using a UMTS network (May 2002);

corporate solutions to small office home office customers in partnership with pme.link;

MMS services, or multimedia messages, which combine picture and sound (May 2002);

GPRS roaming service, launched in partnership with Telefónica (April 2002);

"Spik" products, a mobile phone with a competitive package of minutes;

"Roaming Zone", a roaming service package for post paid customers;

"Biz Office", a mobile office service launched in 2003;

"K" services, including "Kolmi", a service whereby prepaid customers may send a free message asking the receiver to call back, "Karga", a service whereby prepaid customers may transfer credit from their mobile phones to other mobile phones and "Karga mesada," a service which allows customers to establish automatic monthly transfers from €5 to €25 to any pre-paid card (January 2004);

"Key user" services, providing on-line phone card management for TMN customers;

"I9-Inove", a multimedia mobile portal that provides faster, cheaper and easier access to a wide range of services and content and the ability to access e-mails from another mailbox;

"Pakots SMS", a pre-paid SMS package, and "SMS Express", offering competitive tariffs to customers who have high levels of SMS usage; and

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

the "Serie K" sub-brand for kids, which includes mobile handsets targeted to boys and girls from 10-15 years old.

Point-to-point, or P2P, messaging services via SMS or MMS continue to account for a significant portion of TMN's data revenues and is an area where TMN continues to experience significant growth, particularly through MMS, as MMS enabled handsets are made available to a larger number of customers. In addition, TMN offers a wide range of other services in its data service portfolio, such as a multimedia mobile portal (I9-Inove) and a standard mobile portal (My-TMN); multimedia content services, including Logos & Ring Tones or Java games; access to the content of third party brands; connectivity to e-mail or the Internet via GPRS/UMTS; corporate solutions; and mobile payment services.

In June 2003, TMN launched the multimedia portal I9-Inove, which optimizes the current capabilities of the GPRS/UMTS systems to provide customers with faster, easier access and a more attractive wide range of services and content, such as Java games; the three national free-to-air TV

channels; messaging services; goals from the Portuguese football league in video (which is exclusive to TMN); TV Cabo's programming guide; and the Lusomundo cinema ticketing service, the first m-commerce service in Portugal. As of December 31, 2004, I9-Inove had reached 333 thousand TMN customers. In addition, leveraging on the exclusive content for Portugal that we obtained by sponsoring the Euro 2004 Football Championship, TMN used I9-Inove to launch a large number of services surrounding the event, such as video downloads of goals and a tourist helpdesk. This event contributed significantly to roaming revenues in the second quarter of 2004.

TMN's range of offerings includes new services such as Logos & Ring Tones (also polyphonic), Multimédia Messaging (including the ability to send messages to customers of other operators), Java Games and My Message 4u (a service that allows customers to personalize the welcome message or other voice messages with music, dedications or jokes). A customer can also create his or her own MMS Album, with holiday souvenirs, cards and similar items.

TMN also offers a range of Internet access and multimedia services, such as Internet access service via Wi-Fi, GPRS and UMTS and the ability to receive or send a fax over a mobile handset. These services are available to every TMN subscriber, including users of all prepaid services and corporate customers.

TMN offers data services specifically focused on the corporate segment, such as SMS Express and the POS Mobile service. SMS Express allows users to send messages to a mailing list in a quick, automatic and easy form. POS Mobile is a service that allows TMN corporate clients to use POS (point of sale) mobile equipment to receive card payments (through debit or credit cards) at any place and with total security.

TMN offers an m-payment service called Telemultibanco that allows the payment of utility bills by mobile phone.

TMN also has a variety of third party services for SMS/MMS, Logos & Ring Tones and Java Games where TMN invoices its customers for the use of third party brand services and remits to such third parties a percentage of the total fees collected that corresponds to the content and services supplied by such parties.

TMN is also developing services in wireline to mobile convergence, such as a voicemail service that allows mobile telephone users to retrieve voicemail messages from their fixed-line telephones provided by PT Comunicações through mobile telephone handsets.

We expect data-service usage to grow considerably as customers become increasingly familiar with TMN data services, as service offerings are further expanded and as access speed is increased through the introduction of UMTS. We also expect higher data speeds to improve performance and the attractiveness of the TMN package of products, which we expect will result in a higher contribution of data services (beyond P2P messaging) to overall revenues in the future. One example of this growth potential is the recent launch of a video streaming service (12400 Video) that allows customers to see small videos over their mobile phones.

In June 2005, TMN introduced a virtual operator "Uzo" which is positioned commercially as an independent operator targeting low cost providers and using TMN's GSM network. Uzo offers a very simple service to its customers with no obligatory recharges and just one tariff for voice calls and SMSs to all networks of 16 cents and 8 cents per minute, respectively. Uzo will primarily focus on selling SIM cards but will also sell certain low cost mobile phones to its customers. Uzo's products and services will be offered through the Internet, Uzo's call centers (which are separate from TMN's call centers) and certain independent news stands and shops located throughout Portugal.

*Subscribers and Traffic.* TMN is the market leader in mobile services in Portugal. At December 31, 2004, TMN had approximately 5 million subscribers, representing an increase of 3%

from December 31, 2003. At December 31, 2004, TMN's subscribers represented 50.7% of the total mobile subscribers in Portugal. During 2004, TMN's share of new mobile subscribers (net additions) was 27.4%, according to ANACOM. Over the course of 2004, TMN's churn rate, which means the percentage of TMN mobile subscribers that ended their use of TMN's mobile services either by terminating their service or by changing their mobile handset and card number without terminating their existing TMN service, was 27.7%. TMN's churn rate was 23.5% in 2003.

In addition to the increase in the number of subscribers, mobile usage grew during 2004. TMN's voice traffic in terms of minutes grew by 5.9% to 7,148 billion minutes in 2004, compared to 6,752 billion minutes in 2003. Average monthly usage per subscriber decreased 1.7% to 121 minutes in 2004, compared to 123 minutes in 2003. In terms of traffic from data transmission services, SMS increased by 9.6% during 2004 and there was an average of 25.7 SMSs per month per user in 2004, 1.8% more than the average of 25.2 SMSs per month per user in 2003. Traffic from GPRS WAP services increased by 367% in 2004.

*Prices and Revenue Breakdown.* We believe that mobile services in Portugal are priced lower than the European average and are among the lowest in Europe. Mobile telephone charges are not regulated. Traffic charges, sales of handsets and connection and subscription fees represented approximately 88.5%, 9.3% and 2.2%, respectively, of TMN's revenues in 2004, and approximately 88.3%, 9.1% and 2.6%, respectively, of TMN's revenues in 2003. Since May 2003, monthly subscription fees have ranged from €10.00 to €39.96, excluding VAT. TMN no longer charges an initial connection fee. TMN has many different price plans for its mobile telephone services.

*Products and Marketing.* TMN offers a variety of innovative subscriber-oriented products. It was the first operator in the world to offer pre-paid services. TMN's prepaid and discount products have been popular. We estimate that at the end of 2004, approximately 83.4% of its subscribers were using TMN's prepaid products. In order to improve customer retention and segmentation, TMN redesigned its entire offer of prepaid pricing plans in 2004. Through its "TMN puts everything in black and white" marketing campaign, customers were informed about which pricing plan would best meet their needs. TMN has been expanding its subscriber base through increased advertising and the use of its own distribution network. TMN markets its services through more than 2100 points of sale, including TMN's sales forces, Portugal Telecom retail shops, TMN shops, supermarket chains and independent dealers. TMN has been trying to encourage the use of mobile services more broadly in the middle and high end of the market and to increase subscriber retention in this market segment. By focusing on the business segment of the market, TMN experienced an 8.1% increase in the number of postpaid subscribers in 2004.

*Network and Capital Investment.* In recent years, TMN has made significant investments in base stations throughout Portugal for its GSM 900 and GSM 1800 services. As a result of its investments, TMN has a technologically advanced high capacity network that provides extensive coverage across Portugal. As of the end of 2004, TMN's digital network had 3,964 base stations, including 95 base stations added during 2004. These stations covered more than 95% of continental Portugal and 98% of the Portuguese population. The addition of the GSM 1800 band has substantially increased TMN's network capacity in heavily used areas. By the end of December 2004, TMN had installed GSM 1800 technology in 809 base stations. TMN has also been making capital investments in the rollout of its UMTS network, which in 2004 represented more than 30% of total capital expenditures. UMTS coverage now extends to the largest cities in Portugal and is in the process of being expanded to cover the entire country.

*Roaming.* Roaming agreements between operators allow their subscribers to make and receive voice calls automatically, send and receive data, or access other services when traveling outside the geographical coverage area of the home network, by using a visited network. As of the end of 2004, TMN had entered into roaming agreements with a total of 277 operators (in 172 countries or regions);



50 of which are GPRS operators (in 32 countries or regions) and 9 of which are 3G operators (in 9 countries or regions). Since June 2002, as a result of the launch of GSM in Brazil, TMN subscribers have been able to use their own mobile handsets and a TMN SIM card to roam in Brazil.

*Equipment Sales.* TMN sells mobile phones and related equipment in Portugal. Equipment sales contributed €148.1 million, €138.5 million and €142.0 million to TMN's operating revenues in 2004, 2003 and 2002, respectively.

### **Brazilian Mobile Business**

Until 2002, our mobile operations in Brazil, a country with a population of about 177 million people, had been active only in the states of São Paulo, Paraná and Santa Catarina. On January 23, 2001, we entered into a strategic agreement with Telefónica Móviles to aggregate all of our combined mobile assets in Brazil to the extent permitted under Brazilian law. The strategic agreement was approved by the European Commission on March 13, 2001. ANATEL advised us in May 2001 that the joint venture could be formed provided that neither we nor Telefónica Móviles could transfer to the mobile joint venture company more than 19.99% of the ordinary shares with voting rights of the mobile service companies controlled by each of us in Brazil. This limitation was applicable until such time as the mobile service companies to be contributed to the mobile joint venture company migrated from the former SMC mobile services licensing regime to the SMP mobile services licensing regime. See " *Regulation Brazil.*" On December 10, 2002, ANATEL formally approved the migration of our Brazilian mobile subsidiaries from the SMC regime to the SMP regime and the transfer of all of our direct and indirect interests in Brazilian mobile services companies to the mobile joint venture company.

On December 27, 2002, PT Móveis, which holds our interests in Brazilian mobile services companies, and Telefónica Móviles transferred their direct and indirect interests in Brazilian mobile services companies to the joint venture company, operating under the brand name Vivo. Portugal Telecom and Telefónica Móviles transferred to Vivo all their interests in:

TCP, which controls Telesp Celular (the band A operator in the state of São Paulo), Global Telecom (the band B operator in the states of Paraná and Santa Catarina) and Tele Centro Oeste Celular Participações, S.A., or TCO (a band A operator in the Midwestern and Northern regions of Brazil), and was contributed by Portugal Telecom (which had a controlling position) and by Telefónica Móviles;

Tele Sudeste Celular Participações, S.A., which controls Telerj Celular, S.A. (the band A operator in the state of Rio de Janeiro) and Telest Celular, S.A. (the band A operator in the state of Espírito Santo), and was contributed by Telefónica Móviles;

Tele Leste Celular Participações, S.A., which controls Telebahia Celular, S.A. (the band A operator in the state of Bahia) and Telergepe Celular, S.A. (the band A operator in the state of Sergipe), and was contributed by Telefónica Móviles; and

Celular CRT Participações, S.A., which controls CRT Celular, S.A. (the band A operator in the state of Rio Grande de Sul), and was contributed by Telefónica Móviles (which had a controlling position) and by us.

Vivo is the leading mobile company in Brazil, with a total of 26.5 million active mobile telephones at December 31, 2004. The joint venture operates in 19 states in Brazil and in the Federal district of Brasília, which provide more than 83% of Brazil's GDP. In its areas of operation, Vivo had an estimated market share in its areas of operations of approximately 50.9% at the end of 2004. We believe that the joint venture facilitates our ability to serve our Brazilian subscribers on a seamless basis throughout Brazil. We believe the joint venture enables us to benefit from synergies in various areas, including marketing, promotional activities, distribution networks, call center management, network

management and operations, information technology, procurement and support functions, as well as the deployment of new mobile data services for business users. We believe that the joint venture also enables us to respond more effectively to increased competition from existing operators, such as Telecom Itália Móbiles, Telecom Americas, Oi and Brasil Telecom, and from other mobile operators in the markets we serve.

We have described the arrangements by which we and Telefónica Móviles own and manage the joint venture and related issues below in "*Strategic Alliances Alliance with Telefónica*". We have described certain regulatory restrictions applicable to Vivo and its subsidiaries which result from their relationship with Telefónica, including the inability of Vivo and its subsidiaries to provide wireline long distance services in Brazil, below in "*Regulation Brazil SMP Regulation*". See also "*Item 3 Key Information Risk Factors The Conditions Applying to Vivo's Subsidiaries Under the SMP Licensing Regime May Result in Reducing Our Revenues and Results of Operations*".

Although we transferred all of our interests in mobile telecommunications companies in Brazil to Vivo on December 27, 2002, our consolidated statements of income and cash flows for the year ended December 31, 2002 continued to fully consolidate TCP's results. However, our balance sheet as of December 31, 2002 proportionally consolidates all the assets and liabilities of Vivo. Both our consolidated statements of income and cash flow for the years ended December 31, 2003 and 2004 and our balance sheet as of December 31, 2003 and 2004 proportionally consolidate the results of Vivo.

On December 27, 2002, TCP purchased the remaining 51% of the voting shares of Global Telecom. In our consolidated statements of income and cash flows for the year ended December 31, 2002, we continued to account for the results of operations of Global Telecom based on the equity method of accounting. However, TCP's balance sheet as of December 31, 2002, fully consolidates all the assets and liabilities of Global Telecom and accordingly our balance sheet proportionally consolidates all the assets and liabilities of Global Telecom. Both our consolidated statements of income and cash flows for the years ended December 31, 2003 and 2004 and our balance sheet as of December 31, 2003 and 2004 proportionally consolidate the results of Global Telecom. See "*TCP and Telesp Celular*" and "*Global Telecom*", below.

On April 25, 2003, TCP acquired a controlling interest in TCO. As a result, TCO's assets and liabilities as of December 31, 2003 and December 31, 2004 are reflected in our consolidated balance sheets for these years through our proportional consolidation of Vivo, and TCO's income and cash flows from May through December 2003 and for the year ended December 31, 2004 are reflected in our consolidated statements of income and cash flows for the year ended December 31, 2003 and for the year ended December 31, 2004, respectively, through our proportional consolidation of Vivo's statements of income and cash flows. In October 2004, TCP successfully completed a tender offer for additional shares of TCO, thereby increasing its economic interest in TCO to 50.6%, for a total consideration of approximately R\$902 million. See "*TCP and Telesp Celular*" and "*TCO*" below.

In October 2004, Avista, a holding company owned by Vivo, was created for the purpose of acquiring additional interests in Vivo's operating companies. On October 8, 2004, Avista conducted a tender offer for shares of Tele Sudeste, Tele Leste and CRT Celular. As a result of the successful completion of the tender offer, Vivo increased its interest in Tele Sudeste to 90.9%, in Tele Leste to 50.6% and in CRT Celular to 67.0%, for a total of approximately R\$607 million.

The diagram below presents, in a simplified way, the ownership structure of Vivo:

---

\*  
These percentages correspond to the proportion of voting shares owned, directly or indirectly, by Brasilcel.

*Regions.* Vivo provides telecommunications services in Brazil through the following subsidiaries and in the regions described below:

Telesp Celular provides mobile telecommunications services on band A in the state of São Paulo, covering approximately 248,209 square kilometers, representing approximately 2.9% of Brazil's territory. This area includes more than 40.1 million people, representing 21.9% of Brazil's population, and 63 municipalities with populations in excess of 100,000 people, including the City of São Paulo, Brazil's largest city, with more than ten million people.

Global Telecom provides mobile telecommunications services on band B in the states of Paraná and Santa Catarina, covering 80% of its authorization areas.

Tele Sudeste provides mobile telecommunication services on band A in the states of Rio de Janeiro and Espírito Santo, covering 97% of the population of its authorization areas.

Tele Leste provides mobile telecommunication services on band A in the states of Bahia and Sergipe, covering 68% of the population of its authorization areas.

CRT Celular provides mobile telecommunication services on band A in the state of Rio Grande do Sul, covering 96% of the population of its authorization area.

TCO provides mobile telecommunications services in Brazil's Federal District and in 11 Brazilian states, including Acre, Goiás, Tocantins, Mato Grosso, Mato Grosso do Sul and Rondônia on band A and Pará, Amazonas, Amapá, Roraima, and Maranhão on band B. These areas are composed of 5.8 million kilometers and 33.5 million people and 34 municipalities with populations in excess of 100,000 people, representing 68.0% of Brazil's territory and 18.9% of Brazil's population.



*TCP and Telesp Celular*

|   | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| <b><i>Telesp Celular Operating information</i></b>                  |             |             |             |
| Cellular lines in service at year-end (in thousands)                | 6,060       | 7,495       | 9,232       |
| Customer growth during year   | 18.7%       | 23.7%       | 23.2%       |
| Prepaid lines in service at year-end (in thousands)                 | 4,634       | 6,020       | 7,629       |
| Churn(1)  | 17.0%       | 22.7%       | 18.9%       |
| Estimated population of authorization area at year-end (million)(2) | 38.3        | 39.0        | 40.1        |
| Estimated covered population at year-end (millions)(3)              | 37.2        | 38.4        | 39.3        |
| Net operating revenues (in millions of Reais)                       | 3,415.0     | 3,993.2     | 4,329.0     |
| Percentage of population covered(4)                                 | 97.0%       | 98.0%       | 98.0%       |
| Penetration at year-end(5)  | 23.8%       | 30.3%       | 42.7%       |
| <b><i>TCP Financial information(6)</i></b>                          |             |             |             |
| Net operating revenues (in millions of Reais)                       | 3,415.0     | 6,046.3     | 7,341.0     |
| Net Income (loss)(in millions of Reais)                             | (1,140.8)   | (640.2)     | (490.1)     |
| Total assets (in millions of Reais)                                 | 10,202.0    | 13,546.5    | 14,226.3    |

- (1) Churn is the number of customers that leave Telesp Celular during the year, calculated as a percentage of the simple average of customers at the beginning and the end of the year.
- (2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".
- (3) Number of people within the region that can access the cellular telecommunications signal.
- (4) Percentage of the population in the region that can access the cellular telecommunications signal.
- (5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.
- (6) Data taken from TCP's consolidated financial statements prepared under Brazilian GAAP, which include (i) the results of Global Telecom for 2002 recorded by the equity method of accounting and Global Telecom's income and cash flows for 2003 and 2004 fully consolidated and (ii) TCO's income and cash flows from May through December 2003 and for the year ended December 31, 2004 fully consolidated.

Telesp Celular is part of our mobile joint venture with Telefónica and is 100% owned by TCP. Telesp Celular is the leading mobile telephone operator in the Brazilian state of São Paulo. São Paulo has a population of approximately 40.1 million people and is the most economically developed state in Brazil. The state of São Paulo contributes 32.6% of Brazil's GDP. As of December 31, 2004, mobile penetration in the state of São Paulo was 43%, compared to an average of almost 37% in Brazil. Telesp Celular contributed R\$4,329.0 million, \$3,993.2 million and R\$3,415.0 million to our mobile operating revenues in 2004, 2003 and 2002, respectively.

On March 11, 2002, TCP announced its intention to undertake an overall capital increase of its common and preferred shares, including preferred shares underlying its ADSs. As part of this overall capital increase, TCP offered holders of its preferred shares rights to subscribe for new preferred shares, holders of its ADSs rights to subscribe for new ADSs and holders of its common shares rights to subscribe for new common shares. TCP successfully completed its rights offering in September 2002, which generated proceeds of R\$2,403 million.

Portugal Telecom subscribed to a total of 247,224 million common shares and 326,831 million preferred shares in this rights offering. As a result, as of September 2002, we owned 93.7% of TCP's common shares and 49.8% of TCP's preferred shares, representing an economic interest of 65.12%. In



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

October 2002, in connection with the formation of the joint venture, we sold a 14.68% stake in TCP to Telefónica Móviles, reducing our economic interest in TCP to 50.44%. On December 27, 2002, we transferred the rest of our interest in TCP to Vivo. We now hold our interest in TCP, as well as our interest in the other mobile services companies that were transferred to Vivo, indirectly, on a 50/50 basis with Telefónica Móviles.

In February and July 2001, TCP acquired an 81.61% indirect economic interest in Global Telecom, through the acquisition of 49% of the voting shares and 100% of the non-voting shares of each of three holding companies that controlled Global Telecom. The total purchase price was R\$902.6 million. On December 11, 2002, after all of the TCP operators had switched over to the new SMP regulatory licensing regime, ANATEL approved TCP's acquisition of the remainder of the shares and, on December 27, 2002, TCP acquired the remaining 51% of the voting shares of the three holding companies that owned Global Telecom for US\$82.0 million. TCP now owns 100% of the voting and non-voting shares of Global Telecom.

On April 25, 2003, TCP acquired 61.1% of TCO's voting capital stock from the Brazilian company, Fixcel. The purchase price was R\$1,529 million, which corresponded to R\$19.5 per each lot of 1,000 common shares acquired. On November 18, 2003, TCP acquired an additional 25.5% of the common shares of TCO in a tender offer to TCO minority shareholders for R\$538.8 million. Following the tender offer, TCP held 86.6% of the voting capital stock and 28.9% of the total capital stock of TCO, including treasury shares held by TCO. On October 31, 2003, TCP attempted to acquire the remaining share capital of TCO by means of a merger of TCO shares into TCP shares. The exchange ratio was fixed at 1.27 TCP shares for each TCO share held. This merger was cancelled on January 12, 2004 following the issuance of an opinion by the Brazilian Securities and Exchange Commission that the merger did not fully comply with current Brazilian law. On October 8, 2004, TCP acquired an additional interest in TCO through a tender offer whereby it increased its ownership interest in TCO to 90.22% of TCO's voting capital stock, excluding treasury shares, and 50.65% of its total capital stock for approximately R\$902 million.

### *Global Telecom*

|  | 2002    | 2003    | 2004    |
|--|---------|---------|---------|
| Cellular lines in service at year-end (in thousands)                 | 1,176   | 1,691   | 2,579   |
| Customer growth during year  | 36.5%   | 43.7%   | 52.5%   |
| Prepaid lines in service at year-end (in thousands)                  | 924     | 1,411   | 2,281   |
| Churn(1)   | 20.0%   | 19.4%   | 13.7%   |
| Estimated population of authorization area at year-end (millions)(2) | 15.3    | 15.6    | 16.0    |
| Estimated covered population at year-end (millions)(3)               | 11.0    | 11.9    | 12.8    |
| Percentage of population covered(4)                                  | 74%     | 76%     | 80%     |
| Penetration at year-end(5)   | 19%     | 24%     | 39.8%   |
| Net operating revenues (in millions of Reais)(6)                     | 512.2   | 669.0   | 801.5   |
| Net Income (in millions of Reais)(6)                                 | (771.1) | (436.0) | (180.3) |
| Total assets (in millions of Reais)(6)                               | 2,383.6 | 2,130.2 | 2,242.2 |

- (1) Churn is the number of customers that leave Global Telecom during the year, calculated as a percentage of the simple average of customers at the beginning and the end of the year.
- (2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".
- (3) Number of people within the region that can access the cellular telecommunications signal.
- (4) Percentage of the population in the region that can access the cellular telecommunications signal.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

(5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.

(6) Data taken from financial statements prepared under Brazilian GAAP.

Under the terms of Global Telecom's authorization from ANATEL, it operates in the states of Paraná and Santa Catarina. These two states have a combined population of approximately 16.0 million and together generate approximately 10% of Brazil's gross domestic product. As of December 31, 2004, mobile phone penetration in Global Telecom's authorization areas was 39.8%, as compared with an average of almost 37% in Brazil. As of December 31, 2004, Global Telecom had 2,579 thousand subscribers, representing an estimated market share of 42%, as compared to 45% at year end 2003. Global Telecom has been making significant investments to expand the coverage of its network service, to offer mobile data services with potential speeds of up to 14.4 kb per second and to launch Evolution Data Optimized, or EV-DO, in the city of Curitiba, featuring data transmission speeds of up to 2.4 megabits per second (Mbps).

### *Tele Sudeste*

|  | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|--|-------------|-------------|-------------|
| Cellular lines in service at year-end (in thousands)                 | 3,455       | 3,709       | 4,377       |
| Customer growth during year  | 14.1%       | 7.4%        | 18.0%       |
| Prepaid lines in service at year-end (in thousands)                  | 2,368.2     | 2,552       | 3,117       |
| Churn(1)   | 18.2%       | 30.6%       | 31.3%       |
| Estimated population of authorization area at year-end (millions)(2) | 18.0        | 18.1        | 18.7        |
| Estimated covered population at year-end (millions)(3)               | 15.8        | 17.4        | 18.1        |
| Percentage of population covered(4)                                  | 87.4%       | 96.0%       | 96.8%       |
| Penetration at year-end(5)   | 32.7%       | 41.0%       | 49.7%       |
| Net operating revenues (in millions of Reais)(6)                     | 1,847.6     | 1,892.5     | 1,927.0     |
| Net Income (in millions of Reais)(6)                                 | 140.4       | 156.2       | 92.9        |
| Total assets (in millions of Reais)(6)                               | 2,793.8     | 2,824.7     | 2,899.1     |

(1) Churn is the number of customers that leave Telerj Celular and Telest Celular, taken together, during the year, calculated as a percentage of the simple average of customers at the beginning and the end of the year.

(2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".

(3) Number of people within the region that can access the cellular telecommunications signal.

(4) Percentage of the population in the region that can access the cellular telecommunications signal.

(5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.

(6) Data taken from financial statements prepared under Brazilian GAAP.

Tele Sudeste Celular Participações, or Tele Sudeste, holds 100% of Telerj Celular, the leading mobile telephone operator in the state of Rio de Janeiro, and 100% of Telest Celular, the leading mobile operator in the state of Espírito Santo. These states have a combined population of approximately 18.7 million people and together contribute around 14% of Brazil's GDP. As of December 31, 2004, mobile penetration in Tele Sudeste's authorization areas was 49.7%, compared to an average of almost 37% in Brazil. At December 31, 2004, Telerj Celular and Telest Celular had approximately 4,377 thousand cellular lines in service, of which approximately 3,117 thousand were



prepaid. Tele Sudeste's consolidated operating revenues were R\$1,927 million in 2004, R\$1,893 million in 2003 and R\$1,848 million in 2002.

*Tele Leste*

|   | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Cellular lines in service at year-end                               | 973         | 1,126       | 1,321       |
| Customer growth during year   | 18.3%       | 15.8%       | 17.3%       |
| Prepaid lines in service at year-end                                | 673         | 835         | 1,028       |
| Churn(1)  | 25.5%       | 34.3%       | 35.3%       |
| Estimated population of authorization area at year-end (million)(2) | 15.1        | 15.4        | 15.5        |
| Estimated covered population at year-end (million)(3)               | 9.5         | 10.5        | 10.5        |
| Percentage of population covered(4)                                 | 63%         | 68%         | 68%         |
| Penetration at year-end(5)  | 10.6%       | 13.4%       | 20.1%       |
| Net operating revenues (in millions of Reais)(6)                    | 431.4       | 441.3       | 487.0       |
| Net Income (loss) (in millions of Reais)(6)                         | (5.1)       | (42.7)      | (34.2)      |
| Total assets (in millions of Reais)(6)                              | 956.7       | 835.8       | 955.0       |

- (1) Churn is the number of customers that leave Telebahia Celular and Telergipe Celular during the year calculated as a percentage of the simple average of customers at the beginning and the end of the year.
- (2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".
- (3) Number of people within the region that can access the cellular telecommunications signal.
- (4) Percentage of the population in the region that can access the cellular telecommunications signal.
- (5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.
- (6) Data taken from the financial statements prepared under Brazilian GAAP.

Tele Leste Celular Participações, or Tele Leste, holds 100% of Telebahia Celular, the leading mobile telephone operator in the state of Bahia and 100% of Telergipe Celular, the leading mobile operator in the state of Sergipe. These states have a combined population of approximately 15.5 million people and together contribute around 5% of Brazil's GDP. As of December 31, 2004, mobile penetration in Tele Leste's authorization areas was 20.1%, compared to almost 37% in Brazil. At December 31, 2004, Tele Leste had approximately 1,321 thousand cellular lines in service, of which approximately 1,028 thousand were prepaid. Tele Leste's operating revenues were R\$487 million in 2004, R\$441 million in 2003 and R\$431 million in 2002.

*CRT Celular*

|  | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|--|-------------|-------------|-------------|
| Cellular lines in service at year-end (in thousands)                 | 2,078       | 2,523       | 3,215       |
| Customer growth during year  | 16.4%       | 21.4%       | 27.4%       |
| Prepaid lines in service at year-end (in thousands)                  | 1,466       | 1,836       | 2,427       |
| Churn(1)   | 16%         | 21%         | 20%         |
| Estimated population of authorization area at year-end (millions)(2) | 10.5        | 10.6        | 10.7        |
| Estimated covered population at year-end (millions)(3)               | 8.6         | 10.2        | 10.3        |
| Percentage of population covered(4)                                  | 82%         | 96%         | 96%         |
| Penetration at year-end(5)   | 30%         | 39%         | 55%         |
| Net operating revenue (in millions of Reais)(6)                      | 896.3       | 1,032.7     | 1,174.3     |
| Net Income (in millions of Reais)(6)                                 | 147.6       | 189.4       | 182.0       |
| Total assets (in millions of Reais)(6)                               | 1,678.7     | 1,739.5     | 1,922.1     |

- (1) Churn is the number of customers that leave CRT Celular during the year, calculated as a percentage of the simple average of customers at the beginning and the end of the year.
- (2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".
- (3) Number of people within the region that can access the cellular telecommunication signal.
- (4) Percentage of the population in the region that can access the cellular telecommunication signal.
- (5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.
- (6) Data taken from financial statements prepared under Brazilian GAAP.

CRT Celular is the leading mobile telephone operator in the state of Rio Grande do Sul. The state of Rio Grande do Sul has a population of approximately 10.7 million people and contributes around 8% of Brazil's GDP. As of December 31, 2004, mobile penetration in CRT Celular's authorization area was 55%, compared to almost 37% in Brazil. At December 31, 2004, CRT Celular had approximately 3,215 thousand cellular lines in service, of which approximately 2,427 thousand were prepaid. CRT Celular's operating revenues were R\$1,174 million in 2004, R\$1,033 million in 2003 and R\$896 million in 2002.

**TCO**

|  | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|--|-------------|-------------|-------------|
| Cellular lines in service at year-end (in thousands)                 | 3,067       | 4,112       | 5,820       |
| Customer growth during year  | 27.2%       | 34.1%       | 41.6%       |
| Prepaid lines in service at year-end (in thousands)                  | 2,207       | 3,162       | 4,875       |
| Churn(1)   | 20.5%       | 23.8%       | 23.4%       |
| Estimated population of authorization area at year-end (millions)(2) | 31.2        | 31.8        | 33.5%       |
| Estimated covered population at year-end (millions)(3)               | 23.0        | 24.2        | 25.8        |
| Percentage of population covered(4)                                  | 74%         | 76%         | 77%         |
| Penetration at year-end(5)   | 16.3%       | 23.3%       | 34.8%       |
| Net operating revenues (in millions of Reais)(6)                     | 1,572.1     | 1,958.9     | 2,210.4     |
| Net Income (in millions of Reais)(6)                                 | 329.2       | 463.4       | 507.1       |
| Total assets (in millions of Reais)(6)                               | 2,364.7     | 2,654.2     | 3,595.7     |

- (1) Churn is the number of customers that leave the mobile operating subsidiaries of TCO during the year, calculated as a percentage of the simple average of customers at the beginning and the end of the year.
- (2) Projections based on estimates of the Instituto Brasileiro de Geografia e Estatística IBGE and Target 2002 "Brasil em Foco".
- (3) Number of people within the region that can access the cellular telecommunications signal.
- (4) Percentage of the population in the region that can access the cellular telecommunications signal.
- (5) Number of cellular lines in service in the region, including competitors, divided by the population of the region.
- (6) Data taken from financial statements prepared under Brazilian GAAP.

Certain mobile operating subsidiaries of TCO use a frequency range known as band A that covers 50% of the municipalities in the Brazilian states of Acre, Distrito Federal, Goiás, Mato Grosso, Mato Grosso do Sul, Rondônia and Tocantins and 89% of the population of those states. Another mobile operating subsidiary uses a frequency range known as band B that covers 28% of the municipalities in the Brazilian states of Amazonas, Amapá, Maranhão, Pará and Roraima and 65% of the population of those states. At December 31, 2004, the mobile operating subsidiaries of TCO had 5,820 thousand cellular lines in service, which represented a 41.6% net increase from December 31, 2003, and a market share of approximately 51.5% in the states in which it operates.

*Services.* Vivo provides mobile telecommunications services using both digital and analog technologies. Vivo's network provides both CDMA digital service and AMPS, or analog services, through TCP, Tele Sudeste and Tele Leste. TCO and CRT Celular provide mobile telecommunications services using CDMA/TDMA digital technology and AMPS analog technology. All Vivo's services are provided in the 850 MHz frequency range.

Vivo offers voice service, ancillary services, including voicemail and voicemail notification, call forwarding, three-way calling, caller identification, short messaging, limitation on the number of used minutes, mobile chat room, and data services, such as WAP, through which clients can access WAP sites and portals. At December 31, 2004, approximately 50% of Vivo's total subscribers already had WAP-enabled handsets. Vivo offers high speed data services that (i) provide direct access to the Internet through either PCMCIA cards designed to connect compatible PDA's and laptops to 2.5G service or through 2.5G mobile phones by cable connection and (ii) offer corporate subscribers secure access to their intranet and office resources.

In 2003, Vivo launched MMS and MExE (Mobile Execution Environment) that enable customers to download and execute applications through their mobile handsets. Also, Vivo launched a user-friendly interface, with icons on individual mobile handsets that identify the main services provided, such as Voice Mail, Downloads and SMS.

In 2004, Vivo launched creative services, such as locating services, virtual games and videostreaming. Vivo also made initial investments toward the development, and launch in Curitiba, of EV-DO, making it possible to offer third generation extra-high speed services featuring data transmission speeds of up to 2.4 Mbps.

Vivo offers roaming services through agreements with local mobile service providers throughout Brazil and other countries that allow its subscribers to make and receive calls while out of its concession areas. Vivo also provides reciprocal roaming services to subscribers of those mobile service providers while they are in its concession areas. See " *Roaming*".

*Subscribers and Traffic.* At the end of 2004, there were approximately 65.6 million wireless subscribers in Brazil, and there was an estimated market penetration rate of approximately 37% in the areas where Vivo operates. In 2004, the Brazilian market experienced a 42% increase in the number of wireless subscribers and a 41% increase in those areas where Vivo operates. The greatest increase in subscribers was in the Brazilian states of São Paulo, Rio de Janeiro, Rio Grande do Sul and the Cento Oeste region. As of December 31, 2004, Vivo had approximately 26.5 million wireless subscribers, with an estimated market share of 50.9% in its areas of operation and 40.5% in Brazil.

The subscriber growth in Vivo's operating companies was supported by the launch of new products and services, including prepaid products and new messaging services, the growth of the digital capacity of the network, the improvement in CRM systems, marketing campaigns and promotions, and the restructuring and expansion of sales networks.

*Marketing.* Vivo closely follows developments in the markets where it operates and often launches new segment-specific promotions through direct marketing, including mailing and telemarketing campaigns, as well as promotions to its competitors' major customers. Efforts to acquire new customers for the pre-paid and post-paid services were mostly made through voice and data services promotions designed to increase on-net traffic and stimulate the use of data services. With the simultaneous goal of maintaining its existing customer base, Vivo's promotions were also open to existing customers who wanted to change their mobile handsets. Vivo's operators were actively involved in a high-value customer loyalty program, offering competitive discounts on mobile phones through direct marketing actions.

*Customer Service.* As part of its strategy to standardize customer service provided by Vivo's operators, Vivo has outsourced 100% of its customer service while maintaining full management control. Customer service is available on a 24-hour basis from Vivo's call centers and through its website.

Customer satisfaction is evaluated regularly. In 2004, more than 10,000 Vivo customers were interviewed across Brazil to gather their opinions about customer assistance, technical assistance, products and services. Vivo's average overall satisfaction mark was 8.3 on a scale of 1 to 10. Vivo continues to search for ways to increase customer satisfaction.

Vivo has trained or qualified staff to assist and provide explanations to customers in connection with any requests or doubts they may have concerning services provided. Vivo attempts to respond to all customer requests.

Vivo's operating companies were ranked first in 2003 and 2004 in a nationwide survey conducted by the IBRC (Brazilian Institute of Customer Relations) entitled "Companies that Most Respect

Consumers", the results of which were published in the *Consumidor Moderno* (Modern Consumer) magazine.

*Network and Capital Expenditures.* Vivo's networks are connected primarily through fiber-optic transmission systems leased from incumbent wireline operators in the areas in which it operates, consisting of mobile switches, base stations and other network elements, such as voicemail, prepaid service, Short Message Service, Home Location Registers, Signaling Transfer Point, PDSN and gateways. Vivo's main suppliers are NEC do Brasil S.A., Nortel Networks, Motorola do Brasil Ltda., Lucent Technologies do Brasil, Ind. e Com. Ltda. and Ericsson Telecomunicações S.A.

Vivo's operating subsidiaries' networks use analog and digital technology. Digitalization offers certain advantages, such as greater network capacity and additional revenue through the sale of value-added services. Digital mobile telecommunications service also reduces the risk of fraud. Vivo continues to increase network capacity and coverage to improve the quality of service and to meet customer demand.

At December 31, 2004, Telesp Celular's telecommunications network, which provides both CDMA digital and AMPS analog services, covered 79.6% of the municipalities in the state of São Paulo, or 98.0% of the population, in its authorization area.

Global Telecom only offers services through CDMA digital technology. At December 31, 2004, Global Telecom's telecommunications network covered 42.34% of the municipalities, or 80.44% of the population, in its authorization areas.

At December 31, 2004, Tele Sudeste's telecommunications network, which provides CDMA digital and AMPS analog services, covered 100% of the municipalities, or 96.77% of the population, in its authorization areas.

At December 31, 2004, Tele Leste's telecommunications network, which provides CDMA digital and AMPS analog services, covered 31.30% of the municipalities, or 67.85% of the population, in its authorization areas.

At December 31, 2004, CRT Celular's telecommunications network, which provides CDMA digital, TDMA digital and AMPS analog services, covered 68.0% of the municipalities, or 96.0% of the population, in its authorization areas.

At December 31, 2004, TCO's telecommunications network, which provides CDMA digital, TDMA digital and AMPS analog services, covered 40.37% of the municipalities, or 76.51% of the population, in its authorization areas.

Vivo's advanced network management technology ensures global management and supervision of all its network processes and network performance. The network management centers are located in São Paulo, Brasília, Rio de Janeiro, Salvador and Porto Alegre. The São Paulo network management center monitors the critical network operational parameters of Telesp Celular and Global Telecom. The Brasília network management center monitors such parameters for TCO, as does the Rio de Janeiro center for Tele Sudeste, the Salvador center for Tele Leste and the Porto Alegre center for CRT Celular. These centers are able to identify abnormalities in Vivo's networks and in third-party networks, using the failure and signal monitoring systems. In addition, quality and service standards are constantly monitored. The network management centers are integrated with the maintenance and operations teams that maintain and operate the mobile networks, and with the mobile infrastructure and transmission teams, radio network elements, computing bases, service platforms and communications backbone. Vivo's network is prepared to provide continuity of service for its customers in the event of network interruptions. Vivo has developed contingency plans relating to catastrophes in its switching centers, power supply interruptions and security breaches. In 2004, Vivo created a data process unit and

initiated the consolidation of IT platforms, which are helping to improve efficiency and economies of scales across the company.

Vivo's capital expenditures over the past three years related primarily to increasing network capacity and coverage. During the year ended December 31, 2004, Vivo's capital expenditures totaled R\$1,924 million and were mainly related to projects for the improvement and expansion of Vivo's service capacity, the selective implementation of the 1xRTT network, which was overlaid on TCO's and CRT Celular's TDMA networks, the upgrading of Tele Sudeste's, Tele Leste's and Global Telecom's networks to 1xRTT, the offering of new services, the development of a backbone and systems integration at Vivo, and on various consulting projects. Capital expenditures represented 17.6% of Vivo's operating revenues in 2004 as compared to 11.4% in 2003. Vivo's capital expenditures for 2003 and 2002 were R\$1,147 million and R\$888 million, respectively.

*Interconnection Charges.* With the introduction of personal mobile services through the SMP licensing regime in Brazil, Vivo's operators began working as local operators. This means that each operator is responsible for the traffic originated in its authorization area. Calls placed between authorization areas must use a long distance carrier. As a result, for every call in Vivo's authorization areas, Vivo receives a fee for the use of its network in respect of calls originated on its network. For long distance calls terminated on Vivo's network, Vivo receives a fee from the respective long distance carrier for the use of Vivo's network, regardless of the network that originated the call. For long distance calls between authorization areas originated on Vivo's network, Vivo also receives a fee from the long distance carrier for the use of its network for call origination. Vivo earns revenues from any local call that originates from another mobile or fixed-line service provider's network, which connects to one of Vivo's customers. Vivo charges the service provider from whose network the call originates a network usage charge for every minute that Vivo's network is used in connection with the call. See " *Regulation Brazil*".

In February 2003 and again in February 2004, ANATEL authorized all Vivo's operating companies to increase their tariffs per minute. Mobile operating companies are now obligated to grant a 30% discount during off peak hours on certain tariffs for local calls originating with Telesp Fixa (in the case of Telesp Celular), Brasil Telecom and Sercomtel (in the case of Global Telecom), Brasil Telecom (in the case of TCO and CRT Celular), and Telemar (in the case of Tele Sudeste and Tele Leste).

*Roaming.* Vivo has agreements providing for automatic roaming with all mobile CDMA/TDMA service providers in Brazil and with some wireless service operators abroad. These contracts allow its subscribers to access the network of other mobile service providers when traveling outside its coverage area without having to change their handsets or mobile numbers. Vivo provides reciprocal services to subscribers of other mobile service providers when they are within its coverage area. The agreements require the contracting parties to provide service to roaming subscribers on the same basis as they provide service to their own subscribers. Roaming charges are reconciled monthly.

Vivo offers automatic international roaming in Argentina, Uruguay, Chile, the Dominican Republic and South Korea and through third-party partners in the United States, Mexico, Canada and Japan. Vivo also provides international GSM services through the use of GSM handsets in most parts of Europe, Africa, Asia and Oceania.

*License.* Under the SMP regime, Vivo converted its former concessions to SMP licenses. These SMP licenses have substantially the same terms and conditions as the other SMP licenses issued under the SMP regime, although some of the terms of Vivo's former concessions, such as limits on prices charged to subscribers under its postpaid service plan (the Basic Plan), continue to apply despite conversion to SMP licenses. Conversion to SMP licenses offers Vivo greater flexibility in setting its prices, particularly its interconnection fees. Under the new EU regulatory framework, which is expected

to be applied in Portugal during 2005, interconnection fees will be primarily determined by commercial negotiations between operators. See "*Regulation Brazil SMP Regulation*".

By converting its concessions to SMP licenses, Vivo was required to introduce carrier selection on its network to give its subscribers the choice to use another carrier for long distance and international calls. The introduction of carrier selection increased the competitive pressures on Vivo's business. In addition, because the SMP regime permits commercial negotiation of the interconnection rates it charges to wireline operators, Vivo may be forced to reduce these rates in the future. Vivo's SMP licenses expire on the same dates as the concessions were to have expired. Vivo has the same right to apply for renewal as other SMP license holders that migrate to the SMP regime from their existing concessions.

*Bill and Keep.* Under the SMP system, usage of the network remuneration between SMP mobile operators will only be due if traffic carried in the same registration area between two networks, in a given direction, exceeds 55% of the total traffic exchanged between them (a partial Bill and Keep regime). In this case, only those calls which have surpassed the 55% threshold will be subject to payment for network usage. This rule was meant to be valid until June 30, 2005, after which a full Bill and Keep regime was expected to be applied whereby no remuneration would be due for network usage among SMP mobile operators, regardless of the amount of carried traffic. However, ANATEL has not yet decided on the interconnection regime applicable after June 30, 2005. See "*Item 3 Key Information Risk Factors The Conditions Applying to Vivo's Subsidiaries Under the SMP Licensing Regime May Result in Reducing Our Revenues and Results of Operations.*"

*Equipment Sales.* Although Vivo still has some subscribers using analog service (approximately 0.5% of TCP subscriber base, 0.3% of TCO, 0.9% of Tele Sudeste, 1.2% of CRT Celular and 3.0% of Tele Leste at December 31, 2004), it has implemented a series of actions, such as providing discounts on digital handsets, discounts on monthly fees for digital services, digital handset rentals and free digital handsets to its high-value subscribers, to encourage remaining analog subscribers to migrate to digital service. Vivo's net revenues from sales of handsets and accessories were R\$2.3 billion in 2004 and R\$1.9 billion in 2003.

*Management.* TCP's Board of Directors has eleven members, five elected by Portugal Telecom, five by Telefónica and one elected by minority shareholders, in accordance with Brazilian corporate law. Tele Sudeste, CRT Celular and TCO each have ten members on their Boards of Directors, five elected by Portugal Telecom and five by Telefónica. Tele Leste has twelve members on its Board of Directors, five elected by Portugal Telecom, five by Telefónica and two by minority shareholders. Portugal Telecom elects the Chief Executive Officer and Telefónica elects the Chief Financial Officer of Vivo.

## **Multimedia Business**

We provide multimedia services in Portugal through our subsidiary PT Multimédia and its subsidiaries. PT Multimédia and its subsidiaries contributed €729.8 million, €684.3 million and €622.8 million to our multimedia business operating revenues in 2004, 2003 and 2002, respectively.

*Formation and Development.* Portugal Telecom formed PT Multimédia in July 1999 and transferred to the new company certain of its cable and satellite pay-TV activities, as well as its Internet-related activities focused on residential customers and the small office home office and small- and medium-sized enterprise markets, including:

our cable television pay-TV operations through cable and DTH satellite;

cable and direct-to-home satellite programming activities;

the provision of Internet access; and

our minority stake in the leading Portuguese telephone directories business.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

After an initial public offering of ordinary shares of PT Multimédia in November 1999, PT Multimédia's shares are now traded publicly. During the course of 2002 and 2003, we acquired 2.43% and 1.08%, respectively, of PT Multimédia in the open market. As of December 31, 2004, Portugal Telecom held 57.56% of PT Multimédia. Through equity swap contracts, we have access to an additional 9.74% of PT Multimédia's share capital. We have also entered into derivative contracts, which give us the option to acquire up to an additional 4.8% of PT Multimédia's share capital subject to certain terms and market conditions. For a description of these derivatives, refer to Note 31 to our consolidated financial statements.

In March 2000, PT Multimédia created PT Conteúdos to hold its interests in programming ventures, and PTM.com, to which it transferred its Internet-related assets.

In April 2000, PT Multimédia acquired 42.0% of Lusomundo, a leading media and entertainment company in Portugal, through a tender offer on the Euronext Lisbon Stock Exchange. On March 26, 2001, PT Multimédia acquired 57.9% of Lusomundo, after approval from the Portuguese competition authorities in January 2001, thereby increasing its ownership interest in Lusomundo to 99.9% of Lusomundo's share capital. Approval was given on condition that PT Multimédia ensures that content produced by and supplied to Lusomundo, in which it does not face significant present or future competition, will be made available to third parties in accordance with normal market practice and the policy of transparency and non-discrimination that applies to other members of the Portugal Telecom group.

On October 17, 2002, we entered into an agreement with PT Multimédia to acquire its 100% interest in PTM.com, its 24.75% interest in Páginas Amarelas and its 50% interest in Sportinveste Multimédia. These acquisitions took effect as of September 30, 2002 and were completed at an aggregate acquisition price of €199 million. In addition, we also acquired €401 million in shareholder loans that PT Multimédia had extended to PTM.com and Sportinveste Multimédia. This transaction reduced the net debt of PT Multimédia by €600 million to €139 million. As from October 1, 2002, PT Multimédia no longer fully consolidates the financial results of PTM.com, which are now included in our wireline business. PTM.com was renamed PT.com in December 2004. See "*Wireline Business Retail ASDL Services and ISPs*", above.

On February 28, 2005, PT Multimédia announced the disposal of its 100% interest in Lusomundo Serviços, SGPS, S.A., including an 80.91% shareholding in Lusomundo Media, through the execution of a promissory sale and purchase agreement with Controlinveste, SGPS, S.A for a total consideration of €174 million. The Portuguese Media Authority (Alta Autoridade para a Comunicação Social) has issued a binding opinion in favor of the transaction, which now remains subject to the approval of the Portuguese Competition Authority (Autoridade da Concorrência). We can make no assurance that such approval will be granted and the other conditions to the sale will be satisfied. The parties to the transaction agreed upon an enterprise value of €300.4 million for 100% of Lusomundo Serviços, SGPS, S.A. and 100% of all of its subsidiaries. In order to simplify the acquisition, prior to closing, PT Multimédia will acquire the 5.94% stake in Lusomundo Media held directly by Portugal Telecom. Portugal Telecom acquired this stake from Fidelity Investments on October 16, 2003 for €9 million. The proceeds for PT Multimédia from the sale will be equivalent to €173.8 million, of which €10.1 million will be paid to Portugal Telecom in connection with the acquisition of its 5.94% interest in Lusomundo Media.

*Overview.* PT Multimédia's segments consist of:

cable and satellite television through TV Cabo;

broadband Internet access through cable modem provided by TV Cabo;

TV programming activities through PT Conteúdos and its subsidiaries and affiliates;



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

cinema distribution, negotiation of cinema rights for all film exhibition windows and distribution of DVDs, videos, and videogames through Lusomundo Audiovisuais;

cinema exhibition through Lusomundo Cinemas; and

production and distribution of daily newspapers, news radio and a diverse range of magazines through Lusomundo Media (as described above, PT Multimédia announced the disposal of this business on February 28, 2005, which is pending competition authority approval).

The diagram below shows PT Multimédia's major segments and the subsidiaries operating in each of those segments as of December 31, 2004.

**TV Cabo.** PT Multimédia provides cable television and direct-to-home satellite television services through TV Cabo, its wholly owned subsidiary, and TV Cabo's subsidiaries in Madeira and Azores. TV Cabo is also involved in advertising sales. In addition, it provides multimedia services, such as broadband cable Internet access and certain interactive digital television services.

*Cable Television and Direct-to-Home Satellite Television Services.* TV Cabo is the leading cable television operator in Portugal. Its cable television licenses cover approximately 77% of Portugal's population, comprising approximately 3.7 million homes. At December 31, 2004, TV Cabo's cable network passed, or provided potential access to, approximately 2.55 million homes. At December 31, 2004, TV Cabo had approximately 1.16 million cable customers, an increase of 6.1% over the end of 2003. TV Cabo's cable television subscribers are charged an installation fee, a monthly subscription fee for programming packages and, for those with access to premium channels, an annual rental fee for set-top boxes.

Since September 1998, TV Cabo has also distributed a direct-to-home, or DTH, satellite television service in Portugal. TV Cabo distributes its DTH satellite service using Hispasat Satellite broadcasting capabilities. TV Cabo's DTH satellite service is the only DTH digital multi-channel service specifically marketed in Portugal. TV Cabo's DTH satellite subscribers are charged an installation fee and a monthly subscription fee and are required either to purchase or rent from TV Cabo a satellite dish and a digital set-top box. TV Cabo's DTH satellite service is mainly targeted at people whose homes are not passed by TV Cabo's cable television network. In August 2004, the upfront cost of purchasing a DTH satellite dish was reduced by one-third and the DTH distribution network was reorganized, which improved sales.

Because it offers cable and DTH satellite services, TV Cabo can distribute programming and advertising across Portugal. As of December 31, 2004, TV Cabo had approximately 1,533 thousand customers, of which 393 thousand were DTH satellite subscribers. At December 31, 2004, approximately 55.6% of TV Cabo's subscribers subscribed to its premium channels, for which it charges additional fees.

*Programming Content.* As of December 31, 2004, TV Cabo offered over 40 basic channels and nine premium channels to cable and DTH satellite subscribers in continental Portugal. About half of the channels distributed by TV Cabo, including Lusomundo channels (Premium, Gallery and Action) and Sport TV, consist principally of programming that is in Portuguese or that has been dubbed or subtitled in Portuguese. The rest of the channels are mainly in English, but also in other European languages such as Spanish, French and German.

In March 2000, PT Multimédia (on behalf of PT Conteúdos) and TV Cabo established a strategic partnership with SIC, a major television operator in Portugal, to develop television content. This arrangement included the acquisition by SIC on September 4, 2000 of 60% of Lisboa TV, S.A., or Lisboa TV, the owner of a live news and information channel in Portugal, now known as "SIC Notícias", the production of two channels for TV Cabo's basic package and cross-promotion between SIC and TV Cabo. PT Conteúdos holds the other 40% of Lisboa TV.

In the first quarter of 2004, PT Multimédia initiated efforts to improve its basic and premium packages. In April 2004, PT Multimédia re-launched the Discovery Channel, with a programming grid specifically aimed at the Portuguese public, including content produced in Portugal, as part of its basic package. In addition, PT Multimédia launched in April 2004 Lusomundo Action, a premium cinema channel exclusively dedicated to the action genre, and launched in May 2005 Lusomundo Happy, a premium cinema channel dedicated to comedies. These new channels fit into PT Multimédia's strategy of increasing Pay-TV service segmentation, thereby meeting the diverse needs of its client base. During 2004, PT Multimédia made additional improvements to its basic package with the launch of international channels of recognized quality, such as AXN, a Sony Entertainment channel, as well as by increasing the amount of Portuguese content in its programming grid.

*Multimedia Service.* In order to increase its revenues per subscriber, TV Cabo has been developing a set of multimedia services, comprising broadband Internet access through cable modems and the provision of digital services, such as Electronic Programming Guide, multi-camera functionalities and video-on-demand. During 2004, TV Cabo launched the first prepaid broadband product in Portugal under the brand name "Zzt" and was also the first operator to offer 1Mbps downstream speed. TV Cabo had approximately 315 thousand subscribers for its broadband Internet access product at the end of 2004.

*Digitalization.* Throughout 2004, PT Multimédia continued its efforts to digitalize its Pay TV services. Digitalization provides higher security levels in controlling illegal access to content (TV Cabo uses NAGRA's ALADIN conditional access system) and will allow PT Multimédia to make available to customers additional services, such as VoD (video-on-demand), EPG (electronic programming guide), multi-game and multi-camera services, which add value to customers and create a competitive advantage. To enhance digital services and strengthen the digital offer, in May 2005, PT Multimédia launched additional programming content only available to customers through digital set top boxes, including 10 new channels from suppliers such as Fox, Nickelodeon, MTV and Discovery. PT Multimédia aims to stimulate the migration of its clients from analog to digital services by offering a greater selection of content and services. At December 31, 2004, PT Multimédia had over 310 thousand set-top boxes enabled for digital services.

*Network.* TV Cabo has made significant investments in the development of a hybrid fiber-coaxial broadband distribution network. TV Cabo's television signals are transmitted through fiber optic cables

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

owned by our fixed line business, PT Comunicações, under a service agreement regulated by ANACOM. In addition, TV Cabo has used PT Comunicações' existing ducts, wherever possible, to build its network. The network has a bandwidth of 750 MHz and 860 MHz in certain areas, and is sufficient to permit gradual migration to digital signals. The current design of the network allows it to increase capacity without significant additional capital expenditure. TV Cabo has activated the two-way capacity of its bandwidth cable network reaching approximately 2.4 million homes, which at the end of 2004 stands at 95% of homes passed by its network.

**Marketing.** TV Cabo is pursuing aggressive marketing campaigns. It is promoting its premium channels, and highlighting the high level of Portuguese-language content on its channels, the new digital services provided by its new digital set-top boxes and its broadband Internet access (NetCabo). TV Cabo markets its services through door-to-door selling, telemarketing and through Portugal Telecom shops, its own shops, supermarkets and other retail shops. We believe the alliance with SIC, Sport TV and other content producers has been contributing to the increased penetration of TV Cabo, as the agreement contemplates cross promotions between free and cable TV, and increased advertising initiatives.

**PT Conteúdos.** PT Multimédia created PT Conteúdos to manage the Portuguese-language audiovisual programming activities previously managed by TV Cabo. After restrictions on cable operators engaging in any programming business were lifted in 1997, TV Cabo formed two joint ventures to develop programming channels in Portugal (Sport TV and Premium TV) and launched Lisboa TV, now known as SIC Notícias, a live news, information and entertainment channel in Portuguese. These ventures were aggregated under PT Conteúdos, which is 100% owned by PT Multimédia.

Until June 2003, PT Conteúdos owned 54% of Premium TV, a partnership with Globo and SIC. In June 2003, PT Conteúdos acquired the remaining 46% of the share capital of Premium TV held by Globo and SIC, which produced two premium movie channels Telecine Premium and Telecine Gallery using the film libraries of Globo. Until May 2003, these channels were distributed via cable and satellite, through TV Cabo's platforms. In June 2003, PT Conteúdos replaced Telecine Premium and Telecine Gallery with two premium movie channels (Lusomundo Premium and Lusomundo Gallery), produced in-house using the film libraries of Lusomundo. In April 2004, Lusomundo Action, a premium cinema channel exclusively dedicated to the action genre, was launched, and in May 2005, Lusomundo Happy, a premium cinema channel dedicated to comedies, was launched. In December 2004, Premium TV was merged into PT Conteúdos and ceased to exist as a separate company.

PT Conteúdos also owns 50% of Sport TV Portugal, S.A., or Sport TV, a joint venture with PPTV-Publicidade de Portugal e Televisão, S.A., or PPTV, a subsidiary of Olivledesportos, a Portuguese sports marketing firm. This joint venture produces Sport TV, a premium sports channel, which is distributed by Portuguese cable and satellite operators in exchange for a per-subscriber fee. Sport TV holds a license to distribute most league matches of Portugal's leading football league through 2008 and certain other European football leagues through 2005. Until November 2003, 33.33% of Sport TV was owned by each of PT Conteúdos, PPTV and Rádio Televisão Portuguesa, S.A., or RTP, the Portuguese state television operator. In November 2003, PT Multimédia entered into an agreement to purchase, through PT Conteúdos, an additional 16.67% stake in Sport TV from RTP for €16.3 million, thereby increasing its ownership in Sport TV to 50%. The remaining 50% is now held by PPTV. The purchase was completed in April 2004. The agreement guarantees Sport TV exclusive broadcasting rights to Portuguese football league matches from 2004 through 2008.

PT Conteúdos also holds PT Multimédia's 40% interest in Lisboa TV (the owner of the live news and information channel "SIC Notícias"). See "TV Cabo", above.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

PT Conteúdos is engaged in the wholesale business for content. From 2002 onwards this company has been responsible for negotiations with content producers of the acquisition of rights to carry pay TV channels and other content. It resells that content to different distribution platforms, including TV Cabo's pay TV and Internet platforms, as well as those of other operators.

PT Conteúdos sells advertising on its own channels and on others, where PT Conteúdos has acquired the right to sell advertising as part of certain content acquisition contracts entered into. PT Conteúdos also manages the sale of advertising for TV Cabo's channels in exchange for an agency fee.

**Lusomundo Audiovisuais.** Lusomundo Audiovisuais conducts activities in all film exhibition windows, acquiring rights for cinema, DVD, video, pay-per-view and television. It also produces its own Pay TV premium movie channels and distributes DVDs, videos, and videogames. Lusomundo Audiovisuais has the right to distribute the following audiovisual content in Portugal:

Theatrical Exhibition: UIP (Universal, Dreamworks and Paramount), BUENA Vista International (Touchstone, Walt Disney Pictures), Spyglass, Revolution Studios and other independent producers;

Video: BVHE (Walt Disney), Paramount, Spyglass, Revolution Studios and other independent producers; and

Videogames: Sony Playstation (contract expired in April 2004).

**Lusomundo Cinemas.** Lusomundo Cinemas is the market leader in Portuguese cinema exhibition, with 148 screens. It also has 12 multiplexes, with 119 screens, in Spain through its 33% stake in Warner Lusomundo Sogecable, a joint venture with Warner Bros and Sogecable for cinema exhibition in Spain.

**Lusomundo Media.** Through Global Notícias, Publicações, S.A., Lusomundo Media owns several newspapers and magazines in Portugal, such as:

"Jornal de Notícias", one of Portugal's most popular daily newspapers, with an average daily circulation of approximately 113,049 newspapers in 2004;

"Diário de Notícias", one of Portugal's leading daily newspapers, with an average daily circulation of approximately 39,227 newspapers in 2004;

"24 Horas", a daily tabloid newspaper, and "Tal & Qual", a weekly tabloid newspaper;

regional newspapers, including "Açoreano Oriental", "Diário de Notícias da Madeira" and "Jornal do Fundão"; and

6 magazine titles, including "Notícias Magazine", "Grande Reportagem", "Volta ao Mundo", "Evasões", "Playstation 2" and "National Geographic Magazine".

Lusomundo Media also provides radio content and programming and owns "TSF", Portugal's most popular news radio station. As of December 31, 2004, "TSF" had approximately a 28% share of the total radio advertising market in Portugal.

Lusomundo Serviços, SGPS, S.A., a wholly owned subsidiary of PT Multimédia and holder of a 74.97% stake in Lusomundo Media, also has equity stakes in instrumental companies that provide, among other things, printing and distribution services to Lusomundo Media companies.

As discussed above under "*Multimedia Business*," PT Multimédia announced the disposal of its interest in Lusomundo Serviços on February 28, 2005, subject to the approval of the Portuguese competition authority.

## International Investments

### *Investments in Brazil*

We have certain additional investments in Brazil, in addition to our investment in Vivo described above, including, most significantly, PrimeSys, a provider of telecommunications business solutions to large corporate clients, and Mobitel, a call center company.

**PrimeSys.** PrimeSys provides a full spectrum of services to assist corporations in integrating Internet and IT services into their current business operations. These services include outsourcing of both communications and IT services as well as high-margin services such as web enabling and systems integration.

**Mobitel.** Mobitel provides call center services in Brazil primarily to Vivo's subsidiaries, which represent 85% of its client base.

### *Investments in Africa*

We have investments in Cabo Verde Telecom, a global telecommunications operator in the Cabo Verde Islands, and in certain other mobile operators in Morocco, Angola, and, until recently, in Botswana.

**Cabo Verde Telecom.** We own 40% of the share capital of Cabo Verde Telecom. Cabo Verde Telecom has the exclusive right to provide fixed, mobile and data services under the terms of its concession, and is the only provider of mobile services using GSM technology in the Cabo Verde Islands, a Portuguese-speaking country off the coast of West Africa.

At December 31, 2004, Cabo Verde Telecom had 73 thousand fixed lines in service, which represents approximately 17.7 fixed main lines per 100 inhabitants. Cabo Verde Telecom had 66 thousand active mobile telephone cards at December 31, 2004 (approximately 15.8 active mobile telephone cards per 100 inhabitants), of which 99% were prepaid customers. At December 31, 2004, Cabo Verde Telecom reached 6 thousand active Internet users.

Cabo Verde Telecom's total gross operating revenues were €51.5 million in 2004, €52.8 million in 2003 and €51.0 million in 2002.

**Medi Telecom in Morocco.** In August 1999, Medi Telecom, a consortium made up of Portugal Telecom, Telefónica Móviles and certain Moroccan entities, bid for and won a license to operate a GSM mobile network in Morocco. This was the second such license issued by the Moroccan government. The license fee was 9.0 billion Moroccan dirhams (€929 million). Medi Telecom entered into a €1 billion project financing facility. We initially held 34.5% of Medi Telecom, having invested approximately €166 million, but in January 2000 we sold 4% of our interest in compliance with a condition of the bid process for the same license. At the end of 2002, following a capital increase, Portugal Telecom raised its equity share to 31.34%, equal to Telefónica's position. During the fourth quarter of 2003, following another share capital increase, Portugal Telecom raised its equity share to 32.18%, which it maintained as at December 31, 2004.

Medi Telecom began operations at the end of March 2000. By the end of 2004, it had 2,934 thousand subscribers, which corresponds to an estimated market share of approximately 34%. Approximately 96% of its active mobile telephone cards are prepaid. We are managing the operations of Medi Telecom jointly with Telefónica Móviles.

Medi Telecom's total gross operating revenues were 3,590 million Dirhams (€325.8 million) in 2004, 2,918 million Dirhams in 2003 and 2,285 million Dirhams in 2002.

**Unitel in Angola.** At the end of 2000, we acquired 25% of the share capital of Unitel, a GSM mobile operator in Angola. Unitel's other shareholders are Sonangol, which holds 25%, and other local partners, which hold the remaining 50%. We are the operational manager of the venture, which began operations in Luanda in April 2001. As of December 31, 2004, Unitel had 541 thousand subscribers of which 99.5% were prepaid cards.

Unitel's total gross operating revenues were US\$245 million in 2004, US\$119 million in 2003 and US\$47 million in 2002.

**Mascom Wireless in Botswana.** Until recently, we managed the operations of, and had a 50.01% interest in, Mascom Wireless, an international consortium offering GSM services in Botswana. On July 7, 2003, we entered into an agreement to sell our 50.01% interest in Mascom Wireless for 250 million Botswana Pulas (approximately €46 million). We completed the sale in September 2004. We continue to provide consulting services to Mascom Wireless' management within the scope of the existing Management Agreement.

Mascom had gross operating revenues of €81.7 million in 2004, €64.7 million in 2003 and €54 million in 2002. We fully consolidated the assets, liabilities and results of Mascom Wireless up to December 31, 2003. In 2004, we accounted for the results of Mascom Wireless up to September 2004 using the equity method.

#### **Investments in Asia**

We have certain investments in Asia, including, most significantly, our investment in CTM.

**CTM.** We have a 25% interest in Companhia de Telecomunicações de Macau, or CTM, the exclusive provider of fixed line services and a provider of mobile telephone services in Macau. Macau, an enclave situated near Hong Kong on the coast of the Guangzhou Province, China, was a territory administered by the Portuguese government until December 1999 when its administration was transferred to the People's Republic of China. The other shareholders of CTM are Cable & Wireless plc and CITIC Pacific.

At December 31, 2004, CTM had 174 thousand fixed main lines in service. This figure represents approximately 38.7 fixed main lines per 100 inhabitants. CTM's mobile telephone services are growing rapidly, with 221 thousand active mobile telephone cards at December 31, 2004 and 49.1 active mobile telephone cards per 100 inhabitants. CTM uses GSM digital mobile technology. In December 1999, CTM entered into a new concession that will be valid until the end of December 2011.

CTM's total gross operating revenues were 1,667 million Patacas (€167.1 million) in 2004, 1,672 million Patacas (€167.6 million) in 2003 and 1,686 million Patacas (€169.0 million) in 2002.

#### **Instrumental Companies**

**PT SI.** PT SI is the group unit responsible for data centers, information systems and information technology activities of our business units in Portugal. PT SI provides integrated information systems and information technology services to our business units in Portugal, as well as to our existing and new customers. We now hold 100% of the share capital of PT SI, having acquired the remaining 5% held by IBM in 2003. PT SI has subcontracted certain information technology services to DCSI-Dados, Computadores e Soluções Informáticas, or DCSI, an information technology company controlled by IBM.

**PT Inovação.** PT Inovação is the group unit responsible for research and development activities. Our research and development programs focus on intelligent networks, network management systems, advanced services and systems and network integration. Our research and development activities have been responsible for the introduction of innovative products and services and for the development of

in-house technology. These activities have allowed our employees to remain up-to-date in terms of technology and technological development in the telecommunications sector on both a European and a worldwide level. PT Inovação's activities have been a driving force behind the development of new products and services, telecommunications infrastructures and information systems.

**PT Contact.** PT Contact is the group unit responsible for call center operations in Portugal. PT Contact takes advantage of economies of scale and process alignments to reduce costs in our call center operations.

**PT PRO.** In February 2003, we created PT PRO to aggregate all our back-office activities in Portugal. PT PRO takes advantage of economies of scale and process alignments throughout our group to reduce costs in back-office activities. The creation of PT PRO has also allowed for a reduction of the execution risk of our financial reporting function through standardization of processes and application of best practices.

**PT Compras.** In May 2003, we created PT Compras and we transferred our newly created central purchasing unit to this company. PT Compras is optimizing our purchasing function on an integrated basis. Taking advantage of scale and specialization, PT Compras is increasing pressure in reducing suppliers' prices and improving the levels of quality and service.

### Strategic Alliances

We have summarized below our principal existing and planned alliances and joint ventures.

**Alliance with Telefónica.** In 1997, we entered into a cooperation agreement with Telefónica. This agreement focused principally on cooperation in international investments, particularly in Latin America. In 1998 we acquired interests, together with Telefónica, in Brazil. See "*Brazilian Mobile Business*." In 1999 we commenced operations with Telefónica in Morocco. See "*International Investments Investments in Africa Medi Telecom in Morocco*".

On January 23, 2001, we entered into a strategic agreement with Telefónica to create a mobile joint venture company that would aggregate all our Brazilian mobile assets with the Brazilian assets of Telefónica Móviles, the mobile subsidiary of Telefónica, to the extent permitted under Brazilian law. On December 27, 2002, we and Telefónica transferred all of our respective interests in Brazilian mobile services companies to the joint venture, named Brasilcel and operating under the brand name Vivo since April 2003, with its head office in the Netherlands. We hold our interest in Vivo through PT Móveis and Telefónica holds its interest through Telefónica Móviles. Our agreements governing the ownership and management of Vivo have been entered into by those entities. We have discussed the benefits we expect from the joint venture with Telefónica and the reasons for entering into it above under "*Brazilian Mobile Business*".

We have appointed the Chief Executive Officer and Telefónica has appointed the Chief Financial Officer of Vivo. We manage Vivo on an equal basis with Telefónica and appoint ten of the twenty members of its board of directors, including the Vice-Chairman. Five of each party's ten directors must be resident in the Netherlands. In the event that either our or Telefónica's economic and voting interest is diluted below 50%, but not lower than 40%, due to a capital increase, the diluted party can re-build its interest to 50% within 12 months from the date of dilution. During such period, Vivo would be managed on an equal basis. We can maintain our share ownership percentage by contributing with cash or liquid assets. Should the percentage of the share capital in Vivo that we or Telefónica holds fall below 40% and remain below 40% for six consecutive months thereafter, our respective numbers of directors on the board will be changed to reflect our proportional shareholdings and the diluted shareholder will lose its right to appoint the CEO or CFO, as applicable.

As long as both parties have equal voting rights, the decisions of the board of directors shall be made by mutual agreement of the parties and will accordingly require the vote of at least one director appointed by each party. The joint venture agreement specifies that important decisions will be made by the affirmative vote of at least eleven members of the board of directors. If a deadlock over an important issue in the decision-making of Vivo cannot be resolved by the chairmen and CEOs of us and Telefónica, then the issue will be settled by reference to a committee of third party "wise persons". Alternatively, if the parties so agree, the interests contributed by the companies to Vivo will be returned and any subsequent interests acquired by Vivo will be divided according to the agreement of the parties or by arbitration.

Potential acquisitions of wireless and mobile telephone operators in Brazil may be pursued by Vivo or by us or Telefónica and subsequently contributed to Vivo. New acquisitions by Vivo require the approval of a majority of the board of directors of Vivo. If either we or Telefónica acquire a mobile operator in Brazil, the acquiring party must offer the right to a 50% participation in the acquisition to the other party.

In the event of a change of control of either us or Telefónica, the unaffected party shall have the right to sell the shares that it owns in Vivo to the affected party at a value determined pursuant to an independent appraisal. In addition, if we are diluted to below a 40% economic and voting interest in Vivo and fail to increase our interest to 40% within a six-month period, we will have the right to sell our interest in Vivo to Telefónica within one year from the expiration of the applicable six-month period at a price to be determined by a third party.

If either party wishes or is required to transfer all or part of its equity interest in Vivo to a third party, the non-transferring party will have the right to purchase the equity interest on the same terms and conditions offered by the third party.

As part of our initial agreement with Telefónica, we acquired 1.0% of Telefónica's share capital and Telefónica acquired 3.5% of our share capital. We and Telefónica also gave each other a right of first refusal on any transfer of our respective interests. In addition, a member of our board who is an executive officer is serving on Telefónica's board as a non-executive director, and a member of Telefónica's board who is an executive officer is serving on our board as a non-executive director. Under the terms of our strategic agreement with Telefónica, we may acquire up to 1.5% of Telefónica's share capital, and Telefónica may increase its ownership interest in our share capital up to 10%. As of December 31, 2004, Telefónica increased its interest in our share capital to 9.7%. As of December 31, neither party controls the operations or management of the other.

***Alliance with Banco Espírito Santo and Caixa Geral de Depósitos.*** In April 2000, we signed a strategic partnership agreement with the Banco Espírito Santo group, or BES, and Caixa Geral de Depósitos, or Caixa, to develop "new economy" initiatives. Pursuant to this agreement, BES increased its stake in Portugal Telecom to 6% of Portugal Telecom's share capital, and in August 2000 we acquired a stake in BES of 3% of its share capital. As of December 31, 2004, BES owned 9.2% of Portugal Telecom's share capital. In accordance with this arrangement, an executive officer of BES serves as a non-executive member of Portugal Telecom's board of directors. An executive member of Portugal Telecom's board of directors also serves as a non-executive member of the board of directors of BES.

Under this strategic partnership agreement, we launched various initiatives in business-to-consumer and business-to-business e-commerce and new mobile service areas in business-to consumer and e-finance, business-to-business and M-commerce and payment services.



**Properties**

Our principal properties consist of buildings and telecommunications installations. These include various sizes of exchanges, transmission equipment, cable networks, base stations for mobile networks and equipment for radio communications. They are located throughout Portugal and internationally.

We own several office buildings in Portugal. Our main proprietary office space is located at the following addresses:

R. Gonçalves Cristóvão, 195/219, Porto, Portugal (15,116 square meters);

R. General Humberto Delgado, 342/368, Coimbra, Portugal (13,321 square meters);

Largo do Carmo, Faro, Portugal (11,452 square meters);

R. Andrade Corvo, 10/14, Lisboa, Portugal (10,300 square meters);

Av. da Liberdade, 266 and R. Rodrigues Sampaio, 111, Lisboa, Portugal (10,057 square meters);

R. Postiguiño Valadares, 12, Castelo Branco, Portugal (9,464 square meters);

Av. Carvalho Araújo, 629, Vila Real, Portugal (9,030 square meters);

R. Alves da Veiga 145/169, Porto, Portugal (7,203 square meters);

Travessa dos Correios, Torres Novas, Portugal (7,112 square meters);

Av. Liberdade, 643, Braga, Portugal (5,380 square meters);

Rua 9 de Julho, Beja, Portugal (5,331 square meters); and

R. D. Estefânia 78/82, Lisboa, Portugal (4,441 square meters).

We also have some leased offices, which are located at the following addresses:

Av. Fontes Pereira de Melo, 38/40, Lisboa, Portugal (61,534 square meters);

R. José Ferreira Pinto Basto, Aveiro, Portugal (36,030 square meters);

Av. Álvaro Pais, 2, Lisboa, Portugal (31,800 square meters);

Tagus Park, Lt 35, Oeiras, Portugal (27,800 square meters);

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

R. Entrecampos, 28, Lisboa, Portugal (22,820 square meters);

R. Tenente Valadim, 431/453, Porto, Portugal (21,400 square meters);

R. Afonso Costa, 4, Lisboa, Portugal (13,266 square meters);

Tagus Park, Edifício Inovação II, 414, Oeiras, Portugal (7,126 square meters);

Av. 5 de Outubro, 208, Lisboa, Portugal (6,976 square meters)

Praceta Nuno Rodrigues dos Santos, 9, Lisboa, Portugal (5,735 square meters); and

R. Maria Veleda, 1, Lisboa, Portugal (4,333 square meters).

We have registered our important trademarks, such as "Portugal Telecom," "PT Comunicações," "PT Prime," "Telepac," "TMN," "PT Multimédia," "TV Cabo," and their related logos, in Portugal. We have also applied for a European Community trademark for "Portugal Telecom" and our logo. Telesp Celular has registered its important trademarks in Brazil. Brasilcel, through one of its Brazilian subsidiaries, is in the process of registering the trademark "Vivo" in Brazil and Spain; in Portugal, the trademark "Vivo" was approved in 2004. Trademarks registered in Brazil may be subject to less legal

protection in Brazil than registered trademarks in Portugal or the United States. We do not own any registered patents or copyrights which are material to our business as a whole.

### Competition

We now face substantial and increasing competition. The Portuguese telecommunications sector has been open fully to competition since January 1, 2000. We have competitors able to compete with us in each of our service areas. In response to the competition we are already experiencing and in anticipation of intensified competition, we are pursuing a range of strategic initiatives. Through these, we intend to reposition, modernize and prepare ourselves for the challenging new environment in which we operate.

#### *Competition Facing Our Wireline Business*

Since January 1, 2000, we no longer have the exclusive right to provide domestic and international public switched fixed line telephone services or to install and operate the related telecommunications networks in Portugal.

**Retail.** Our wireline business faces increasingly strong competition from new fixed-line operators as well as from mobile telephone service providers, including our own mobile service provider, TMN. The number of subscribers to mobile services in Portugal now outnumbers the number of wirelines in Portugal. At the end of 2004, there were approximately 95 active mobile telephone cards per 100 inhabitants in the Portuguese market. This growth comes as more residential subscribers add mobile lines for family members and as businesses add mobile cards for their employees. Vodafone Portugal and Optimus are already marketing their mobile services as an alternative to our wireline telephone services. We compete with them for market share.

Vodafone Portugal and Optimus have major shareholders that can provide them with substantial resources. As well as strengthening their position in the mobile telephone market, this may enable them to compete directly and aggressively with our fixed-line telephone services. Optimus and Vodafone Portugal already offer direct access through fixed wireless access technology.

At December 31, 2004, according to ANACOM figures, PT Comunicações, which provides retail services as part of our wireline business, had an estimated 93.2% market share of access lines. At December 31, 2004, according to ANACOM figures and our estimates, PT Comunicações had an estimated 83.7% market share of total outgoing traffic (in minutes), a decrease of 4.8 percentage points from December 31, 2003, and an estimated 78.1% market share of domestic outgoing voice traffic (in minutes), a decrease of 4.3 percentage points from December 31, 2003.

The main competitors in the wireline voice market include Oni Telecom Infocomunicações, S.A. (owned by Electricidade de Portugal, Banco Comercial Português and Brisa Autoestradas Portugal), Novis (owned by Sonae and France Telecom), Tele 2, Jazztel, Vodafone Portugal and the international competitors Colt and Global One. Jazztel, Vodafone Portugal and Global One are offering services mainly to small- and medium-sized enterprises and corporate segments. Jazztel is constructing fiber rings in Lisbon and Oporto. It holds a license to offer fixed wireless access local loop services. As Jazztel rolls out its service offering, we expect it to be a significant source of competition for the provision of wireline telephone services to small- and medium-sized enterprises. Sonae, the leading Portuguese retail group and a major Portuguese enterprise, in joint venture with France Telecom, formed Novis, the operator for fixed communications, and the mobile operator Optimus. All of the new entrants have focused on providing their customers national and international services over their networks without direct interconnection. These customers must still connect to our competitors' services through our fixed lines.

The cable operator, Cabovisão, offers a package of Internet, cable TV and voice services to the residential segment. Cabovisão has attracted some of our local customer market and may continue to do so.

The development of fixed wireless access local loop infrastructure represents a significant competitive challenge to our local loop infrastructure, because it provides an alternative to our local loop direct connections to customers. According to ANACOM, 7 fixed wireless access licenses were awarded to companies in Portugal as of December 31, 2004. The fixed wireless access local loop infrastructure that is being developed under these licenses is used to offer voice services in competition with our fixed-line telephone services.

Measures such as call-by-call selection (introduced on January 1, 2000) and carrier pre-selection (introduced on October 1, 2000), as well as number portability (introduced on July 1, 2001), make it easier for our competitors to attract our customers to their services. At December 31, 2004, we estimate that there were approximately 496.6 thousand lines in pre-selection.

We lose revenues from our international telephone services because we no longer have the exclusive right to provide fixed-line telephone services, and large telecommunications users lease lines through which they connect to networks outside Portugal. At December 31, 2004, according to ANACOM data and our estimates, PT Comunicações had an estimated 77.5% market share of international traffic (in minutes), a decrease of 4.6 percentage points from December 31, 2003. In addition, we are losing revenues from our international telephone services as mobile operators establish direct international interconnections with mobile or fixed-line networks outside of Portugal, enabling them to offer international telephone services without using our network. We face indirect competition in international fixed-line telephone services from calling cards and rerouting of calls by other international operators. Together with falling international call prices worldwide, these factors put pressure on us to reduce international fixed-line telephone prices.

In response to full competition, we have been lowering the prices of our wireline telephone services. In 2004, prices reduced by 10.2% for regional calls and 13.8% for domestic long distance on average, compared with 2003. We believe our price structure is now competitive and that we are meeting the challenge of full competition.

The overall effect of full competition partly depends on the prices that other mobile and wireline network operators pay us to interconnect with our network. Portuguese law requires us to lease lines to our competitors. It also obliges us to interconnect our network with our competitors' networks or lines leased by them. Our interconnection rates are subject to regulatory review. See "*Regulation Portugal Pricing of Wireline Services Interconnection Prices*". If ANACOM intervenes in the future to set interconnection prices at low levels, we believe new entrants to the Portuguese market would have a competitive advantage. New entrants and resellers of lines leased from existing operators have made very rapid inroads into other EU telecommunications markets that have also opened up to full competition.

**Wholesale.** Mobile operators, other than TMN, are establishing direct international interconnections with mobile or wireline operators outside Portugal, enabling them to offer international telephone services without using our network. This is reducing our wholesale revenues generated from connecting mobile operators in Portugal to operators abroad.

Our interconnection business faces more direct competition now that other operators may install and operate their own public wireline telephone networks. Mobile and wireline networks, which are our interconnection customers, can interconnect with these new networks rather than with ours. Other competitors may also establish local networks using other technologies such as local radio systems, fiber optic technologies and new mobile systems that may be used to complete calls which are currently made to our subscribers. For instance, Refer, the owner of the Portuguese national railway

infrastructure, and Águas de Portugal, a Portuguese state holding company with interests in water distribution companies, have formed Netrail, a fiber optic network company.

**Data and Corporate.** We face significant competition from several operators. Our principal data communications and business solutions competitors include companies associated with Oni Telecom, Novis, Jazztel, Vodafone Portugal and other international operators, such as Global One, Colt, Equant and KPN Qwest. These companies compete with us in providing data communications, voice and Internet services to business customers. Such service providers can use lines leased from us or their own networks. This market is now highly competitive. These customers tend to have large volumes of traffic, particularly international and long distance.

Our competitors may use satellite-based networks, the infrastructure of public network operators, leased lines and their own infrastructure to offer telecommunications services to customers. These are all alternatives to leasing lines from us for data communications. As a result of competition, we have reduced our prices for leased lines and focused on value-added solutions based on Internet Protocol Virtual Private Networks, or IP VPN, to establish managed internal voice and data transmission networks to our customers, as well as data center and outsourcing services.

#### ***Competition Facing TMN in Portugal***

TMN competes with Vodafone Portugal and Optimus, the two other mobile operators licensed to provide mobile telephone services in Portugal. According to figures from ANACOM, at the end of 2004, in terms of the number of active mobile telephone cards in the Portuguese market, TMN had a 50.7% market share. TMN has made maintaining its market share a priority. As a result of competitive pricing strategies, quality of service, innovative services and technology and excellent subscriber care, it has sustained its market share of new mobile subscribers.

Vodafone Portugal and Optimus each have major shareholders that could provide them with substantial resources to compete aggressively against us in the Portuguese mobile telephone market. Vodafone Group plc, which was already Vodafone Portugal's controlling shareholder, acquired the remainder of its share capital during 2003. Sonae (one of Portugal's largest groups with a leading position in the retail business in Portugal) and France Telecom are the major shareholders in Sonae.com, the holding company that controls Optimus. We expect Vodafone and France Telecom to use Vodafone Portugal and Optimus, respectively, as vehicles to market their own services in the Portuguese market.

The Portuguese government awarded four licenses to provide third generation mobile services in December 2000. Each of TMN, Vodafone Portugal and Optimus has received one of these licenses. The fourth license was awarded to Oniway, a subsidiary of Oni Solutions and a new entrant in the Portuguese mobile market. However, Oniway decided not to participate in the provision of third generation mobile services, and, as a result, the Portuguese government repealed the license granted to Oniway by ministerial order on January 13, 2003. The other three recipients of third generation licenses, including TMN, requested that the additional frequency that had been allocated to the new entrant be reallocated to them. This request was granted by a special ministerial order in January 2003. See " *Regulation Portugal Summary of Our Concession and Existing Licenses Third Generation Mobile Services Licenses*".

Competition is increasing in the mobile services sector in Portugal as TMN and its competitors develop new services. In addition, the commercial introduction in Portugal of third generation mobile services could heighten competition and reduce the potential profitability of providing third generation services. Moreover, ANACOM may open the mobile market to MVNOs which do not have their own network infrastructure and thus would not have the fixed cost burdens facing our current GSM and UMTS services. Competition from companies providing WLAN services, which can deliver wireless data services more cheaply than UMTS in concentrated areas, may also affect the market and pricing

for third generation services. We believe that our mobile competitors, Vodafone and Optimus, will continue to market their services aggressively. In June 2005, Optimus introduced a virtual operator "Rede 4" in response to our new offer "Uzo" at a significant discount to our new tariffs. Although Uzo and Rede 4 are divisions of TMN and Optimus, respectively, they are both positioned commercially as independent operators. See "Item 3 Key Information Risk Factors Increased Competition in the Portuguese Mobile Market May Result, in Decreased Tariffs and Loss of Market Share".

#### **Competition Facing Vivo in Brazil**

Throughout 2004, Vivo faced increasing competition not only from its established competitors, but also from new operators in some of the markets where Vivo operates. As of December 31, 2004, Vivo had 26.5 million subscribers, corresponding to a market share of 50.9% in its areas of operation, compared with 56.2% in 2003. Vivo's major competitors are Claro (Telecom Américas), TIM (Telecom Itália Mobiles) and Oi.

Telesp Celular competed with two mobile operators in the state of São Paulo in 2004: Claro and TIM. BCP and Tess, two former competitors of Telesp Celular, which began offering services in their respective areas of the state of São Paulo in 1998, were acquired by Telecom Américas and were merged into Claro in 2003. In February 2002, TIM acquired a band D license for the entire state of São Paulo, beginning operations in September 2002, using the GSM/GPRS technology.

Telesp Celular also competes for subscribers with wireline telephone service providers. Some existing and potential subscribers may shift to wireline services for a number of reasons, including price, if the availability of wireline services and the quality of the service improve. The main wireline service provider in São Paulo state is Telefónica, through Telesp Fixa.

In 2004, Global Telecom competed with Claro, TIM and Brasil Telecom in the states of Paraná and Santa Catarina. In 2003, Tele Celular Sul, Global Telecom's previous competitor, was acquired by TIM. In February 2002, Telecom Américas, which controls Claro, acquired a band D license and Brasil Telecom (a wireline operator) acquired a band E license, for the states of Paraná and Santa Catarina. During the second half of 2002, Claro began operations in Paraná and Santa Catarina using the GSM/GPRS technology. Brasil Telecom began operations at the end of 2004 in the states of Paraná and Santa Catarina using GSM/GPRS technology.

Tele Sudeste competed with three mobile operators in the states of Rio de Janeiro and Espírito Santo in 2004: Claro, Oi, which is controlled by Telemar (a wireline operator), and TIM. Oi and TIM launched their operations during the second half of 2002. In 2003, ATL, Tele Sudeste's previous competitor, was acquired by Claro. In February 2002, TIM acquired a band D license and Oi a band E license for the states of Rio de Janeiro and Espírito Santo. During the second half of 2002, TIM and Oi began operations in Rio de Janeiro and Espírito Santo using the GSM/GPRS technology.

Tele Leste competed with three mobile operators in the states of Bahia and Sergipe in 2004: Claro, Oi and TIM. Oi and TIM launched their operations during the second half of 2002. In 2003, Maxtel, Tele Leste's previous competitor, was acquired by TIM. In February 2002, Telecom Américas, which controls Claro, acquired a band D license and Oi a band E license for the states of Bahia and Sergipe. During the second half of 2002, Claro and Oi began operations in Bahia and Sergipe using the GSM/GPRS technology.

CRT Celular competed with three mobile operators in the state of Rio Grande do Sul in 2004: Claro, TIM and Brasil Telecom. In 2003, Telet, CRT Celular's previous competitor, was acquired by Claro. In February 2002, TIM acquired a band D license and Brasil Telecom a band E license for the state of Rio Grande do Sul. During the second half of 2002, TIM began operations in this region using the GSM/GPRS technology. Brasil Telecom began operations during 2004 in the state of Rio Grande do Sul using GSM/GPRS technology.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

TCO competed with three mobile operators in the states of Acre, Rondônia, Mato Grosso, Goiás, Mato Grosso do Sul, Tocantins and in the Federal District in 2004: Claro, TIM and Brasil Telecom. In 2003, Americel, TCO's previous competitor, was acquired by Claro. In February 2002, TIM acquired a band D license and Brasil Telecom a band E license for the states of Acre, Rondônia, Mato Grosso, Goiás, Mato Grosso do Sul, Tocantins and the Federal District. During the second half of 2002, TIM began operations in these states using the GSM/GPRS technology. Brasil Telecom began operations at the end of 2004 in these states using GSM/GPRS technology. TCO also competed with four mobile operators in the states of Amazonas, Pará, Maranhão, Roraima and Amapá in 2004: Tele Norte Celular, Oi, Claro and TIM. In February 2002, Claro acquired a band C license, TIM a band D license and Telemar, which controls Oi, a band E license, for these states. During the second half of 2002, Claro, Oi and TIM began operations in these states using the GSM/GPRS technology.

ANATEL has auctioned nine new SMP licenses, three per region, operating under band C, band D and band E. An operator that was awarded a license in the SMP auction was also granted a license to operate long distance fixed telephony, both national and international, after December 31, 2001. The band C auction was canceled due to a lack of bidders. ANATEL is analyzing the best way to allocate the relevant frequency, and a new band C auction is not expected to take place. The band D auction was successfully completed on February 13, 2001. Telemar was awarded a band D license for Region I (North and East Region, including the states of Rio de Janeiro, Minas Gerais and the states in the Northeast and North of Brazil) and TIM was awarded a band D license for Region II (Center and South Region, including the states of Rio Grande do Sul, Santa Catarina, Paraná and the states in the Center of Brazil) and Region III (São Paulo Region, including the metropolitan area of the city of São Paulo and the rest of the state of São Paulo). The initial band E auction was held on March 13, 2001. TIM was awarded a band E license for Region I. The auction for band E licenses in Regions II and III was postponed due to a lack of bidders. However, on January 22, 2002, ANATEL published a new invitation to bid for band E licenses in Regions II and III, as well as for band D and E licenses in four smaller regions, some of which cannot be operated by TIM due to its ownership interests in mobile operators. This auction was scheduled to take place on March 12, 2002 but was canceled due to a lack of bidders. Another auction took place in November 2002, and Brasil Telecom received three of the remaining licenses in the regions in which it already operated in wireline telecommunications, including the states of Paraná, Santa Catarina and Rio Grande do Sul. The licenses for four of the regions were returned by the bidders, and it is expected that they will be re-auctioned by ANATEL in the future. In September 2004, ANATEL auctioned off the remaining band E licenses in Regions II and III. No operators bid for the band E licenses covering the State of São Paulo or the Northeast region of Brazil. However, two operators bid for and received a band E license for rendering services in the State of Minas Gerais (Stemar, which is owned by Claro, for the whole state, and Telemig Celular for the CTBC region).

### *Competition Facing PT Multimédia's Pay TV and Cable Internet Business*

Certain cable television operators are authorized to provide services in Portugal in addition to PT Multimédia's subsidiary, TV Cabo. Portuguese cable television authorizations cover different regions. TV Cabo has control over nine cable authorizations covering 125 counties in seven regions in continental Portugal and the Madeira and Azores Islands. As of the end of 2004, TV Cabo's cable television licenses covered approximately 51% of Portugal's population (not including its DTH satellite coverage). PT Multimédia's competitors operate principally in Portugal's major cities and include Cabovisão (which has control over six cable authorizations), Parfitel (which has control over at least five cable authorizations), TV TEL (which has control over four cable authorizations) and Bragatel (which has control over one cable authorization). According to ANACOM figures, we estimate that at the end of 2004, TV Cabo's competitors had approximately 14% of the total number of subscribers in the pay-TV market.

We believe the first cable television operator in any region has a competitive advantage over other operators. TV Cabo began providing services in Portugal before its competitors. TV Cabo began to provide services in Lisbon and Oporto, Portugal's largest cities, in 1995. In addition, TV Cabo has completed building most of its planned cable network.

PT Multimédia competes for advertising revenue with terrestrial television companies and other forms of media such as newspapers, magazines, radio, billboards and the Internet. It also competes with terrestrial television companies for the acquisition of programming to attract viewers. Such competition can increase program acquisition costs.

PT Multimédia competes with cable companies, such as Cabovisão, in the provision of broadband Internet services.

In August 2001, the Portuguese government granted an authorization to Plataforma de Televisão Digital Portuguesa, S.A., or PTDP, to provide digital terrestrial television services. ANACOM instructed PTDP that it must begin operations before March 1, 2003. As PTDP had difficulty complying with the instruction, ANACOM, with PTDP's agreement, proposed to the Ministry of Economy that PTDP's authorization be revoked. By order of the Minister of Economy, dated March 25, 2003 (Ministerial order 6973/2003, published on April 9, 2003), the authorization was revoked. To date, ANACOM has only announced its interest in launching a new auction for the authorization but no date has been announced for completion of this procedure. We are not aware of any immediate plan of the government to grant an authorization to any other entity to provide digital terrestrial television services in Portugal.

As existing technology develops and new technologies emerge, competition is likely to intensify, in particular with regard to products and services related to subscription TV and the Internet. PT Multimédia's cable and satellite business face competition from broadband local loop access based on wireless technologies (Broadband Wireless Access). In January 2005, Jazztel, a direct competitor, launched a commercial offer in the geographic areas where it operates. Also, we expect video over ADSL to increase competition. Novis may launch an IP television offer that would compete with PT Multimédia's television services.

#### ***Competition Facing PT Multimédia's Audiovisuals Business***

In the five main sub-segments of this business segment (Film distribution, Cinema exhibition, Video distribution, Video games distribution and Distribution of rights for TV broadcasting), PT Multimédia faces competition from various entities that differ from segment to segment, as follows:

Film distribution: Filmes Castello Lopes, LNK Filmes, Columbia Tristar Warner Filmes de Portugal, Atlanta Filmes and Sociedade Distribuidora Vitora Filmes;

Cinema exhibition: Socorama Sociedade Comercial de Cinemas, Medeia Filmes, New Lineo Cinemas de Portugal, UCI Cinemas United Cinemas international and AMC;

Video distribution: LNK Filmes, Ecovideo, Universal Home Video, Warner Home Video; Castello Lopes, Selecções Readers Digest and Planeta Agostini; and

Distribution of rights for TV broadcasting: Warner Television, Columbia Television, Fox Television, Paramount Television, Buena Vista International Television, Universal Television, LNK, Ecofilmes and Castello Lopes.

In all of the activities mentioned above, except in the distribution of rights for TV broadcasting, where the free-to-air TV stations are basically supplied by the international market, Lusomundo Audiovisuais and Lusomundo Cinemas are market leaders in Portugal in terms of the number of movie titles distributed and the number of movie theaters owned.



**Competition Facing Lusomundo Media**

The Portuguese market for newspapers and magazines has moved towards consolidation among the main media groups and the disappearance of independent publications. Excluding sports newspapers, Portugal has one of the lowest readership rates in Europe for newspapers and magazines.

In terms of daily newspapers, Lusomundo Media's "Jornal de Notícias" and "Diário de Notícias" have been dealing with more direct competition from "Público" (Sonae Group) and "Correio de Manhã" (Cofina Group).

The Portuguese magazine market has been particularly active in the last ten years. Lusomundo Media's current portfolio includes six magazines aimed at different audiences, as follows:

| Segment                | Magazine                       |
|------------------------|--------------------------------|
| News                   | "Grande Reportagem"            |
| Travel                 | "Volta ao Mundo"               |
|                        | "Evasões"                      |
| Information/technology | "Playstation2"                 |
| General interest       | "National Geographic Magazine" |
|                        | "Notícias Magazine"            |

With a per issue circulation in excess of 200 thousand copies, "Notícias Magazine" (distributed on Sundays with Lusomundo Media's newspapers, "Diário de Notícias", "Jornal de Notícias" and "Diário de Notícias da Madeira") is the market leader.

Other significant magazine publishers in Portugal, apart from Lusomundo Media, are Impresa (in association with the Swiss media group Edipress), Impala and Cofina.

As discussed above under " *Multimedia Business*," PT Multimédia announced the disposal of its interest in Lusomundo Media on February 28, 2005, subject to the approval of the Portuguese competition authority.

**Regulation**

The telecommunications industry has traditionally been heavily regulated in most countries of the world, including Portugal and Brazil. Over the last several years, both countries (Portugal beginning in 1991 and Brazil in 1998) have substantially privatized their state-held telecommunications operators and have been opening their telecommunications markets to competition. Portugal, a member of the European Union, opened its telecommunications market to full competition as of January 1, 2000. Portugal is pursuing further EU-led initiatives aimed at increasing the competitiveness of its market. Brazil has also been introducing further measures designed to increase competition. In this section, we explain the main laws and regulations in Portugal and Brazil that affect our operating companies in these two countries.

**Portugal**

In the increasingly competitive Portuguese telecommunications market, the regulatory measures which most affect our operations, our revenues and our costs, concern:

restrictions on the products we offer and the prices we charge in our wireline retail business;

obligations to allow our competitors to interconnect with and use our wireline network;

certain wireline services that we are obliged to provide to the public under our "universal service obligation";

measures that are intended to make it easier for our customers to migrate to our competitors' services, including carrier pre-selection, number portability, unbundling of the local loop and wholesale line rental, which is expected to be introduced during the second half of 2005; and

the terms of our Concession and our licenses, including the new third-generation mobile license that TMN received at the end of 2000.

Law 91/97 of August 1, 1997, known as Law 91 or the Basic Law of Telecommunications, provided the legislative framework and the basis for telecommunications regulation in Portugal. This law was enacted to implement the European Commission's legal framework for the opening of the telecommunications sector in the European Union to full competition. Law 91 provided for the opening of the Portuguese telecommunications market, including public switched wireline telephone services and related infrastructure, to full competition, as of January 1, 2000. It also established the legislative framework for the transition to a fully competitive telecommunications sector in Portugal.

Law 91 required the Portuguese government to ensure that a basic telecommunications network exists and basic telecommunications services are provided on a universal basis in Portugal. In addition, Decree Law 381-A/97, of December 30, 1997, provided that any entity can provide telecommunications networks and services if they obtain a license from or register with the Portuguese telecommunications regulator.

Our wireline business unit provides domestic and international public wireline voice telephone services in Portugal pursuant to a Concession. Portugal Telecom transferred this Concession to PT Comunicações. On December 11, 2002, we agreed to prepay the future rental payments due under the Concession in exchange for full ownership of the basic telecommunications network and to ensure that there will be no reversion of the assets related to the provision of Concession services to the Portuguese government in 2025. On December 27, 2002, we acquired full ownership of the basic telecommunications network for €365 million, which included the 2002 Concession rental fee in the amount of €16.6 million. Our other subsidiaries in Portugal hold licenses to provide their services, including mobile telephony, data transmission and cable television. See " *Summary of Our Concession and Existing Licenses*", below.

Law 91, our Concession and Decree Law 458/99 of November 5, 1999, which implemented the EU universal service regulation, imposed on us universal service obligations in Portugal. Currently, we are the only telecommunications company in Portugal subject to these universal service obligations. See " *Universal Service Obligations*", below. Law 91 imposed on the operators of public telecommunications networks an obligation to permit the use of their networks by other network operators and service providers on terms and conditions that are determined competitively and without discrimination. It also prohibited unfair competitive acts and abuse of a dominant position by a network operator or service provider. Law 91 has been changed by Law 29/2002 of December 6, 2002, which enabled the sale of the ownership of the basic network assets to PT Comunicações on December 27, 2002. See " *Summary of Our Concession and Existing Licenses Our Wireline Concession*" and " *Item 8 Financial Information Legal Proceedings*". Law 91 also codified our right to use public rights-of-way free of municipal fees and taxes. Decree Law 458/99 (Universal Service) and Decree Law 415/98, which implemented the EU Interconnection Directive in Portugal, address the pricing mechanism and the financing procedures regarding universal service obligations. According to our Concession, PT Comunicações should be compensated for losses if the rights-of-way regime changes.

In February 2002, the European Union agreed upon a new regulatory framework for electronic communications networks and services, consisting of five directives governing procedures, authorizations, access, universal service obligations and data protection; one decision on the availability and use of radio spectrum; and a recommendation on relevant product and service markets within the electronic communications sector subject to "ex ante" regulation in accordance with Directive

2002/21/EC of the European Parliament and Council on a common regulatory framework for electronic communications networks and services. Four of the five directives that make up the new EU framework were adopted into law in Portugal on February 10, 2004, and the fifth directive was adopted into law on August 18, 2004, as Law 5/2004. Law 5/2004 is in the process of being implemented through regulations by the Portuguese regulator, ANACOM; however, this process is not yet complete.

The final implementation of the new EU framework will change the current regulatory framework applicable to us. The new EU directives and recommendations, which adopt competition law principles such as market dominance for the designation of significant market power and the definitions of relevant product and geographic markets which may be subject to "ex ante" regulation, will result in significant changes and refinements to the current regulatory regime applicable to us in Portugal.

Under the new regulatory regime, regulatory obligations can be imposed on operators having significant market power in any one of 18 relevant retail and wholesale markets identified by the European Commission. Since we are active in many of these markets, the new regulatory regime could result in an increase in the regulatory measures affecting our businesses and operations.

According to Articles 7, 14 and 16 of the new EU framework directive, ANACOM must analyze the 18 retail and wholesale markets and identify which electronic communications operators and service providers it considers to have significant market power in such markets in Portugal and notify the European Commission with respect to its findings.

ANACOM has started its analysis of 16 of the 18 retail and wholesale markets. ANACOM considers the Portugal Telecom group to have significant market power in the following: (i) retail markets access to the public telephone network at a fixed location (residential and business); publicly available local and/or national telephone services provided at a fixed location (residential and business); and publicly available international telephone services provided at a fixed location (residential and business); and (ii) wholesale markets call origination on the fixed telephone network provided at a fixed location, call termination on individual public telephone networks provided at a fixed location and wholesale unbundled access to local metallic loops. ANACOM has notified the European Commission regarding its conclusions about the markets it has already analyzed. In addition, ANACOM added a nineteenth market, covering telephone services at a fixed location using non-geographic numbers, and has declared the Portugal Telecom group to have significant market power in this area.

In addition to the Portugal Telecom group, all other wireline operators in Portugal were determined to have significant market power in the call termination on individual public telephone networks provided at a fixed location wholesale market. Final decisions with respect to the existence of significant market power in each of the relevant markets is expected during the course of 2005.

ANACOM has not yet started the analysis of the 2 remaining wholesale markets.

In addition, certain other aspects of the former regulatory scheme, such as the basis upon which we and other operators in Portugal can use public rights-of-way and the rules governing access to ducts, may be subject to further review and changes, and were opened by ANACOM to public comment. Overall, however, we believe that the new framework will permit an increasingly flexible approach to regulation as competition develops in Portugal.

### ***Regulatory Institutions***

*ANACOM.* The Autoridade Nacional das Comunicações, or ANACOM, created in January 2001 (formerly The Instituto das Comunicações de Portugal, or ICP), is the Portuguese telecommunications regulator. Since it commenced operations in 1989, it has been closely involved in developing the telecommunications regulatory framework in Portugal. It advises the Portuguese government on telecommunications policy and legislation and monitors compliance with concessions, licenses and permits granted to telecommunications providers in Portugal.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

ANACOM is accountable to the Ministry of Public Works, Transport and Communications. The Ministry of Public Works, Transport and Communications retains basic responsibility for telecommunications policy in Portugal. Together with the Ministry of Finance, it has ultimate responsibility for monitoring our compliance with our Concession. It also has certain supervisory powers with respect to our activities. The Portuguese government delegated a significant number of those powers and functions to ANACOM in our Concession.

Over the past several years the Portuguese government has substantially increased the autonomy of ANACOM and allowed it to become a more effective and independent regulatory body. ANACOM acts on complaints against us by our competitors, our customers and other interested parties. It can impose fines on us if we do not meet our obligations under our Concession, including our obligations to supply public switched wireline telephone services, leased lines and other services to our competitors on a timely basis. ANACOM has, from time to time, addressed complaints against us by our competitors. However, such complaints have been resolved in a manner that has not had a material adverse effect on our businesses or operations. ANACOM's decisions are subject to possible reconsideration and can be submitted for judicial review.

*EC Commission.* Most of the EU competition rules have the force of law in all EU member states and therefore apply to us in Portugal. The current priority of the European Commission is to ensure that EU member states fully and correctly implement EU requirements in national law. The European Commission routinely monitors the status of EU member states in implementing EU directives.

The Directorate-General for Competition of the European Commission is responsible for considering, on its own initiative as well as in response to complaints by interested parties, potential claims that our business activities or Portuguese government regulations are inconsistent with the key provisions of the Treaty of Amsterdam, also known as the EC Treaty, relating to competition in the EU. Article 81 of the treaty prohibits agreements or coordinated action between competitors that may affect trade between EU member states and have as their objective or effect the prevention, restriction or distortion of competition within the EU. Article 82 of the treaty prohibits any abuse of a market-dominating position within the EU, or a substantial part of the EU, that may affect trade between EU member states. The Directorate-General for Competition enforces these rules in cooperation with the national competition authorities. In addition, national courts have jurisdiction over violations of EU competition law. To the best of our knowledge, there is currently one material complaint relating to our activities and the regulatory framework of the Portuguese government pending before the Directorate-General for Competition, filed by Sonae.com. See "*Item 3 Key Information Risk Factors EU Regulation Regarding Abuse of Dominant Position Could Adversely Affect our Business*" and "*Item 8 Financial Information Regulatory Proceedings*".

We understand that at the end of 2001 the Directorate-General for Competition and the Directorate-General for Information Society of the European Commission requested information from the Portuguese government regarding the telecommunications rights-of-way regime in Portugal, which provides PT Comunicações with the exclusive right to use public rights-of-way free of municipalities' fees and taxes. Since we have not been party to the communications between the Directorates-General and the Portuguese government, we are unable to assess the potential outcome and implications, if any, for us, of such communications. However, Law 5/2004 establishes a new rights-of-way regime in Portugal whereby each municipality may establish a fee, up to a maximum of 0.25% of each wireline services bill, to be paid by the customers of those wireline operators whose network infrastructures are located in each such municipality. Proceedings to implement this new regime are currently in progress.

*Autoridade da Concorrência.* Our activities are also overseen by Autoridade da Concorrência (formerly Direcção Geral do Comércio e da Concorrência, or DGCC), which is responsible for enforcement of Portuguese competition law. It is also responsible for considering complaints relating to

our business practices or other business arrangements. We expect the Autoridade da Concorrência to take a more active role in matters relating to pricing and to the determination of which companies have "significant market power" and the regulatory implications for such companies.

On February 10 and 11, 2004, the Autoridade da Concorrência conducted an unannounced search of the offices of PT Comunicações and PT Prime, seizing several documents, in order to investigate alleged abusive practices, including predatory pricing, price discrimination at the wholesale level, price discrimination at the retail level in the wireline telephone market and margin squeezes. The potential penalty for such practices could be as high as 10% of our turnover in the preceding fiscal year. This administrative investigation is still in a preliminary stage involving document collection and review. The Autoridade da Concorrência periodically requests that we provide them with additional information regarding the documents they seized in February 2004, which we have responded to in a timely manner. We expect that the next phase could involve the Autoridade da Concorrência formally charging us with the alleged abusive practices, which would result in an administrative proceeding, referred to as a "statement of objections", in which we would defend our position before the competition authority. If we were unsuccessful in our defense, the competition authority could issue a fine in connection with such abuses. We are permitted under Portuguese law to appeal any adverse decision of the Autoridade da Concorrência to the Commerce Court. To our knowledge, the Autoridade da Concorrência has not yet reached any decision on this matter. See *"Item 3 Key Information Risk Factors Regulatory Investigations and Litigation May Lead to Fines or Other Penalties"* and *"Item 8 Financial Information Legal Proceedings Regulatory Proceedings"*.

To our knowledge, there are also several other complaints relating to our activities pending before the Autoridade da Concorrência, including complaints against: (i) PT.com (this complaint was formerly against Telepac, which was merged into PT.com in December 2004) and TV Cabo regarding alleged anti-competitive practices in the broadband Internet market; (ii) TV Cabo and Sport TV by TV TEL, a cable TV company operating in the Oporto area, for alleged refusal to supply advertising space; (iii) TMN by Optimus for alleged abuse of dominant position in the call termination market; (iv) "Jornal de Notícias" for alleged predatory pricing and price discrimination regarding regional advertising; (v) PT Comunicações for alleged anti-competitive practices in the public wireline telephone market and for granting discriminatory discounts on leased lines; and (vi) PT Conteúdos for alleged anti-competitive practices in connection with media content and its strategic partnership with SIC. The Autoridade da Concorrência has requested information with respect to these complaints, which we have responded to in a timely manner.

In addition, in the fourth quarter of 2004, the Autoridade da Concorrência initiated an administrative proceeding against PT Comunicações, referred to as a "statement of objections", for abuse of dominant position against a cable competitor in connection with access to ducts. This proceeding is at a preliminary stage and has not yet been made public. PT Comunicações has responded to this "statement of objections", but there has been no update on this proceeding since the end of 2004.

#### ***Pricing of Wireline Services***

Decree Law 458/99 required that ANACOM, DGCC and the provider or providers of the universal service in Portugal enter into a new pricing convention that governed only prices for services that we provided under universal service obligations. We are currently the only universal service provider in Portugal. See *"Universal Service Obligations"*, below. On December 30, 2002, we, ANACOM and the DGCC entered into a new pricing convention pursuant to article 11 of Decree Law 458/99. The pricing convention established the price regime applicable to the following universal services provided by PT Comunicações: (i) wireline services for subscribers, including traffic and subscription to analog lines within Portugal; and (ii) wireline services for public pay telephone calls made within Portugal, as well as making telephone directory and information services available. In

addition, the pricing convention governed certain obligations of PT Comunicações to provide services to retirees, low income pensioners, low consumption residential users and customers with special needs.

Under the pricing convention, the prices of universal services were adjusted based on actual costs, and the prices charged had to comply with the principles of transparency, non-discrimination and cost orientation. As a result, PT Comunicações was required to maintain a system of cost accounting, which enabled it to monitor the costs of the services it provides, and it was required to publicize current prices. For wireline subscribers, the pricing regime means that the weighted average variation of the prices they paid for domestic services did not exceed CPI minus 2.75% in 2003. PT Comunicações was also obligated under the pricing convention to make available an optional pricing plan for the benefit of residential customers with low consumption and for low income pensioners.

The pricing convention expired on December 31, 2003. However, according to new Law 5/2004, until the full implementation of the new pricing regime, which was established by ANACOM in accordance with the new EU regulatory framework on December 14, 2004, the rules governing domestic prices established by the preceding pricing convention remained in effect. As a result, the average variation of domestic prices in 2004 did not exceed CPI minus 2.75%.

On May 7, 2004, ANACOM approved the 2004 fixed telephone service prices proposed by PT Comunicações, which are applicable to wireline customers. These prices comply with the price cap of CPI minus 2.75%, in terms of average annual change and assuming an inflation range of 1.5% to 2.5% as per the Portuguese State Budget for 2004. The new prices have been effective since August 2004, with a line rental increase of 2.9% and a decrease of 20.7% and 28.0% in the cost of regional and domestic long distance calls, respectively. See " *Our Businesses Wireline Business*".

The new pricing regime for wireline services, which was established by ANACOM on December 14, 2004 in accordance with the terms of the new EU regulatory framework, has created the following regulatory obligations on the retail market for telephone services at a fixed location:

In 2005, the price-cap applying to residential access and domestic calls is CPI minus 2.75% (new prices for 2005 are expected to be effective as of July 1, 2005 within this price cap);

The fixed retention part of fixed-to-mobile calls (residential and non-residential) are required to be in line with the cost orientation principle;

The tariffs of domestic payphone calls are required to correspond to a maximum of three times the tariff of a residential phone call; and

PT was released from its obligations under the low user scheme, as well as certain discount schemes for retired people, except for the monthly fee discount for retired people that is financed by the Portuguese government.

In addition, general regulatory obligations of transparency, non-discrimination, cost orientation, cost accounting and account separation apply to access to the fixed line network and to the telephone services at a fixed location.

*Other Requirements.* The regulatory framework requires PT Comunicações to submit periodic reports on quality of service and comply with specified indicators. Penalties may occur if we do not achieve such indicators. We must also provide white page directories and certain other facilities to certain specified categories of subscribers free of charge.

*Interconnection Prices.* Law 5/2004 establishes the new access and interconnection regime in Portugal in accordance with the requirements of the new EU regulatory framework. Our initial reference interconnection offer for 2004 was published on March 31, 2004 and an updated version of the interconnection offer was published on October 1, 2004. See " *Interconnection*", below. We also

submitted our reference Internet access offer to ANACOM. See " *Interconnection Internet Access*", below.

*Prices for Leased Lines.* Prices for our leased lines are not subject to the pricing convention. The principles of cost-orientation, non-discrimination and transparency apply to our leased line prices, because ANACOM determined in February 2002 that we have significant market power in the provision of leased lines.

### ***Universal Service Obligations***

Law 91, the Concession and Decree Law 458/99 of November 5, 1999 imposed universal service obligations on us in Portugal. These obligations include providing connection to the public telephone network at a wireline location. They also include providing access to public switched wireline telephone services, including enabling users to make and receive local, national and international telephone calls, facsimile communications and data communications. They also include providing public pay telephones, making directories available and at least one telephone directory enquiry service covering all public voice telephone subscribers' numbers.

The existing EU Interconnection Directive sets out the rules for costing and financing of universal service in a competitive environment. The EU allows EU member states to decide which operators have an obligation to provide universal service. It also describes how these states may allocate any unfair burden that may arise as a result of the universal service obligation. However, it does limit the services that are eligible for any support payments made to the universal service provider, and it requires an incumbent telecommunications operator to justify any amounts payable by other operators to meet its net costs of meeting the universal service obligation.

Decree Law 415/98, which implemented the EU Interconnection Directive in Portugal, and Decree Law 458/99, which implemented the EU universal service regulation in Portugal, address the pricing mechanism and the financing procedures regarding the universal service obligations, as well as those who must contribute to its cost. Law 91 required that operators of public telecommunications networks and providers of voice services must contribute to the costs of our universal service obligation. Decree Law 415/98 and Decree Law 458/99 required us to disclose to ANACOM our negative margins involved in meeting the universal service obligations. ANACOM will establish and publish the criteria for contributions to the cost of universal service. It will also determine, on an annual basis, the amounts and timing of contributions by other operators and service providers. Decree Law 458/99 also required that we, ANACOM and the DGCC enter into a new pricing convention governing the prices of services provided pursuant to the universal service obligation. As discussed above, we entered into a new pricing convention on December 30, 2002. See " *Pricing of Wireline Services*".

According to Law 5/2004, enacted to promulgate the new EU framework directive, if ANACOM determines that the provision of universal service obligations has become an excessive burden, it may compensate us accordingly. This provision of Law 5/2004 has not yet been implemented.

On August 21, 2003, ANACOM decided that Portugal Telecom should not be compensated for universal services provided prior to January 2001, because Portugal Telecom had an exclusive right to provide such services prior to that time. Portugal Telecom does not agree with the decision reached by ANACOM and is challenging this decision in the Lisbon administrative court. The court has not yet reached a decision on this matter.

### ***Interconnection***

Law 5/2004 implemented the EU Access and Interconnection Directive and established the general conditions for access and interconnection among telecommunications operators in competitive markets.

It guarantees the rights of new entrants to obtain interconnection from telecommunications operators with significant market power.

As a result of the enactment of Law 5/2004, ANACOM adopted a measure in March 2004 on call origination on fixed telephone networks provided at a fixed location and call termination on individual public telephone networks provided at a fixed location and on significant market power designation in these fixed locations, declaring the Portugal Telecom group to have significant market power in these markets.

In December 2004, all mobile operators were declared to have significant market power in the call termination in mobile networks market. ANACOM is in the process of determining who has significant market power in the call origination on mobile networks market. A decision is expected during 2005.

*Internet Access.* On February 21, 2001, ANACOM issued an administrative decision instructing PT Comunicações to submit a Reference Offer for Internet Access proposal changing the connection of ISPs to its wireline network from a model based on revenue sharing to one based on call origination charges and establishing maximum prices that PT Comunicações is permitted to charge ISPs for Internet access service. This administrative decision instructed PT Comunicações to implement the new billing structure by May 31, 2001. PT Comunicações published its Reference Offer for Internet Access on March 1, 2001, and since that time has modified how it accounts for revenues attributable to the interconnection of ISPs to its wireline network. We believe that PT Comunicações is in full compliance with ANACOM's administrative decision. As discussed below in "*Item 8 Financial Information Legal Proceedings Other Legal Proceedings*", PT Comunicações has submitted a claim to the Lisbon administrative court requesting relief from ANACOM's February 2001 administrative act and contesting the legality of such act.

Under the new billing structure, two different types of pricing methods with ISPs are possible. Under the first method, ISPs pay a call origination charge to PT Comunicações, and, if the ISPs request that PT Comunicações invoice customers on their behalf, they also pay PT Comunicações the corresponding charge for the invoicing service. Under the second method, PT Comunicações charges the ISPs a wholesale flat rate and the ISPs bill their own customers. On September 23, 2003, ANACOM decided that data traffic and Internet traffic should be included in our Reference Interconnection Offer. Accordingly, PT Comunicações now offers two access regimes to ISPs: (i) the Reference Offer for Internet Access, which includes the two pricing methods described above, and (ii) the Reference Interconnection Offer, which includes a pricing method based on call origination. On March 16, 2004, ANACOM issued a new administrative decision regarding the billing structure for our Reference Interconnection Offer. As a result, the call origination pricing arrangements between PT Comunicações and ISPs are now ruled by two different billing regimes. The primary differences between the two billing regimes relate to origination prices, the manner in which ISP infrastructures are connected to PT Comunicações' wireline network and billing arrangements. The regime introduced in March 2004 has lower origination charges, involves the use of leased lines and does not require PT Comunicações to maintain billing arrangements with ISPs. The ISPs determine which billing regime will apply to their arrangements to connect with PT Comunicações' wireline network.

*The Interconnection Framework.* The EU Access and Interconnection Directive requires that interconnection services be made available in a non-discriminatory manner. It also requires that operators with significant market power in the provision of wireline telephone network services or of leased lines make interconnection available by publishing a reference interconnection offer which includes interconnection price lists. Interconnection prices must be cost-based and supported by transparent accounting systems. The EU Access and Interconnection Directive encourages commercial negotiations among operators but requires national regulatory authorities to establish mechanisms for effective dispute resolution.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

According to the EU Access and Interconnection Directive, all telecommunications companies with significant market power in the provision of wireline telephone networks or services, leased lines or mobile telephone networks or services must:

make interconnection access to their networks available to other network operators;

not discriminate between interconnection customers;

provide to those requesting interconnection the information and technical specifications necessary for them to interconnect their networks;

offer interconnection prices that are transparent and cost-oriented and do not discriminate between interconnection customers; and

maintain a separate accounting system for interconnection activities.

Pursuant to Law 5/2004, ANACOM is entitled to review and modify our proposed interconnection rates and arrangements in our reference interconnection offer. ANACOM has established in Portugal an overall interconnection framework based on cost and consistent with the EU legal framework for both wireline and mobile services. We expect that convergence of interconnection rates and practices in Portugal with those in the EU will occur in a step-by-step process over the next several years.

Through its competition directorate, the European Commission may become involved in complaints with respect to interconnection arrangements and practices brought by new entrants against incumbent telecommunications operators. Although the European Commission often defers to initiatives undertaken by national regulatory agencies with respect to interconnection-related matters, there can be no assurance that the European Commission will not further investigate or become actively involved in matters concerning the establishment of interconnection arrangements in Portugal on its own initiative or in response to a complaint by another telecommunications operator.

### ***Number Portability and Carrier Selection***

An amendment in September 1998 to the EU Interconnection Directive required member states to introduce number portability among telecommunications operators in most EU countries by January 1, 2000. Where implemented, number portability allows a subscriber at a specific location to change service providers without having to change telephone numbers. PT Comunicações introduced number portability for wireline services on July 1, 2001. Number portability for mobile services was introduced in January 2002.

ANACOM has required call-by-call carrier selection to be offered by us for long distance and international calls since January 1, 2000. We have been offering it for local and regional calls since January 1, 2001 and for fixed-to-mobile calls since October 1, 2000. Call-by-call carrier selection enables customers to select the carrier of their calls by dialing a code connecting them to the selected carrier.

Law 5/2004 requires that all wireline network operators with significant market power must offer carrier pre-selection. Carrier pre-selection allows customers to select the carrier that will be their default carrier. They then do not need to dial any code to connect to their selected carrier when they make their calls. ANACOM introduced interim carrier pre-selection using auto dialers on July 1, 2000 and full carrier pre-selection has been available throughout Portugal since October 15, 2000.

ANACOM also introduced call-by-call carrier selection for mobile operators, including TMN, on March 31, 2000. Following this introduction, mobile operators are required to offer call-by-call carrier selection for international calls only.

Number portability and carrier pre-selection are in the process of being revised, and a public comment period was commenced to solicit opinions on this process on March 11, 2004. We expect the

results of this process to result in carrier pre-selection being revised to include non-geographical services.

### ***Unbundling of the Local Loop***

On December 18, 2000, the European Commission approved a regulation requiring wireline network operators to make the local loop between their customers and the local switches on their networks available to competitors. Such a requirement also exists in Law 5/2004. This allows such competitors to connect their networks to the copper "local loop" and use it to provide their services directly to those customers without having to rely upon the network operator's relationship with the customers. According to the regulation and Law 5/2004, we are required to maintain a reference offer for unbundled access to our local loops and related facilities and to meet reasonable requests for unbundled access to our local loops and related facilities under transparent, fair and non-discriminatory conditions. Prices charged must be cost-oriented. ANACOM has announced that unbundling of the local loop should be available in Portugal in accordance with the terms of the EC regulation and Law 5/2004. Our PT Comunicações wholesale unit published its last version of the reference offer for unbundled access to our local loops on December 16, 2004. The reference offer is in accordance with terms established by ANACOM.

PT Comunicações has made available to its competitors all of the local switches for remote and physical co-location where technical and space conditions are available, 101 of which are co-located.

### ***Internet and Related Services***

Various regulatory developments may affect our Internet business. Portugal has adopted Decree Law 290-D/99 regarding digital signatures, which established a legal framework for electronic documents and digital signatures. This framework is a key component for developing e-commerce business. Portugal is expected to enact further measures pursuant to the EU Electronic Signature Directive, adopted in December 1999. The EU Electronic Commerce Directive, which was implemented in January 2002, further promotes the free movement of electronically provided services and commerce within the EU. For example, it requires EU member states to absolve information carriers and host-services providers from liability for the content of information transmitted over the Internet. Such provisions provide us with legal protection that is important in carrying out our business. The 1995 EU Data Protection Directive, which was implemented in Portugal in 1998, places restrictions on the use by Internet companies of personal data stored on their networks. It is not possible at this time to ascertain the burden that data protection schemes or other self-regulation and content-monitoring requirements may impose on our Internet business.

### ***EU Cable Television Directive***

The European Commission issued a directive on June 23, 1999 that requires member states to enact legislation directing incumbent telecommunications operators to separate their cable television and telecommunications operations into distinct legal entities. The European Commission has indicated that further actions to reduce the potential anti-competitive effects of the joint provision of cable television and telephone infrastructures will be justified in specific cases. We believe, however, that steps already taken to operate our cable television business in Portugal through PT Multimédia, a separate legal entity that has independent shareholders, satisfy the requirements of the directive implemented in Portugal.

### ***Licensing Framework***

The EU Licensing Directive prohibits any limitation in the number of new entrants in telecommunications markets, except as required to ensure an efficient use of radio frequencies. It gives

priority to general authorizations as opposed to licensing of particular activities; however, it permits national regulatory authorities to decide when licenses should be required for particular activities.

The Portuguese government approved Decree Law 381-A/97, which implemented the EU Licensing Directive. This decree law requires a separate license to:

provide public wireline telephone services;

establish and/or provide public telecommunications networks;

establish networks or provide services which require the granting of frequencies; or

conduct operations in which the operator is subject to universal service obligations, interconnection obligations or duties that derive from having significant market power.

Pursuant to the authorization directive, which is part of the new EU framework, Law 5/2004 has established a new regime, whereby an operator must have a general authorization or license in order to obtain radio spectrum or numbering resources. ANACOM is responsible for issuing regulations to implement the authorization directive. PT Comunicações' Concession will be treated as a license under the new regime.

#### ***Summary of Our Concession and Existing Licenses***

Our Concession is for the installation, management and operation of the infrastructure that forms part of the basic telecommunications network in Portugal (as discussed below) and the terrestrial broadcasting network in Portugal, and it permits us to provide public switched wireline telephone, packet switched data (the rights to which were transferred to our subsidiary PT Prime) on X.25 mode, leased lines and telex and telegraphy services in Portugal. We also provide mobile telephone services, cable television and data communications services under licenses granted to our subsidiaries by the Portuguese government. The subsidiaries holding the licenses are subject to separate financial reporting and other requirements.

*Our Wireline Concession.* The Portuguese government granted Portugal Telecom a Concession on March 20, 1995. The Concession had an initial term of 30 years, expiring in 2025, and could be renewed for successive minimum periods of 15 years by agreement between us and the Portuguese government. As part of the reorganization of our businesses, Portugal Telecom transferred the Concession to its subsidiary PT Comunicações. The Council of Ministers approved this transfer in a Decree Law that came into effect upon publication in the Portuguese Official Journal on September 9, 2000. The Concession confers rights with respect to provision of transmission infrastructure and leased circuit services as well as wireline telephone, telex and telegraphy services in Portugal.

The Concession granted to us the right to install, manage and operate the infrastructure that forms part of the basic telecommunications network and the terrestrial broadcasting network. Some of our assets that are part of the basic telecommunications network (as defined in Portuguese legislation) were treated as being within the "public domain" under the terms of the Concession. During the term of the Concession, we were permitted to receive economic benefits from the use of public domain assets as if we owned them completely. However, such public domain assets would have reverted to the Portuguese government without compensation when the Concession expired.

On December 11, 2002, we agreed to prepay the future rental payments due under the Concession in exchange for full ownership of the basic telecommunications network and to ensure that there will be no reversion of the assets related to the provision of Concession services to the government in 2025. On December 27, 2002, Portugal Telecom acquired full ownership of the basic telecommunications network for €365 million, which included the 2002 Concession fee in the amount of €16.6 million. As a result of this acquisition, the terms of the Concession have been modified so that PT Comunicações no longer is obligated to pay a concession fee to the Portuguese government and ownership of the network

and assets related to the Concession will not revert back to the Portuguese government in 2025. On February 17, 2003, Decree Law 31/2003 was enacted, establishing the basic regulatory principles supporting the terms of our modified Concession. On April 3, 2003, we entered into an agreement formally modifying the terms of our Concession with the Portuguese government.

The Portuguese government retains the ability to suspend or terminate our rights under the Concession. In cases of serious non-performance by us of our obligations under the Concession, the Portuguese government may, on a provisional basis, take over the development and operation of services authorized under the Concession. The Concession may also be terminated in cases of "severe, continual or insoluble" failure to perform our obligations. We believe that we have the resources to fulfill all our obligations under the Concession.

In addition, after 2010 the Portuguese government may revoke the Concession upon at least one year's notice if it deems such action to be justified in the public interest. In that event, we have the right to compensation in an amount equal to the value of the assets which constitute the infrastructure of the basic telecommunications network, including other of our assets included in our infrastructure development plan, net of depreciation and revaluation. This compensation would be payable prorated over the remaining term of the Concession. We would also be entitled to additional compensation equaling our annual average net profits for the five years prior to notification of revocation multiplied by the number of years remaining before the Concession expires. See *"Item 3 Key Information Risk Factors The Portuguese Government Could Terminate Our Wireline Concession and Licenses"*.

Our modified Concession provides that we are exempt from all taxes, fees and charges with respect to the usage of public rights-of-way for our telecommunications infrastructure. Further, Law 91/97 codified our right to use the public rights-of-way for our telecommunications infrastructure. Law 91/97 provides that we are exempt from municipal taxes and rights-of-way and other fees with respect to access to and installation and use of our telecommunications network in connection with our obligations under the Concession. Our exemption from municipal taxes prior to the enactment of Law 91/97 is being challenged in the Portuguese courts by the Municipality of Oporto. If the legal situation for rights-of-way changes, and PT Comunicações has to pay for these rights, our Concession provides that PT Comunicações should be compensated up to 2025, when the Concession expires. See *"Item 8 Financial Information Legal Proceedings Claims for Municipal Taxes and Fees"*.

Under the former terms of the Concession, we had to pay the Portuguese government a fee of up to 1% of our operating revenues from the services provided under the Concession, after certain deductions. As a result of the acquisition of the basic telecommunications network, the terms of the Concession have been modified so that PT Comunicações no longer is obligated to pay a concession fee to the Portuguese government, which in 2002 amounted to €16.6 million and was included in the amount paid for the acquisition of the ownership of the basic telecommunications network property. The Concession also requires us to supply telecommunications services free of charge to certain Portuguese state officials, including the President of the Republic, the President of the Parliament, the Prime Minister and the President of the Supreme Court. In 2002, 2003 and 2004, the value of such services was approximately €0.1 million, €0.1 million and €0.2 million, respectively.

We are required to provide special telephone prices to certain eligible retired and pensioner Portuguese citizens. The costs of providing these special prices are directly reimbursed by the Portuguese government. In addition, we offer supplementary discounts to certain retired and pensioner Portuguese citizens without reimbursement from the Portuguese government. The cost of these discounts for our wireline business was approximately €12.6 million in 2002, €10.2 million in 2003 and €8.7 million in 2004.

Under the Concession, we have to establish objectives for the development of our infrastructure and service offerings. This includes indicators of the quality of services to be complied with by us. These objectives must be defined by ANACOM.

The Concession imposes a universal service obligation on us. See " *Universal Service Obligations*", above.

The Ministry of Finance is responsible for monitoring financial issues with respect to the Concession. The Ministry of Economy is responsible for all other issues under the Concession. ANACOM is authorized to monitor and assess penalties up to a maximum of €500,000 if we fail to fulfill our obligations under the Concession or other obligations imposed by law. Disputes concerning the application and interpretation of the Concession are dealt with by arbitration.

*PT Prime's Data Licenses and Registrations.* PT Prime holds:

a renewable, non-exclusive license, valid until 2015, to provide wireline services;

a renewable, non-exclusive license, valid until 2015, to be a "Public Telecommunications Networks" operator; and

due to our reorganization, all the former Telepac licenses, including a data communications license, valid until 2010.

PT Prime's data communications license authorizes it to provide X.25/X.32 synchronous services and X.28 asynchronous services and other switched and non-switched data communications services, including frame relay and virtual private networks for data communications. The license also authorizes PT Prime to provide value-added services such as electronic data interchange and videotext services. In addition, the license authorizes the company to construct certain networks infrastructure in connection with licensed services. With respect to packet switched data, the data communications license is valid for 30 years and renewable by right thereafter for 15-year periods, unless PT Comunicações' Concession is terminated earlier. The license is valid for 15 years for other data transmission services. Licenses have also been granted to other providers of data communications and Internet access services, including companies associated with major international telecommunications providers. However, under Decree Law 381-A/97, and in accordance with the EU licensing regime, companies are not required to have a license to provide data communications services and Internet access. Instead, it is sufficient to register their intended services with ANACOM under its service registration scheme.

In April 1997, ANACOM granted PT Prime a license to provide data communications services using satellite infrastructure.

In April 1997, ANACOM also granted PT Prime a license to offer voice services to corporate networks and other closed groups of users. This license is valid for 15 years. Other providers of data communications services have also been issued licenses to provide such voice services, including Global One and Oni-Solutions.

*TMN's Mobile Service Licenses.* Mobile telephone service licenses are valid for 15 years and are issued by ANACOM under Decree Law 381-A/97. These licenses authorize the installation of base stations, base station controllers and control switching centers and require the licensee to construct networks capable of reaching at least 75% of Portugal's population within a specified period of time. Charges for the provision of mobile telephone services are not subject to regulation.

Through TMN, we hold a renewable, non-exclusive license to provide traditional and GSM digital mobile telephone services throughout Portugal. This license is valid until 2007 and may be renewed thereafter by authorization of the Portuguese telecommunications regulator. TMN terminated the provision of traditional analog mobile services, after being authorized by the Portuguese regulator, in 1999. Two other operators hold licenses to provide GSM digital mobile telephone services on substantially the same terms as those applicable to us. Vodafone Portugal was awarded its license in 1991. Optimus was awarded a license in 1997 and began operations in September 1998. In addition to GSM 900 services, all three mobile service operators have been authorized since April 1998 to provide GSM 1800 services in Portugal on substantially similar terms and conditions.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

We are required to comply with a number of mobile telephone service criteria. These include satisfying minimum quality standards regarding blocked call rates, network effectiveness and servicing time, and providing certain services. We are also required to provide ANACOM with monthly information about our mobile telephone operations, including the number of customers, number and average duration of calls and quarterly information about the development of infrastructure.

*Third Generation Mobile Services Licenses.* In 2000, ANACOM conducted a tender for four licenses for universal mobile telecommunications services, known as UMTS. UMTS services are the European version of the globally accepted technical standards for "third generation" mobile communications. UMTS constitutes a significant advance over the "second generation" digital GSM mobile services currently provided. The "first generation" services were traditional analog mobile services. The broadband capacity of the frequency spectrum to be allocated under the UMTS licenses will enable operators to supply video and Internet content to mobile handsets at higher transmission speeds.

The UMTS licenses were issued by ANACOM at the end of 2000. The licenses cover all of Portugal and are valid for 15 years. The Ministry of Economy, under direction from ANACOM, initially postponed the mandatory initiation of third-generation services by license holders from January 1, 2003 to December 31, 2003. In February 2004, ANACOM issued a decision requiring the initiation of third-generation services in 2004. UMTS license holders were required to initiate UMTS services commercially by June 30, 2004. On April 19, 2004, TMN launched UMTS in Portugal, with a service that allows customers to make video calls. The 3G handsets function both on GSM/GPRS and UMTS, allowing customers to use all the voice, multimedia and data services already offered by TMN. For data access exclusively, TMN also offers a 3G access card. TMN currently provides UMTS coverage in Portugal's major cities, and is in the process of extending this coverage to cover the whole of Portugal.

The license fee was €100 million per license. TMN and the other two main mobile operators in Portugal were each awarded one of these licenses at the end of 2000. One of the licenses was also awarded to Oniway, a new entrant in the Portuguese mobile market. However, Oniway decided not to participate in the provision of third generation mobile services, and, as a result, requested that the Portuguese government repeal the license granted to it in January 2001. The Portuguese government granted this request by ministerial order on January 13, 2003. The other three recipients of third generation licenses, including TMN, requested that the additional frequency that had been allocated to Oniway be reallocated to them. This request was granted by a special ministerial order in January 2003.

The tender was for 2x15MHz of paired spectrum in the 1920-1980 MHz / 2110-2170 MHz bands and 5 MHz of non-paired spectrum in the 1900-1920 MHz band for each of the licenses. License holders are required to offer their services to:

at least 50.7% of the Portuguese population by the end of the first year;

65.7% by the end of the third year; and

77.3% by the end of the fifth year.

To ensure a competitive market develops in the new services, license holders are limited in the amounts of share capital that they and their shareholders may hold of any other license holder. Neither a license holder nor a shareholder of a license holder may hold, directly or indirectly, more than 10% of the share capital of another license holder.

*TV Cabo's Cable Television Authorizations.* Cable television authorizations are issued upon proposal by the member of government responsible for telecommunications and are valid for 15 years. These authorizations permit the construction of the main cable distribution centers as well as cable distribution networks. They also contain quality of service standards and, in most cases, obligations to

construct networks capable of reaching 80% of the population of the authorized area. The remaining 20% of the population may request connection at an extra charge. The charges for the provision of cable television services are not subject to regulation.

Although not public domain assets and not subject to our wireline Concession, the cable television infrastructure that TV Cabo has installed and operates may be subject to reversion or transfer to third parties without compensation. Under the terms of Decree Law 241/97 infrastructure installed on the property of a governmental authority will become part of such authority's property when authorizations granted to cable television operators expire or terminate. Infrastructure installed on the property of a telecommunications operator, including us, will revert to such operator. Also, unless otherwise agreed, infrastructure installed on other property will revert to the property owner.

TV Cabo holds a total of nine renewable, non-exclusive authorizations to provide cable television services in 125 counties in continental Portugal and the Madeira and Azores Islands. Currently, certain other operators are also authorized to provide cable television services in Portugal. See " *Competition Competition Facing PT Multimédia's Pay TV and Cable Internet Business*".

Under Portuguese law, advertising on TV Cabo's channels is generally restricted on the same terms as broadcast TV. These restrictions include a ban on alcohol advertisements before 10 p.m. and a complete ban on tobacco advertisements. Advertising on premium channels cannot take up more than 10% of air-time, and advertising on basic channels cannot take up more than 15% of air-time.

Portuguese law currently permits television operators to produce and broadcast their own television programming if they have national coverage. In addition, Portuguese legislation permits the use of two-way signaling capability over cable television networks. The ability to transmit and receive signals allows the introduction of pay-per-view, home shopping and similar products in Portugal.

In 1997, the Portuguese government decided to allow competition in the provision of infrastructure to telecommunications services that are already open to competition. As a result, cable operators can hold a public network operator license under Decree Law 381-A/97 and Decree Law 290-A/99 and cable networks may be used to provide infrastructure to providers of already liberalized services.

## **Brazil**

*General.* Our Brazilian mobile business, the services they provide and the prices they charge are subject to regulation under the General Telecommunications Law and various administrative enactments, which regulate the services provided by Brazilian telecommunications operators.

ANATEL is the agency that regulates telecommunications under the General Telecommunications Law and the July 2001 Regulamento da Agência Nacional de Telecomunicações, known as the ANATEL Decree. ANATEL is financially autonomous, and administratively independent of the federal government. ANATEL maintains a close relationship with the Ministry of Communications. Any regulation proposed by ANATEL is subject to a period of public comment, which may include public hearings. ANATEL's actions may be challenged in the Brazilian courts under Brazilian administrative law. On November 25, 1998, ANATEL enacted "Resolution 73 Regulation of Telecommunication Services," which regulates in detail the new comprehensive framework for the provision of telecommunications services in Brazil established by the General Telecommunications Law.

*Concessions and Authorizations.* Prior to January 2000, ANATEL had only authorized two mobile service providers in each of the ten franchise areas under bands A and B. Band A and band B mobile service providers, including Vivo's operating subsidiaries, were granted concessions pursuant to the *Lei Mínima*, or the Minimum Law. Each concession is a specific grant of authority to supply cellular telecommunications services, subject to certain requirements contained in the applicable list of obligations appended to each concession. If a mobile service provider wishes to offer any

telecommunications service other than those authorized by its concession, it may apply to ANATEL for an authorization to offer such other services.

In accordance with the General Telecommunications Law, a concession relates to the provision of telecommunication services under the public regime, as determined by the public administration. A concession may only be granted upon a prior auction bidding process. As a result, regulatory provisions are inserted in the relevant concession agreements and the concessionaire is subject to public service principles of continuity, changeability and equal treatment of customers. Also, the government authority is entitled to direct and control the performance of the services, to apply penalties and to declare the expiration of the concession and the return of assets of the concessionaire to the government authority upon termination of the concession. Another distinctive feature is the right of the concessionaire to maintain an economic and financial balance of the concession agreement. The concession is granted for a limited duration and is generally renewable once.

An authorization is a permission granted by the public administration under the private regime, which may or may not be granted upon a prior auction bidding process, to the extent that the authorized party complies with the objective and subjective conditions deemed necessary for the exploitation of the relevant type of telecommunications service in the private regime. The authorization is granted for an indeterminate period of time. Under an authorization, the government will not guarantee an economic and financial balance, as guaranteed under a concession.

*SMP Regulation.* In November 2000, ANATEL adopted certain regulations for the issuance of new licenses to provide wireless communications services through SMP rules to compete with the then existing cellular operators in the various regions of Brazil. These regulations divided Brazil into three main regions covering the same geographic area as the concessions for the fixed-line telecommunications services. ANATEL organized auctions for three new licenses for each of those regions. The new licenses provided that the new services would be operated in the 1800 MHz radio frequency bands, and they were denominated band C, band D and band E. These new licenses were auctioned by ANATEL and awarded during the first quarter of 2001, at the end of 2002 and in September 2004.

Under these new licenses, services were to be provided using the 1800 MHz frequency, each operator would be able to provide domestic and international long distance services in its licensed area, and existing cellular service providers, as long as they do not have partnerships with fixed-line operators, as well as new entrants into the Brazilian telecommunications market, could bid for band C, band D and band E licenses. However, fixed-line operators, their controlling shareholders and affiliated cellular providers may only bid for band D and band E licenses. A cellular operator, or its controlling shareholders, cannot have geographical overlap between licenses. Existing band A and band B cellular service providers could apply for an extra frequency range.

Pursuant to the SMP services regulation, each of the three main regions is divided into registration areas, or tariff areas.

Vivo's operating subsidiaries all held concessions prior to the introduction of the SMP regime. Subsequent to its introduction, they have migrated to the new SMP regime and their concessions have been converted into licenses to use the radio frequency spectrum in their respective bands and provide services in the regions in which they operate. See "*Our Businesses Brazilian Mobile Business*". In order to migrate services to the SMP regime, Telesp Celular and other operators owned by Vivo were required to comply with several technical and operational conditions, including, among others, the adoption of a carrier selection code for long distance calls originating from their networks.

Under the new SMP regime, interconnection fees for the termination of calls on mobile networks will be determined through commercial negotiations between Vivo's subsidiaries and other telecommunications operators. If the parties do not reach an agreement, the matter will be determined



through arbitration, which will be conducted by ANATEL. Vivo's interconnection fees should have been revised pursuant to the new regime in February 2005, but the parties have not yet reached a final agreement through commercial negotiations. Prior to the introduction of the new regime, the interconnection fees for termination of calls on mobile networks were determined by ANATEL.

The general instructions governing interconnection are contained in the "Interconnection Regulation", which provides the basic principles and rules on interconnection between telecommunications networks and systems. It governs the commercial, technical and legal aspects of interconnection. The criteria for remuneration of mobile network usage are set out in ANATEL Resolution #319.

Because ANATEL considers the operators owned by Vivo to be affiliated with Telefónica, which already provides wireline long distance services in the state of São Paulo and was awarded a license to provide these services nationwide, ANATEL will not award wireline long distance licenses to the operators owned by Vivo. Though Vivo, through its operating subsidiaries, has requested that ANATEL revise the current SMP regime, there can be no assurance it will do so. Under the SMP regime, our operations will receive revenues from interconnection fees paid to us by wireline long distance operators due to long distance traffic originating and terminating on our network. However, the interconnection fees that we receive from wireline long distance operators do not fully compensate for the revenues that the operators owned by Vivo would have received from our customers for directly providing long distance services to them, and this has had a negative impact on the overall revenues of Vivo's subsidiaries.

The SMP regime may change the interconnection fees that other operators currently pay to Vivo's operators as a result of traffic originating on other networks and terminating on the mobile networks of Vivo's operators. The SMP regime permits commercial negotiation of the interconnection rates Vivo's operators charge other operators for the use of the network.

Each SMP license consists of two licenses – one to provide mobile telecommunications services, and another to use the frequency spectrum for a period of 15 years. The frequency license is renewable for a second 15-year period upon the payment of an additional license fee.

*Potential Benefits Relating to the SMP System.* According to the General Telecommunications Law and Decree No. 2056/96, control of a concession can only be transferred after five years from the date of privatization in the case of band A concessions, or the commencement of services in the case of band B concessions. On the other hand, under the SMP system, a licensee can be transferred through merger or incorporation of the relevant mobile service provider, whether they are providing services under the band A or band B.

*Obligations of Telecommunications Companies.* As telecommunications service providers, the companies operating under the Vivo brand are subject to regulations concerning quality of service and network expansion, as established in their SMP licenses and their original concession agreements.

Any breach by the companies of telecommunications legislation or of any obligation set forth in their authorizations may result in a fine of up to R\$50 million.

Our Brazilian mobile businesses' SMP licenses impose obligations to meet quality of service standards, such as the system's ability to make and receive calls, call failure rates, the network's capacity to handle peak periods, failed interconnection of calls and customer complaints. ANATEL published the method for assessing these quality service standards on April 23, 2003 (ANATEL Resolution No. 335/03).

*Interconnection.* Under the General Telecommunications Law, telecommunications service providers are classified as providers of either collective or restricted services. All mobile operators, including SMP service providers, are classified by ANATEL as collective service providers. All providers

of collective services are required to provide interconnection upon request to any other collective service provider. The terms and conditions of interconnection are freely negotiated between parties. Providers must enter into interconnection agreements, regarding, among other things, tariffs, commercial conditions and technical issues, with all requesting parties on a non-discriminatory basis.

Interconnection agreements must be approved by ANATEL and may be rejected if they are contrary to the principles of free competition and the applicable regulations. If the parties cannot agree upon the terms and conditions of interconnection, ANATEL may determine terms and conditions by arbitration.

Currently, under the SMP system, remuneration for network usage between SMP mobile operators will only be due if traffic carried in the same registration area between two networks, in a given direction, exceeds 55% of the total traffic exchanged between them (partial "Bill & Keep" regime). In this case, only those calls which have surpassed the 55% threshold will be subject to payment for network usage. In the future, SMP operators will be permitted to adopt full "Bill & Keep", by which no remuneration will be due for network usage among SMP networks, regardless of the amount of carried traffic. The timing of the implementation of full "Bill & Keep" is still under final negotiation, but was intended to be in place after June 30, 2005.

*Rate Regulation.* SMP licenses continue to provide for a price-cap mechanism to set and adjust rates on an annual basis. The cap is a maximum weighted average price for a package of services. The package consists of the services in Vivo's Basic Plan, including activation fees, monthly subscription fees, and certain roaming charges, which are charged for the use of mobile services under the SMP regime. The price cap is revised annually to reflect the rate of inflation as measured by the IGP-DI. However, mobile operators are able to freely set the rates for alternative service plans.

The initial price cap agreed to by ANATEL and Vivo's operating subsidiaries in their SMP licenses was based on the previously existing or bidding prices, and was adjusted annually on the basis of a formula contained in their licenses. The price cap has been revised to reflect the rate of inflation as measured by the IGP-DI. The weighted average price for the entire package of services may not exceed the price cap, but the price for individual services within the package may be increased.

Telecommunications companies that interconnect with and use Vivo's operating subsidiaries' networks must pay an interconnection fee. Under the new SMP regime, interconnection fees for the termination of calls on mobile networks will be determined through commercial negotiations between Vivo's subsidiaries and other telecommunications operators. If the parties do not reach an agreement, they will go to arbitration, which will be conducted by ANATEL. Vivo's interconnection fees should have been revised pursuant to the new regime in February 2005, but the parties have not yet reached a final agreement through commercial negotiations. Prior to the introduction of the new regime, the interconnection fees for termination of calls on mobile networks were determined by ANATEL.

*Competition Issues.* ANATEL is required to consult with the Brazilian competition authority, Conselho Administrativo de Direito Econômico, or CADE, in carrying out certain of its responsibilities, including those related to the review of acquisitions and joint venture agreements entered into by telecommunications operators. In turn, CADE does not exercise its responsibilities without initially seeking the views of ANATEL and would not intervene with respect to any proposed acquisition or agreement affecting competition in the telecommunications sector without first seeking the views of ANATEL. Telecommunications operators must concurrently seek review from ANATEL and CADE of acquisitions and joint venture agreements.

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

You should read the following discussion in conjunction with our audited consolidated financial statements and the accompanying notes included elsewhere in this report. Our audited consolidated financial statements have been prepared in accordance with Portuguese GAAP, which differs in significant respects from U.S. GAAP. For a discussion of the principal differences between Portuguese GAAP and U.S. GAAP, as they relate to us, see Notes 36, 37 and 38 to our audited consolidated financial statements. The statement of income and cash flow data presented below for the year ended December 31, 2002 reflects the full consolidation of TCP's results of operations with our financial results. However, as a result of the transfer of our interest in TCP to Vivo on December 27, 2002 and our acquisition of a 50% ownership interest in Vivo as of that date, our statements of income and cash flow data presented below for the years ended December 31, 2003 and 2004 proportionally consolidate the financial results of Vivo and all balance sheet data as of December 31, 2003 and 2004 proportionally consolidate the financial results of Vivo.

**Overview**

***Our Business Reorganization and Revenue Reporting Categories***

Portugal Telecom, SGPS, S.A. is a group holding company. Our business operations are conducted by our subsidiaries, which are classified for financial reporting purposes according to the general type of telecommunications services provided. This current classification is different than that used prior to 2003. Portugal Telecom's business segments now consist of the following:

|                              |  |
|------------------------------|--|
| Wireline Business            | Offering wireline services through PT Comunicações, PT Prime and PT.com, as follows:<br>Retail business through PT Comunicações, including the fixed line telecommunications service, and, through PT.com, Internet services to residential customers(1);<br>Wholesale business through PT Comunicações; and<br>Data and corporate business through PT Prime, including data communications, leased lines, outsourcing and net solutions, and Internet business-to-business.   |
| Domestic Mobile Business     | Offering mobile services, such as voice, data and Internet-related services, through TMN.  |
| Brazilian Mobile Business(2) | Offering mobile services, such as voice, data and Internet-related services, through Vivo and its subsidiaries, including:<br>Telesp Celular, which operates in the Brazilian state of São Paulo;<br>Global Telecom, which operates in the Brazilian states of Paraná and Santa Catarina(3);<br>Tele Centro Oeste, which operates in the Northern and Midwestern regions of Brazil(4);<br>Tele Sudeste Celular, which operates in the Brazilian states of Rio de Janeiro and Espírito Santo;<br>Tele Leste Celular, which operates in the Brazilian states of Bahia and Sergipe; and<br>CRT Celular, which operates in the Brazilian state of Rio Grande do Sul. |

|                     |   |
|---------------------|---|
| Multimedia Business | Offering multimedia and Internet-related services for the residential market through PT Multimédia and its subsidiaries, including:<br>Cable and satellite television through TV Cabo;<br>Broadband Internet access through cable modem provided by TV Cabo<br>TV programming activities through PT Conteúdos and its subsidiaries and affiliates;<br>Cinema distribution, negotiation of cinema rights for all film exhibition windows and distribution of DVDs, videos, and videogames through Lusomundo Audiovisuais;<br>Cinema exhibition through Lusomundo Cinemas; and<br>Production and distribution of daily newspapers, news radio and a diverse range of magazines through Lusomundo Media(5).  |
| Other               | International investments other than Vivo, instrumental companies and the Portugal Telecom, SGPS, S.A. holding company, including:<br>PrimeSys, providing data communications services in Brazil;<br>Mobitel, providing call center services in Brazil;<br>Cabo Verde Telecom, providing fixed and mobile telecommunications services in the Cabo Verde Islands;<br>Medi Telecom, providing mobile telecommunications services in Morocco(6);<br>Unitel, providing mobile telecommunications services in Angola(6);<br>Mascom Wireless, providing mobile telecommunications services in Botswana (7);<br>CTM, providing fixed and mobile telecommunications services in Macao(6); and<br>Instrumental companies, including PT SI, PT Inovação, PT Contact, PT PRO and PT Compras. |

- 
- (1) As a result of PT Multimédia's sale of PT.com to Portugal Telecom in October 2002, PT.com's operations and results have been included in the wireline business segment since the beginning of 2003.
- (2) During the year ended December 31, 2002, we offered mobile services in the Brazilian market through Telesp Celular, Global Telecom and Celular CRT. On December 27, 2002, Portugal Telecom's interest in these subsidiaries was transferred to Vivo in exchange for a 50% interest in Vivo. As a result, we now proportionally consolidate the financial results of Vivo. See *"Item 4 Information on the Company Our Businesses Brazilian Mobile Business"*.
- (3) We accounted for this investment during 2002 using the equity method.
- (4) On April 25, 2003, TCP acquired a controlling interest in TCO. As a result, TCO's assets and liabilities as of December 31, 2003 and 2004 are reflected in our consolidated balance sheet as of that date through our proportional consolidation of Vivo, and TCO's income and cash flows from May through December 2003, and for the year ended December 31, 2004 are reflected in our consolidated statement of income and cash flow data for the years ended December 31, 2003 and 2004 through our proportional consolidation of Vivo's statement of income and cash flow data.

- (5) As discussed above under "*Item 4 Information on the Company Our Businesses Multimedia Business*," PT Multimédia announced the disposal of its interest in Lusomundo Media on February 28, 2005, subject to the approval of the Portuguese competition authority.
- (6) We account for these investments using the equity method.
- (7) In September 2004, we disposed of our interest in Mascom Wireless, and in 2004, we accounted for the results of Mascom Wireless up to September 2004 by the equity method.

We discuss and analyze our financial condition and results of operations in this section according to the classification of our business segments described above. For comparative purposes, financial results by business segment discussed below for the year ended December 31, 2002 have been reclassified in order to reflect the new composition of each business segment, except for the financial results of the Brazilian Mobile business segment for the year ended December 31, 2002, which continue to fully consolidate TCP's results. See "*Consolidation Treatment of Vivo*" below and "*Item 4 Information on the Company Our Businesses Business Units*".

#### ***Consolidation Treatment of Vivo***

On December 27, 2002, we transferred our interest in TCP to our mobile joint venture with Telefónica Móviles in Brazil, originally named Brasilcel and rebranded Vivo in April 2003. We hold a 50% interest in Vivo, which now holds directly the following investments:

the controlling interest in TCP (which holds 100% of Telesp Celular, 100% of Global Telecom since December 27, 2002 and 86.2% of the voting shares of TCO since November 18, 2003, including treasury shares owned by TCO) and a minority interest in Celular CRT Participações (which holds 100% of CRT Celular), which we used to hold; and

the controlling interest in Tele Sudeste Celular Participações (which has 100% of the mobile operators in the Brazilian states of Rio de Janeiro and Espírito Santo), Tele Leste Celular Participações (which holds 100% in the mobile operators in the Brazilian states of Bahia and Sergipe) and Celular CRT Participações, which Telefónica Móviles used to hold.

Since the transaction occurred at the end of 2002, our statement of income and cash flow data for the year ended December 31, 2002 continued to fully consolidate the financial results of TCP, but our consolidated balance sheet at December 31, 2002, proportionally consolidated 50% of the assets and liabilities of Vivo rather than fully consolidating those of TCP. In 2003 and 2004, we proportionally consolidated the financial results of Vivo in our consolidated financial results.

On April 25, 2003, TCP acquired a controlling interest in Tele Centro Oeste, or TCO, a mobile telecommunications operator in the Midwestern and Northern regions of Brazil. As a result, TCO's assets and liabilities as of December 31, 2003 and 2004 are reflected in our consolidated balance sheets as of December 31, 2003 and 2004 through our proportional consolidation of Vivo, and TCO's income and cash flows from May through December 2003 and for the year ended December 31, 2004 are reflected in our consolidated statements of income and cash flow data for the years ended December 31, 2003 and 2004 through our proportional consolidation of Vivo's statements of income and cash flow data.

#### ***Changing Composition of Our Operating Revenues***

The composition of our operating revenues has been changing in recent years. Mobile services and multimedia services, such as Cable TV, have been growing rapidly in Portugal. Revenues from fixed line telephone services, particularly voice services, account for a decreasing share of our total operating revenues. The decrease in our fixed line telephone services revenues since 1998 reflects the migration of users from fixed line voice services to mobile voice services in Portugal, as well as price reductions.

Wireline revenues accounted for 35.3% of total operating revenues in 2004, 37.0% in 2003 and 40.7% in 2002. The proportion of our total operating revenues derived from the provision of mobile telephone services in Portugal and Brazil accounted for, on a combined basis, 48.9% in 2004, 46.9% in 2003 and 44.5% in 2002. The trends above are affected by the devaluation of the Brazilian Real, since a substantial part of our mobile telephone operations are in Brazil. Wireline revenues currently include retail, wholesale and data and corporate revenues. The proportion of our total operating revenues attributable to our multimedia business accounted for 12.1% in 2004, 11.8% in 2003 and 11.1% in 2002.

#### ***Cost Reduction Program***

Our principal costs include employee costs (including wages and salaries, post retirement benefits and work force reduction program costs), costs of telecommunications (principally accounting rate payments to other international telecommunications operators), costs of products sold, other general and administrative costs and depreciation and amortization. Since our formation in 1994, we have focused on consolidating operations, identifying administrative duplication and generally improving the efficiency of our operations.

In 2004, we reduced our workforce in Portugal by 651 employees. See "*Item 6 Directors, Senior Management and Employees Employees Work Force Reductions*". We expect these workforce reductions to decrease our labor costs and increase productivity. Workforce reductions in our fixed line telephone services will continue to be a significant part of our cost management in 2005. We believe that the productivity of our fixed line telephone service unit is commensurate with European standards generally. We believe that there is potential for further efficiency gains as a result of the continued implementation of the current cost reduction programs and network modernization, as well as management's continuous efforts to identify other areas to improve our efficiency.

#### ***Market and Economic Developments in Brazil***

A material portion of our business, prospects, financial condition and results of operations is dependent on general economic conditions in Brazil. Since 1998, we have made significant investments in telecommunications operators such as TCP, and in December 2002, we and Telefónica transferred our investments in Brazilian mobile operators to a 50/50 joint venture, Vivo, the largest provider of mobile telecommunications in the Brazilian market. The following significant factors have the potential to impact negatively our investments in Brazil, including Vivo, and our results of operations in Brazil, including Vivo's:

general economic conditions in Brazil and in other Latin American countries;

the devaluation of the Real, which could negatively affect the stability of the Brazilian economy;

changes in the Brazilian government's economic policy, including changes in the exchange control policy; and

high rates of inflation, as well as governmental measures put in place to combat inflation.

In December 2001, we recorded a provision for impairment amounting to €500 million. This provision included an estimated impairment of our investment in TCP amounting to €1,500 million, net of the related tax effect of €1,000 million resulting from the corporate restructuring of our mobile businesses. During the fourth quarter of 2002, this provision was used to offset the impairment in the investment in TCP following the contribution of this investment to Vivo.

***Critical Accounting Policies under Portuguese GAAP***

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with Portuguese GAAP. Our reported financial condition and results of operations are sensitive to accounting methods, assumptions and estimates that underlie preparation of the financial statements. We base our estimates on historical experience and on various other assumptions, the results of which form the basis for judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our consolidated financial statements.

***Accounting for long-lived assets.*** Fixed assets and intangible assets other than goodwill are recorded at their acquisition cost or revalued amount in the case of certain fixed assets. When such assets are acquired in a business combination, purchase accounting requires judgment in determining the estimated fair value of the assets at the date of the acquisition and their useful lives over which the costs of acquiring these assets are charged to the income statement.

Other intangible assets and plant, property and equipment are depreciated when, due to events and circumstances arising in the period, impairments are identified. The determination of such impairments involves the use of estimates, which include, but are not limited to, the cause, the timing and the amount of the impairment. Among impairment indicators, Portugal Telecom typically considers obsolescence, physical damage, significant changes in their usage, performance below forecast, decreasing revenues and other external indicators. When impairment is deemed necessary in the light of those indicators, the recoverable value of the assets is estimated by Portugal Telecom's management. The recoverable value is the higher of the realizable value and the value in use. Impairment tests are performed by group of assets by comparing the recoverable value and the carrying value (when an impairment charge appears necessary, the amount recorded is equal to the difference between the carrying value and the recoverable value).

For assets destined to be kept and used, the recoverable value is most often determined on the basis of the value in use, representing the value of expected future economic advantages from its use and disposal. It is assessed notably by reference to discounted future cash flows determined using economic assumptions and forecast operating conditions used by the management of Portugal Telecom or by reference to the cost of replacement taking into account asset ageing or cost of technology. For assets destined to be divested, the recoverable value is determined on the basis of the realizable value, and this is assessed on the basis of market value.

***Goodwill.*** The determination of goodwill is dependent on the allocation of the purchase price to the tangible and intangible assets acquired and the liabilities assumed. Such an allocation is based on management's judgment. The useful lives assigned to different goodwill are estimates based on management's assumptions and defined objectives at the time of the acquisition. As of December 31, 2004, the net book value of goodwill recorded in our balance sheet was approximately €1,410.4 million.

The recoverable value of goodwill is subject to review annually and when events or circumstances occur indicating that an impairment may exist. Such events or circumstances include significant adverse changes, other than temporary, in the business environment, or in assumptions or expectations considered at the time of the acquisition.

The need to record impairments is assessed by comparison of the carrying value of the investments and the corresponding fair value, which is estimated based on the discounted future cash flows determined using economic assumptions and forecast operating conditions used by Portugal Telecom's management.

These estimates, as well as the use of certain valuation methods, are the basis for the evaluation of the value of goodwill and therefore the amount of any impairment.

**Deferred taxes.** As of December 31, 2004, Portugal Telecom recorded deferred tax assets, net of valuation allowances and deferred tax liabilities, amounting to approximately €949.2 million. This balance consists primarily of (i) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes and (ii) tax losses carried forward mainly resulting from the corporate restructuring undertaken in 2002. The realization of deferred tax assets is reviewed by Portugal Telecom's management using each entity's tax results forecast based on budgets and strategic plans. Valuation allowances are considered in respect of deferred tax assets to the extent that the recovery of the related taxes is not considered probable. If Portugal Telecom's management were to consider that certain deferred tax assets for which allowances had been made were to be realized, a previously recorded valuation allowance would be fully or partially reversed.

**Accrued post retirement liability.** As of December 31, 2004, Portugal Telecom recorded an accrued post retirement liability amounting to approximately €1,269.9 million to cover for its unfunded obligations regarding pensions and post retirement healthcare benefits, net of the related actuarial losses. We estimate our obligations regarding post retirement benefits based on actuarial valuations prepared annually by our independent actuaries, which use the projected unit credit method and consider certain demographic and financial assumptions. If we and our actuaries were to consider different assumptions from the ones that have been used in the actuarial valuations, the value of our accrued post retirement liability and related costs could differ from the amounts recorded in our financial statements.

**Provisions for other risks and charges.** Provisions are recorded when, at the end of the period, there is an obligation of Portugal Telecom to a third party which is probable or certain to create an outflow of resources to the third party, without at least equivalent return expected from the third party. This obligation may be legal, regulatory or contractual in nature. It may also be derived from the practice of Portugal Telecom or from public commitments having created a legitimate expectation for such third parties that Portugal Telecom will assume certain responsibilities.

To estimate the expenditure that Portugal Telecom is likely to bear to settle its obligation, Portugal Telecom's management takes into consideration all of the available information at the closing date for its consolidated financial statements. If no reliable estimate of the amount can be made, no provision is recorded; information is then presented in the notes to the financial statements.

Contingencies, representing an obligation which is neither probable nor certain at the time of drawing up the financial statements, or a probable obligation for which the cash outflow is not probable, are not recorded. Information about them is presented in the notes to the financial statements.

Because of the inherent uncertainties in the foregoing evaluation process, actual losses may be different from the original estimated amount provisioned at the closing date.

**Revenue and expense recognition from telecommunications services.** Revenues from telecommunications services are recognized when earned. Billings for these services are made on a monthly basis throughout the month. Operating revenues are reported on a gross basis, with the compensation paid to other telecommunications operators being accounted for as operating expenses in the same period the revenue is earned. Unbilled revenues from the billing cycle are estimated based on the minutes of usage of the period and the prior month's pattern of traffic revenues, and are accrued at the end of the month.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Unbilled expenses related to telecommunications costs incurred during the period are also estimated based on the traffic information regarding the usage of other operators' networks during the period and the prior month's pattern of telecommunications costs.

Differences between estimated and actual unbilled revenues and expenses, which are recognized in the following period, may impact our results of operations in the period that such differences are recorded.

**Provision for doubtful accounts.** The provision for doubtful accounts receivable is stated at the estimated amount necessary to cover potential risks in the collection of overdue accounts receivable balances. A determination of the amount of provisions required is made after careful analysis of the evolution of accounts receivable balances and our knowledge of our customers' financial situation. The required provisions may change in the future due to changes in economic conditions and our knowledge of specific issues. Future possible changes in recorded provisions would impact our results of operations in the period that such changes are recorded.

### Results of Operations

Our operating results reflect the changing patterns in our business described above in " Overview". The key changes over the course of 2002, 2003 and 2004 include:

increasing revenues from mobile services and from pay TV and Internet services;

decreasing wireline telephone service revenues; and

a high level of work-force reduction program costs in 2003 and 2004, as we focus on increasing the efficiency of our wireline business.

The following tables set forth the contribution to our consolidated operating revenues of each of our major business lines, as well as our major consolidated operating costs and expenses, for the years ended December 31, 2002, 2003 and 2004.

|                           | Year Ended December 31, |                               |                          |                 |                               |                          |                 |                               |
|---------------------------|-------------------------|-------------------------------|--------------------------|-----------------|-------------------------------|--------------------------|-----------------|-------------------------------|
|                           | 2002                    |                               |                          | 2003            |                               |                          | 2004            |                               |
|                           | EUR<br>Millions         | % of<br>Operating<br>Revenues | %<br>Increase of<br>Item | EUR<br>Millions | % of<br>Operating<br>Revenues | %<br>Increase of<br>Item | EUR<br>Millions | % of<br>Operating<br>Revenues |
| <b>Operating Revenues</b> |                         |                               |                          |                 |                               |                          |                 |                               |
| Wireline Business         | 2,273.6                 | 40.73%                        | (5.96)%                  | 2,138.1         | 37.02%                        | (0.67)%                  | 2,123.8         | 35.26%                        |
| Retail                    | 1,465.6                 | 26.25%                        | (4.26)%                  | 1,403.1         | 24.29%                        | (1.85)%                  | 1,377.2         | 22.87%                        |
| Wholesale                 | 371.5                   | 6.65%                         | (15.18)%                 | 315.1           | 5.45%                         | 3.39%                    | 325.8           | 5.41%                         |
| Data and Corporate        | 225.9                   | 4.05%                         | 0.33%                    | 226.7           | 3.92%                         | (0.47)%                  | 225.7           | 3.75%                         |
| Directories               | 139.1                   | 2.49%                         | (2.19)%                  | 136.1           | 2.36%                         | (4.68)%                  | 129.7           | 2.15%                         |
| Sales                     | 34.8                    | 0.62%                         | 5.66%                    | 36.8            | 0.64%                         | 0.56%                    | 37.0            | 0.61%                         |
| Other                     | 36.8                    | 0.66%                         | (44.54)%                 | 20.4            | 0.35%                         | 39.46%                   | 28.4            | 0.47%                         |
| Domestic Mobile Business  | 1,266.6                 | 22.69%                        | 6.32%                    | 1,346.7         | 23.32%                        | 7.25%                    | 1,444.3         | 23.98%                        |
| Services                  | 1,132.7                 | 20.29%                        | 7.10%                    | 1,213.2         | 21.00%                        | 7.19%                    | 1,300.4         | 21.59%                        |
| Sales                     | 133.9                   | 2.40%                         | (0.27)%                  | 133.5           | 2.31%                         | 7.81%                    | 143.9           | 2.39%                         |
| Brazilian Mobile Business | 1,217.6                 | 21.81%                        | 11.82%                   | 1,361.5         | 23.57%                        | 10.39%                   | 1,503.0         | 24.95%                        |
| Services                  | 1,048.6                 | 18.79%                        | 4.31%                    | 1,093.8         | 18.94%                        | 8.19%                    | 1,183.4         | 19.65%                        |
| Sales                     | 169.0                   | 3.02%                         | 58.43%                   | 267.7           | 4.64%                         | 19.39%                   | 319.6           | 5.30%                         |
| Multimedia Business       | 621.9                   | 11.14%                        | 9.90%                    | 683.5           | 11.83%                        | 6.65%                    | 729.0           | 12.10%                        |
| Pay-TV and Cable Internet | 367.0                   | 6.57%                         | 17.77%                   | 432.2           | 7.48%                         | 14.44%                   | 494.6           | 8.21%                         |
| Audiovisuals              | 110.7                   | 1.98%                         | (2.71)%                  | 107.7           | 1.86%                         | (25.56)%                 | 80.2            | 1.33%                         |
| Media                     | 134.5                   | 2.41%                         | 6.77%                    | 143.6           | 2.49%                         | 7.05%                    | 153.7           | 2.55%                         |
| Other                     | 9.8                     | 0.18%                         | (99.5)%                  | 0.1             | 0.00%                         | 373.00%                  | 0.5             | 0.01%                         |
| Other Businesses          | 202.2                   | 3.62%                         | 21.81%                   | 246.3           | 4.26%                         | (9.55)%                  | 222.8           | 3.70%                         |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Year Ended December 31,

|                          |         |         |          |         |         |          |         |         |
|--------------------------|---------|---------|----------|---------|---------|----------|---------|---------|
| Services                 | 194.0   | 3.48%   | 23.83%   | 240.2   | 4.16%   | (8.81)%  | 219.0   | 3.64%   |
| Sales                    | 8.2     | 0.15%   | (25.68)% | 6.1     | 0.11%   | (39.20)% | 3.7     | 0.06%   |
| Total Operating Revenues | 5,582.0 | 100.00% | 3.48%    | 5,776.1 | 100.00% | 4.27%    | 6,022.9 | 100.00% |

93

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Year Ended December 31,

|  | 2002         |                         |                    | 2003         |                         |                    | 2004         |                         |
|--|--------------|-------------------------|--------------------|--------------|-------------------------|--------------------|--------------|-------------------------|
|  | EUR Millions | % of Operating Revenues | % Increase of Item | EUR Millions | % of Operating Revenues | % Increase of Item | EUR Millions | % of Operating Revenues |
| <b>Operating costs and expenses</b>                        |              |                         |                    |              |                         |                    |              |                         |
| Wages and salaries   | 694.8        | 12.45%                  | 1.60%              | 705.9        | 12.22%                  | 5.70%              | 746.2        | 12.39%                  |
| Post retirement benefits                                   | 183.2        | 3.28%                   | 21.68%             | 222.9        | 3.86%                   | (37.86)%           | 138.5        | 2.30%                   |
| Costs of telecommunications                                | 622.9        | 11.16%                  | (5.75)%            | 587.1        | 10.17%                  | (5.94)%            | 552.3        | 9.17%                   |
| Depreciation and amortization                              | 962.8        | 17.25%                  | (0.92)%            | 954.0        | 16.52%                  | 0.35%              | 957.3        | 15.90%                  |
| Costs of products sold                                     | 462.7        | 8.29%                   | 18.91%             | 550.2        | 9.52%                   | 8.08%              | 594.7        | 9.87%                   |
| Marketing and publicity                                    | 108.8        | 1.95%                   | 30.45%             | 141.9        | 2.46%                   | 33.00%             | 188.7        | 3.13%                   |
| General and administrative                                 | 925.6        | 16.58%                  | 4.43%              | 966.5        | 16.73%                  | 11.32%             | 1,075.9      | 17.86%                  |
| Provisions for doubtful receivables, inventories and other | 132.8        | 2.38%                   | (1.47)%            | 130.8        | 2.26%                   | 31.29%             | 171.7        | 2.85%                   |
| Other  | 221.8        | 3.97%                   | (8.48)%            | 203.0        | 3.51%                   | 12.76%             | 228.9        | 3.80%                   |
| Total operating costs and expenses                         | 4,315.3      | 77.31%                  | 3.41%              | 4,462.4      | 77.26%                  | 4.30%              | 4,654.3      | 77.27%                  |
| <b>Operating income</b>                                    | 1,266.7      | 22.69%                  | 3.71%              | 1,313.7      | 22.74%                  | 4.18%              | 1,368.6      | 22.72%                  |
| Other expenses, net(1)                                     | 543.9        | 9.74%                   | (55.81)%           | 240.3        | 4.16%                   | 32.09%             | 329.5        | 5.47%                   |
| Work Force Reduction Program                               |              |                         |                    |              |                         |                    |              |                         |
| Costs  | 53.7         | 0.96%                   | 484.87%            | 314.1        | 5.44%                   | (45.61)%           | 170.8        | 2.84%                   |
| Extraordinary items(2)                                     | 38.6         | 0.69%                   | 36.79%             | 52.8         | 0.91%                   | 65.42%             | 87.4         | 1.45%                   |
| <b>Income before income taxes</b>                          | 653.5        | 11.71%                  | 6.70%              | 697.3        | 12.07%                  | 11.97%             | 780.8        | 12.96%                  |
| <b>Income Taxes</b>  | (337.1)      | 6.04%                   | 12.10%             | (377.9)      | 6.54%                   | (52.61)%           | (179.1)      | 2.97%                   |
| <b>Consolidated net income before minority interests</b>   | 316.4        | 5.67%                   | 0.96%              | 319.5        | 5.53%                   | 88.33%             | 601.7        | 9.99%                   |
| <b>Loss (income) applicable to minority interests</b>      | 74.6         | 13.36%                  | (206.16)%          | (79.2)       | 1.37%                   | 28.28%             | (101.6)      | 1.68%                   |
| <b>Consolidated net income</b>                             | 391.1        | 7.01%                   | (38.57)%           | 240.2        | 4.16%                   | 108.20%            | 500.1        | 8.30%                   |

- (1) In 2002, net other expenses primarily included: (i) net interest expenses amounting to €197.0 million; (ii) goodwill amortization amounting to €142.9 million; and (iii) net equity losses in affiliated companies amounting to €160.9 million. In 2003, net other expenses primarily included: (i) net interest expenses amounting to €201.8 million; (ii) goodwill amortization amounting to €110.6 million; (iii) net equity losses in affiliated companies amounting to €19.2 million; and (iv) other net financing income amounting to €95.4 million (including gains on the fair value of certain derivatives contracts). In 2004, other expenses, net primarily included: (i) net interest expenses amounting to €202.9 million; (ii) goodwill amortization amounting to €97.1 million; and (iii) net equity gains in affiliated companies amounting to €27.7 million.
- (2) In 2002, extraordinary items included primarily: (i) €50.9 million related to a provision to adjust assets and liabilities in TMN; and (ii) €30.5 million gained as a result of the disposal of certain investments in Telefónica. In 2003, extraordinary items included mainly €51.6 million related to a provision to cover estimated losses resulting from the activities of TV Cabo. In 2004, extraordinary items included mainly: (i) €40 million related to a provision for impairments in the audiovisuals business; (ii) €26 million related to a provision recorded by TV Cabo in connection with the obligation to dismantle its analog premium service and the implementation of a digital offer; (iii) expenses of €10 million incurred in the wireline business for the settlement of a litigation case with DECO (the Portuguese consumer association); and (iv) €25 million gained as a result of the disposal of the investment in Mascom Wireless in Botswana.
- (3) In 2002, net losses applicable to minority interests included the share of minority shareholders in the losses of TCP (€23 million) and PT Multimédia (€61 million). In 2003, income applicable to minority interests included 50% of the share of minority shareholders of Vivo's subsidiaries in their corresponding income (€52 million) and the share of minority shareholders in the income of PT Multimédia (€13 million). In 2004, income applicable to minority interests included 50% of the share of minority shareholders of Vivo's subsidiaries in their corresponding income (€43 million) and the share of minority shareholders in the income of PT Multimédia (€47 million).

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

**Operating Revenues**

Our operating revenues increased to €6,022.9 million in 2004 from €5,776.1 million in 2003, an increase of 4.3%, primarily as a result of strong revenue growth in our mobile and multimedia businesses in Portugal and in our mobile business in Brazil. This increase was achieved

notwithstanding the 4.2% devaluation of the Brazilian Real's average exchange rate in 2004 as compared to the previous year.

**Wireline Business.** Operating revenues from our wireline business decreased by 0.7% to €2,123.8 million in 2004 from €2,138.1 million in 2003. This slowdown in the rate of decrease in 2004

was underpinned by several key broadband initiatives that focused on customer retention and the creation of new revenue opportunities.

**Retail.** Retail revenues decreased by 1.9% to €1,377.2 million in 2004 from €1,403.1 million in 2003. The decrease was mainly due to declining traffic volumes, the implementation of a price cap and the reduction of fixed-to-mobile prices, which was partially offset by the increase in the line rental (in accordance with the price cap), the higher contribution from pricing plans and the increase in ADSL revenues. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

**Wholesale.** Operating revenues from wholesale services increased by 3.4% to €325.8 million in 2004 from €315.1 million in 2003. This increase was mainly due to a change in the accounting for transit traffic from net to gross.

**Data and Corporate.** Data and corporate revenues decreased by 0.5% to €225.7 million in 2004 from €226.7 million in 2003. This decrease was mainly due to the decrease in leased lines and network management and outsourcing resources, primarily as a result of lower prices due to increased competition. This decrease was partially offset by an increase in data communications revenues, in connection with the launch of new services and the hosting of the Euro 2004 championship. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

**Domestic Mobile Business.** Operating revenues from our domestic mobile business increased by 7.2% to €1,444.3 million in 2004 from €1,346.7 million in 2003. This increase reflects the 3.4% increase in the number of TMN's active mobile telephone cards in 2004. There was a 1.7% decrease in average minutes per month per subscriber in 2004 compared with 2003 mainly due to the rising weight of double SIM card penetration and a subdued economic environment. We estimate that TMN's revenues per active mobile telephone card decreased by 3.4% in 2004 to an average of approximately €24.4 per month compared to €25.2 per month in 2003. Revenues from sales of handsets increased 7.8% to €143.9 million in 2004 from €133.5 million in 2003. See "*Item 4 Information on the Company Our Businesses Domestic Mobile Business*".

**Brazilian Mobile Business.** Operating revenues from our Brazilian mobile business increased to €1,503.0 million in 2004 from €1,361.5 million in 2003. This increase reflects the fact that from January through April 2003, TCO's results were not included in Vivo's results as a result of its acquisition by TCP in May 2003. Excluding the devaluation of the Real, revenues would have increased by 15.2% to €1,568.1 million in 2004 due to strong customer growth and price increases. The average revenue per user per month in 2004 was R\$32.8, as compared to R\$39.4 in 2003. See "*Item 4 Information on the Company Our Businesses Brazilian Mobile Business*".

**Multimedia Business.** Operating revenues from our multimedia business increased by 6.7% to €729.0 million in 2004 from €683.5 million in 2003. This increase was largely due to the increase in the number of TV Cabo subscribers and broadband services, as a result of which operating revenues from the pay TV and cable Internet business rose by 14.4% to €494.6 million in 2004 from €432.2 million in 2003. Average monthly revenue per customer in the Pay TV business increased by 6.6% to €25.4 in 2004 from €23.8 in 2003. Revenues from the audiovisuals business in 2004 totaled €80.2 million, a 25.5% decrease over 2003, mainly due to the termination of the distribution contract with Sony and the decline of 13.0% in video revenues. In 2004, Lusomundo Media's revenues reached €153.7 million, a 7.1% increase over 2003, as a result of recovery in the advertising market that began at the end of 2003 and the hosting by Portugal of events including the Euro 2004 championship and "the Rock in Rio Festival" in Lisbon. See "*Item 4 Information on the Company Our Businesses Multimedia Business*".

**Other Businesses.** Operating revenues from our other businesses included in our consolidated financial results decreased by 9.6% to €222.8 million in 2004 from €246.3 million in 2003. The decrease

was mainly the result of the exclusion of Mascom Wireless' operating revenues (€64 million in 2003) from our consolidated financial results as from January 2004.

### ***Operating Costs and Expenses***

Our operating costs and expenses increased to €4,654.3 million in 2004 from €4,462.4 million in 2003, an increase of 4.3%. This increase was primarily due to an increase in wages and salaries, costs of products sold, marketing and publicity, general and administrative expenses and provisions for doubtful receivables, inventories and other, which was partially offset by a decrease in post retirement benefits costs.

***Wages and salaries.*** Wages and salaries, including employee benefits and social charges, were €746.2 million in 2004, compared to €705.9 million in 2003. This 5.7% increase was primarily due to the fact that TCO was only fully consolidated by Vivo as of May 2003. In our wireline business, which accounted for 39.5% of consolidated wages and salaries in 2004, there was a 6.2% decrease in wages and salaries as a result of our curtailment program.

***Post retirement benefits.*** Costs of post retirement benefits decreased by 37.9% to €138.5 million in 2004 from €222.9 million in 2003, primarily due to a recent change in Portuguese law revising the method of calculating the pension of an employee upon retirement, which generated a prior year service gain of €67 million. Furthermore, the Portuguese State agreed to increase its contribution to healthcare costs, which also resulted in lower costs of post retirement benefits. This cost item does not include early termination programs related to our work force reduction program. These are treated as an extraordinary item and not as operating costs and expenses and so are not included in our operating income. See " *Work Force Reduction Program Costs*" and " *Liquidity and Capital Resources Post Retirement Benefits*".

***Costs of telecommunications.*** Costs of telecommunications dropped to €552.3 million in 2004 from €587.1 million in 2003, representing a decrease of 5.9%. This decrease was mainly due to lower traffic volumes in wireline and also to lower fixed-to-mobile interconnection fees in Portugal. See " *Item 4 Information on the Company Our Businesses Wireline Business Wholesale*".

***Costs of products sold.*** The costs of products sold amounted to €594.7 million in 2004, as compared to €550.2 million in 2003, representing an increase of 8.1%. This increase relates primarily to: (i) strong customer growth in Vivo; and (ii) SACs incurred by TMN during 2004 were no longer deferred but rather expensed in the year, while those from previous years were still amortized in operating costs.

***Marketing and publicity.*** Marketing and publicity costs amounted to €188.7 million in 2004, corresponding to a 33.0% increase over 2003. This increase was mainly the result of the increase in advertising spend and promotional activities in connection with the rollout of new products and services across all business units and the fact that TCO was only fully consolidated by Vivo as of May 2003.

***General and administrative expenses.*** General and administrative expenses include specialized work and subcontracts and various other administrative expenses. This cost item increased to €1,075.9 million in 2004 from €966.5 million in 2003, an increase of 11.3%, primarily relating to higher commercial costs in the wireline business and in Vivo (mainly commissions and call centers), resulting from the strong growth of ADSL and pricing plans in the wireline business and the strong growth of clients in Vivo, and also the fact that TCO was only fully consolidated by Vivo as of May 2003.

***Provisions for doubtful receivables, inventories and other.*** Provisions for doubtful receivables, inventories and other increased to €171.7 million in 2004 from €130.8 million in 2003. This increase of 31.3% is primarily the result of a higher level of provisioning in the wireline business, resulting mainly from one-off provisions to cover risks associated with cancellations of certain onerous contracts.

**Depreciation and amortization.** Depreciation and amortization costs remained broadly flat in 2004 at €957.3 million. Excluding the effect of a transfer to intangible assets of a portion of goodwill related to the value attributable to licenses held by Vivo's subsidiaries, depreciation and amortization would have decreased by 4.1% in 2004.

#### **Operating Income**

Our operating income increased to €1,368.6 million in 2004 from €1,313.7 million in 2003 an increase of 4.2%. Excluding the devaluation of the Brazilian Real, operating income would have been €1,379 million, representing an increase of 5.0% over 2003. The increase was primarily due to the increase in operating income from our mobile and multimedia businesses in Portugal. Operating margin (operating income as a percentage of total operating revenues) remained flat in 2004 at 22.7%.

#### **Other Expenses, Net**

Other expenses, net, which increased by 32.1% to €329.5 million in 2004 from €240.3 million in 2003, primarily includes our net financial charges, including net interest and related expenses, foreign exchange losses and gains, goodwill amortization, equity in earnings of affiliated companies and other financial gains and costs.

Net financial charges increased from €201.8 million in 2003 to €202.9 million in 2004. Portugal Telecom's average cost of debt was 6.2% in 2004, as compared to 5.45% in 2003. Excluding the financing costs in Brazil, the average cost of debt would have been 4.7%.

Net foreign exchange losses amounted to €32.7 million in 2004, as compared with €41.9 million in 2003, primarily because of the evolution of the Real exchange rate over the year.

Net other financial expenses amounted to €12.5 million in 2004, as compared to net other financial income of €95.4 million in 2003. Net other financial expenses in 2004 included various financial expenses, including banking commissions and related taxes, and gains from swaps on PT Multimédia shares. In 2003, this caption included gains related to a reduction in a provision to cover estimated losses on certain equity swaps related to PT Multimédia and Portugal Telecom treasury shares (as a result of the increase in the underlying share price as at December 31, 2003) and gains in certain derivative products.

Goodwill amortization decreased by 12.2% during 2004 to €97.1 million. This decrease was mainly due to the fact that the amortization of licenses held by Vivo's subsidiaries, which in 2004 amounted to approximately €33 million, is now included in the depreciation and amortization line item. Goodwill amortization includes mainly the amortization relating to our investments in Vivo (€39 million), PT Multimédia (€10 million), PT.com (€9 million) Lusomundo Media (€8 million), PT Comunicações (€7 million) and Lusomundo Audiovisuals (€6 million).

Equity accounting in earnings of affiliated companies amounted to €27.7 million in 2004, as compared to equity in losses of affiliated companies of €19.2 million in 2003. This improvement was primarily due to the reduction in the losses of Medi Telecom (from €25 million to €6 million) and Sport TV (from €5 million to €1 million); the increase in the earnings of Unitel (from €6 million to €17 million); and the change in the consolidation method of Mascom Wireless in 2004 from full consolidation to the equity method (earnings of €8 million in 2004).

#### **Work Force Reduction Program Costs**

Work force reduction program costs amounted to €170.8 million in 2004 as compared with €314.1 million in 2003, in connection with the reduction of the work force by 651 employees during 2004. See " *Liquidity and Capital Resources Post Retirement Benefits*" and " *Item 6 Directors, Senior Management and Employees Employees Work Force Reductions*".

### ***Extraordinary Items***

Extraordinary items were a net loss of €87.4 million in 2004 as compared with €52.8 million in 2003. In 2004, extraordinary items included primarily (i) a provision of €40 million for potential impairments in the audiovisuals business, (ii) a provision of €26 million recorded by TV Cabo in connection with the obligation to dismantle its analog premium service and the implementation of a digital offer, (iii) expenses of €10 million incurred in the wireline business for the settlement of a litigation case with DECO (the Portuguese consumer association), and (iv) a gain of €25 million related to the disposal of the investment in Mascom Wireless.

### ***Income Taxation***

Income taxes decreased by 52.6% to €179.1 million in 2004 from €377.9 million in 2003. This decrease was mainly a result of the recognition in 2004 of a deferred tax asset of €103 million in connection with tax losses carried forward at PT Multimédia and the €142 million increase in this caption in 2003 resulting from an accounting adjustment in deferred taxes related to the decrease of the corporate tax rate in Portugal from 33% to 27.5%. In 2004, this item included €238 million which was recorded against a reduction of tax losses carried forward recorded in deferred tax assets in previous years.

### ***Minority Interests***

Income applicable to minority interests in 2004 amounted to €101.6 million and related primarily to 50% of the minority interests attributable to the share of minority shareholders in the net income of Vivo's subsidiaries (€43 million) and to the share of minority shareholders in the net income of PT Multimédia (€47 million). In 2003, income applicable to minority interests amounted to €79.2 million.

### ***Net Income***

Our net income increased to €500.1 million in 2004 compared to €240.2 million in 2003. This increase was impacted mainly by lower curtailment costs in 2004.

Earnings per ordinary and A share in 2004 increased to €0.43 from €0.19 in 2003 on the basis of 1,166,485,050 shares issued at December 31, 2004 and 1,254,285,000 shares issued at December 31, 2003.

### ***Year Ended December 31, 2003 Compared to Year Ended December 31, 2002***

#### ***Operating Revenues***

Our operating revenues increased to €5,776.1 million in 2003 from €5,582.0 million in 2002, an increase of 3.5%, primarily as a result of strong revenue growth in our mobile and multimedia businesses in Portugal and in our mobile business in Brazil. This increase was achieved notwithstanding the 20% devaluation of the Brazilian Real's average exchange rate in 2003 as compared to the previous year. Excluding this devaluation, operating revenues would have increased to €6,139.3 million, representing an increase of 10% over 2002.

***Wireline Business (PT Comunicações, PT Prime and PTM.com).*** Operating revenues from our wireline business decreased by 6.0% to €2,138.1 million in 2003 from €2,273.6 million in 2002. This decrease was due to the general slow down in economic conditions and the continued substitution of mobile telephone usage in place of wireline telephone services that resulted in lower traffic volumes.

***Retail.*** Retail revenues decreased by 4.3% to €1,403.1 million in 2003 from €1,465.6 million in 2002. The reduction was mainly due to the decline experienced in traffic revenues, notwithstanding the improvement in fixed charges, caused by the increase in the monthly fee, the growth of pricing



packages and the strong rollout of ADSL throughout the year. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

**Wholesale.** Operating revenues from wholesale services decreased by 15.2% to €315.1 million in 2003 from €371.5 million in 2002. This decrease was mainly due to the reduction in interconnection rates and tariffs of wholesale leased lines and the growing use by competitors of their own infrastructures. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

**Data and Corporate.** Data and corporate revenues increased by 0.3% to €226.7 million in 2003 from €225.9 million in 2002. This increase resulted primarily from the growth in the number of corporate Internet subscribers and the expansion in Internet and broadband services. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

**Domestic Mobile Business (TMN).** Operating revenues from our domestic mobile business increased by 6.3% to €1,346.7 million in 2003 from €1,266.6 million in 2002. This increase reflects the 10.4% increase in the number of TMN's active mobile telephone cards in 2003. There was a 5.7% decrease in average minutes per month per subscriber in 2003 compared with 2002 mainly due to the higher level of penetration and the strong increase of the customer base in the fourth quarter of 2003. We estimate that TMN's revenues per active mobile telephone card decreased by 6.9% in 2003 to an average of approximately €25.2 per month compared to €27.1 per month in 2002. Revenues from sales of handsets decreased 0.3% to € 133.5 million in 2003 from €133.9 million in 2002 primarily as a result of the high level of mobile phone market penetration in Portugal. See "*Item 4 Information on the Company Our Businesses Domestic Mobile Business*".

**Brazilian Mobile Business (Vivo).** Operating revenues from our Brazilian mobile business increased to €1,361.5 million in 2003 from €1,217.6 million in 2002. This increase reflects the fact that (i) in 2002, consolidated operating revenues fully consolidate TCP's results, while in 2003 consolidated operating revenues of the Brazilian mobile business segment proportionally consolidate 50% of Vivo's results; (ii) in 2002, Global Telecom was consolidated under the equity method, while in 2003 it was fully consolidated in Vivo's results; and (iii) from May through December 2003, TCO's results were included in Vivo's results as a result of its acquisition by TCP in May 2003. Adjusting revenues for the year ended December 31, 2002 to include eight months of TCO and 50% of Vivo in the Brazilian mobile business, revenues would have been €1,361.5 million in 2003, as compared to €1,459.9 million in 2002. Excluding the devaluation of the Real, revenues would have increased by 16.8% to €1,704.6 million in 2003 due to strong customer growth and price increases. Notwithstanding the challenging economic environment in Brazil, the average revenue per user per month in 2003 was R\$39, as compared to R\$41 in 2002. See "*Item 4 Information on the Company Our Businesses Brazilian Mobile Business*".

**Multimedia Businesses.** Operating revenues from our multimedia businesses increased by 9.9% to €683.5 million in 2003 from € 621.9 million in 2002. This increase was largely due to the increase in the number of subscribers of TVCabo and in the number of subscribers using TV Cabo's premium channels (particularly satellite TV subscribers) and broadband services, as a result of which operating revenues from the pay TV and cable Internet business rose by 17.8% to €432.2 million in 2003 from € 367.0 million in 2002. Average monthly revenue per pay TV subscriber increased by 5.3% to €19.98 in 2003 from €19.03 in 2002. Revenues from the audiovisuals business in 2003 totaled €107.7 million, a 2.7% decrease over 2002, mainly due to the decrease in the sale of video games. In 2003, Lusomundo Media's revenues reached €143.6 million, a 6.8% increase over 2002, as a result of increased newspaper circulation and product sales promotions, which more than offset the decrease in advertising revenues. See "*Item 4 Information on the Company Our Businesses Multimedia Business*".

**Other Businesses.** Operating revenues from our other businesses included in our consolidated financial results increased by 21.8% to € 246.3 million in 2003 from €202.2 million in 2002. The increase

was mainly the result of the increase in the operating revenues of PrimeSys (€27.2 million) and Mascom (€10.3 million).

### ***Operating Costs and Expenses***

Our operating costs and expenses, excluding depreciation and amortization, increased to €3,508.4 million in 2003 from €3,352.5 million in 2002, an increase of 4.7%. This increase was primarily due to an increase in post retirement benefits, costs of products sold, marketing and publicity and general and administrative expenses.

***Wages and salaries.*** Wages and salaries, including employee benefits and social charges, were €705.9 million in 2003, compared to € 694.8 million in 2002. This 1.6% increase was primarily due to the in-sourcing of staff from franchised shops of Vivo and the consolidation of PrimeSys in the second half of 2002. In our wireline business, which accounted for 44.4% of consolidated wages and salaries in 2003, there was a 10.4% decrease in wages and salaries as a result of our curtailment program.

***Post retirement benefits.*** Costs of post retirement benefits increased by 21.7% to €222.9 million in 2003 from €183.2 million in 2002. The change resulted primarily from an increase in the interest cost component of post retirement benefits resulting from the increase in unfunded liabilities and higher charges resulting from the amortization of actuarial losses deferred in previous years due to lower returns generated by the pension funds compared with the 6% return assumed in the actuarial studies. These actuarial losses are amortized over the expected working life of our active employees which are covered by these benefits (currently 16 years). Post retirement benefits costs do not include curtailment costs related to our work force reduction program. These are treated as an extraordinary item and not as operating costs and expenses and so are not included in our operating income. See " *Work Force Reduction Program Costs*" and " *Liquidity and Capital Resources Post Retirement Benefits*".

***Costs of telecommunications.*** Costs of telecommunications dropped to €587.1 million in 2003 from €622.9 million in 2002, representing a decrease of 5.7%. This decrease was mainly due to lower fixed-to-mobile and mobile-to-mobile traffic volumes and also to lower mobile-to-mobile interconnection fees. See " *Item 4 Information on the Company Our Businesses Wireline Business Wholesale*".

***Costs of products sold.*** The costs of products sold amounted to € 550.2 million in 2003, as compared to €462.7 million in 2002 and represented 9.5% of consolidated operating revenues in 2003, compared to 8.3% in 2002. This increase relates primarily to higher sales of terminal equipment, which in 2003 increased by 40%, mainly related to Vivo.

***Marketing and publicity.*** Marketing and publicity costs amounted to €141.9 million in 2003, corresponding to a 30.4% increase over 2002. This increase was mainly the result of a €6 million increase in marketing and publicity costs at TMN (due to increased advertising of new services, namely MMS and I9-Inove) and a €22 million increase in marketing and publicity costs at Vivo (due to the launching of the Vivo brand name and also the promotion of new services).

***General and administrative expenses.*** General and administrative expenses include specialized work and subcontracts and various other administrative expenses. This cost item increased to €966.5 million in 2003 from €925.6 million in 2002, an increase of 4.4%, primarily relating to higher commission costs at Vivo.

***Provisions for doubtful receivables, inventories and other.*** Provisions for doubtful receivables, inventories and other decreased to €130.8 million in 2003 from €132.8 million in 2002. This decrease of 1.5% is primarily the result of a higher than expected level of collection of doubtful receivables, which had been provided for in previous years, and the effect of the devaluation of the Brazilian Real in relation to the provisions booked by Vivo during 2003.

**Depreciation and amortization.** Depreciation and amortization costs remained broadly flat in 2003 at €954 million, mainly due to devaluation of the Brazilian Real. Excluding this effect, depreciation and amortization costs would have increased by 6.0% over 2002, as a result of the increased investment in equipment depreciated over a shorter period of time.

**Operating Income**

Our operating income increased to €1,313.7 million in 2003 from € 1,266.7 million in 2002, an increase of 3.7%. Excluding the devaluation of the Brazilian Real, operating income would have been €1,380.4 million, representing an increase of 9% over 2002. The increase was primarily due to the increase in operating income from our mobile businesses in Portugal (an increase of €51.7 million or 11.5%) and Brazil (an increase of €6.7 million or 2.7%). Operating margin (operating income as a percentage of total operating revenues) was 22.7% in 2003 and in 2002.

**Other Expenses, Net**

Other expenses/income, which decreased by 55.8% to €240.3 million in 2003 from €543.9 million in 2002, primarily includes our net financial charges, including net interest and related expenses, foreign exchange losses and gains, goodwill amortization, equity in earnings of affiliated companies, gains/(losses) on sales and disposals of fixed assets and other financial gains and costs.

Net financial charges increased from €197.1 million in 2002 to €201.8 million in 2003. Portugal Telecom's average cost of debt was 5.45% in 2003, as compared to 5.5% in 2002. Excluding the financing costs in Brazil, the average cost of debt would have been 3.74%.

Net foreign exchange losses amounted to €41.9 million in 2003, as compared with net foreign exchange gains of €88 million in 2002. The net foreign exchange gains in 2002 relate primarily to the gains obtained in connection with the unwinding of certain derivative instruments.

Goodwill amortization decreased by 22.6% during 2003 to €110.6 million. This decrease was mainly due to impairment charges recorded in 2002 in connection with the investments in TCP, Global Telecom, Lusomundo, PrimeSys and other smaller Brazilian investments. Goodwill amortization includes mainly the amortization relating to our investments in Vivo (€ 53 million), Lusomundo (€14.0 million), PT Multimédia (€ 10.0 million) and PTM.com (€8.9 million).

Equity in losses of affiliated companies amounted to €19.2 million in 2003, as compared with €160.9 million in 2002. This improvement was primarily due to a significant reduction in our proportion of the losses of Medi Telecom (€24.9 million in 2003 compared with €55.5 million in 2002) and the fact that the financial results of Global Telecom, which were recorded by the equity method of accounting in 2002 (€88.6 million), are now fully consolidated by Vivo in its financial results and accordingly proportionally consolidated in our financial results for 2003. See "*Item 4 Information on the Company Our Businesses Brazilian Mobile Business*".

Net gains from the sale and disposal of fixed assets increased to € 28.6 million in 2003 from €4.0 million in 2002. In 2003, this caption includes mainly gains (€38 million) related to the sale of a building in Lisbon to one of PT Comunicações' pension funds. See "*Liquidity and Capital Resources Post Retirement Benefits*".

Net other financial income amounted to €95.4 million in 2003, as compared to negative €111.7 million in 2002. This increase was mainly due to: (i) gains obtained on the cancellation of certain derivative contracts; (ii) gains from changes in the fair value of certain foreign currency derivatives that had been previously used for hedging purposes but are currently considered for accounting purposes as free standing derivatives; and (iii) a reduction in the provision to cover estimated losses on certain equity swaps, as a result of the rise in the market price of the underlying shares as at December 31, 2003.

**Work Force Reduction Program Costs**

Work force reduction program costs increased to €314.1 million in 2003 from €53.7 million in 2002, in connection with the reduction of the work force by 1,530 employees during 2003. See " *Liquidity and Capital Resources Post Retirement Benefits*" and " *Item 6 Directors, Senior Management and Employees Employees Work Force Reductions*".

**Extraordinary Items**

Extraordinary items were a net loss of €52.8 million in 2003 as compared with a net loss of €39 million in 2002. In 2003, extraordinary items included principally a provision for other risks and costs recorded by PT Multimédia, related to estimated losses on the value of fixed assets in connection with the restructuring of the IDTV business, and the acceleration of the digitalization of TV cable services. This provision also covers certain liabilities with third parties and losses on financial investments.

**Income Taxation**

Income taxes rose by 12.1% to €377.9 million in 2003 from € 337.1 million in 2002. Our income taxes in 2003 included €229 million related to the estimate of income taxes for the year plus €145 million in connection with a one-off accounting adjustment in deferred taxes related to the decrease in the corporate tax rate in Portugal from 33.0% to 27.5%. Excluding the adjustment in deferred taxes in 2003, the effective tax rate would have been 33%. See Note 29 to our Audited Consolidated Financial Statements.

**Minority Interests**

Income applicable to minority interest in 2003 amounted to €79.2 million and related primarily to 50% of the minority interests attributable to the share of minority shareholders in the net income of Vivo's subsidiaries (€51.5 million) and to the share of minority shareholders in the net income of PT Multimédia (€13.0 million). In 2002, losses applicable to minority interest amounted to €74.6 million and included primarily the share of minority shareholders in the losses of TCP and PT Multimédia.

**Liquidity and Capital Resources****Overview**

**Sources of Cash Flow.** During 2002, 2003 and 2004, we financed our operations and acquisitions mainly from cash generated from operations, equity financings and debt financings. The breakdown of our cash flows for the years ended December 31, 2002, 2003 and 2004 is as set out below:

|                                     | <b>2002</b>  | <b>2003</b>  | <b>2004</b>    |
|-------------------------------------|--------------|--------------|----------------|
|                                     | <b>_____</b> | <b>_____</b> | <b>_____</b>   |
| Cash flow from operating activities | 2,092.3      | 2,334.0      | 2,017.8        |
| Cash flow for investing activities  | (1,003.5)    | (429.8)      | (637.0)        |
| Cash flow for financing activities  | (486.1)      | (1,654.1)    | (1,987.5)      |
|                                     | <b>_____</b> | <b>_____</b> | <b>_____</b>   |
| <b>Total</b>                        | <b>602.7</b> | <b>250.1</b> | <b>(606.7)</b> |
|                                     | <b>_____</b> | <b>_____</b> | <b>_____</b>   |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following table provides a reconciliation between operating cash-flow and net income for the years ended December 31, 2002, 2003 and 2004.

|   | <u>2002</u>    | <u>2003</u>    | <u>2004</u>    |
|---|----------------|----------------|----------------|
| <b>Consolidated Net Income Before Minority Interests</b>                | 316.4          | 319.5          | 601.7          |
| Interest expenses, net  | 197.1          | 201.8          | 202.9          |
| Goodwill amortization   | 142.9          | 110.6          | 97.1           |
| Other net financing (income) losses                                     | 24.0           | (53.5)         | 45.2           |
| Losses/(Gains) on sales and disposals of fixed assets, net              | (4.0)          | (28.6)         | 12.0           |
| Equity in (gains)/losses of affiliated companies                        | 160.9          | 19.2           | (27.7)         |
| Extraordinary items   | 38.6           | 52.8           | 87.4           |
| Depreciation and amortization   | 962.8          | 954.0          | 957.3          |
|   | <u>1,838.7</u> | <u>1,575.7</u> | <u>1,976.0</u> |
| (Increase)/Decrease in accounts receivable trade                        | 109.5          | (106.7)        | (48.2)         |
| (Increase)/Decrease in accounts receivable other                        | (328.3)        | 76.9           | (59.2)         |
| (Increase)/Decrease in inventories, net                                 | 4.8            | 46.9           | (74.2)         |
| (Increase)/Decrease in prepaid expenses and other current assets        | (10.5)         | (5.9)          | (13.4)         |
| (Increase)/Decrease in accounts payable trade                           | 1.0            | 231.0          | 40.4           |
| (Increase)/Decrease in accounts payable other                           | 21.8           | (195.1)        | (103.5)        |
| (Increase)/Decrease in accrued expenses, excluding financial operations | 14.1           | 95.2           | 33.6           |
| (Increase)/Decrease in taxes payable                                    | (82.5)         | 31.9           | (20.1)         |
| (Increase)/Decrease in deferred income                                  | (47.4)         | 88.1           | 50.9           |
| (Increase)/Decrease in current deferred tax assets                      | (214.2)        | 71.8           | (25.7)         |
| (Increase)/Decrease in non-current deferred tax assets                  | (449.9)        | 293.8          | 91.5           |
| (Increase)/Decrease in current deferred tax liabilities                 | 0.9            | (11.4)         | (4.8)          |
| (Increase)/Decrease in non-current deferred tax liabilities             | (218.3)        | (58.3)         | (12.0)         |
| (Increase)/Decrease in accrued post retirement liability                | (748.6)        | 194.6          | 13.8           |
| (Increase)/Decrease in consolidation (TCO)                              |                | 18.8           |                |
| Intangible assets post retirement liabilities                           | 761.9          |                |                |
| Provisions related with taxes losses carryforward                       | 1,350.5        |                |                |
| Other non-current liabilities   | 50.9           | (50.9)         |                |
| Other   | 37.9           | 37.6           | 34.4           |
|   | <u>253.6</u>   | <u>758.3</u>   | <u>41.8</u>    |
| <b>Cash flow from operating activities</b>                              | <u>2,092.3</u> | <u>2,334.0</u> | <u>2,017.8</u> |

We believe that cash generated from operations and bank facilities are sufficient to meet present working capital needs. Our cash and short term investments totaled €1,940.1 million at December 31, 2004, a decrease of 23.3% over December 31, 2003. This decrease was primarily attributable to the repayments in June 2004 of an exchangeable bond amounting to €450.1 million and in November 2004 of a bond amounting to €124.7 million.

**Investments.** During 2004, our investments in financial assets (including goodwill) amounted to €309 million and were mainly related to: (i) €16 million in connection with the acquisition of a further 17% stake in the share capital of Sport TV; (ii) €40 million in connection with an intercompany loan granted to Sport TV for the acquisition of Portuguese league football rights; (iii) €86 million in connection with Portugal Telecom's share in the acquisition by Brasilcel of a further 4.2% in Tele Sudeste Celular Participações, 22.7% in Tele Leste Celular Participações and 15.5% in CRT Celular Participações; and (iv) €127 million in connection with Portugal Telecom's share in the acquisition by TCP of a further 21.7% in TCO. We made total investments in 2004, including capital expenditures, of €1,092 million, a decrease of 2.1% over 2003 (€1,116.0 million). During 2003, our investments in

financial assets (including goodwill) amounted to €464.3 million and were mainly related to Vivo's acquisition, through TCP, of a controlling interest in the share capital of TCO (€308 million). See "Item 4 Information on the Company Our Businesses".

#### ***Cash from Operating Activities***

Cash flows from operating activities include collections from clients, payments to suppliers, payments to personnel and other collections and payments relating to operating activities. All of our cash flows from operating activities result mainly from operations conducted by our subsidiaries and not by Portugal Telecom. The operations of our subsidiaries are described in relation to each business line in "Item 4 Information on the Company Our Businesses".

None of our subsidiaries is subject to economic or legal restrictions on transferring funds to us in the form of cash dividends, loans or advances that would materially affect our ability to meet our cash obligations. Our joint venture in Brazil contains provisions relating to important decisions, including the declaration and/or payment of dividends or other distributions by Vivo. Such decisions must be made by a majority of the board of directors of Vivo. Telefónica and we each appoint ten of the twenty board members. Accordingly, it will effectively be necessary for Telefónica and us to agree to transfer funds from Vivo and its subsidiaries to us if we wish to do so. See "Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Telefónica".

**2004.** Net cash generated from operating activities decreased by 13.5% to €2,017.8 million in 2004 from €2,334.0 million in 2003. This decrease was due mainly to the fact that in 2003 we received an extraordinary inflow amounting to €201.2 million relating to the tax payment on account made in 2002 that was reimbursed as a result of the tax loss carry forward by Portugal Telecom.

**2003.** Net cash generated from operating activities increased by 11.6% to €2,334.0 million for 2003 from €2,092.3 million for 2002. This increase was due mainly to net receivables relating to income taxes in 2003 of €144.4 million, compared with payments of €289.1 million in 2002, and to the decrease in payments to suppliers (€2,796.6 million in 2003 compared with €2,940.5 million in 2002). The net receivables relating to income taxes in 2003 include €201.2 million relating to the tax payment on account made in 2002 that was reimbursed as a result of the tax losses carryforward by Portugal Telecom.

#### ***Cash for Investing Activities***

Cash flows used in investing activities include the acquisitions and disposals of investments in associated companies, as well as the purchase and sale of property, plant and equipment.

**2004.** Net cash used for investing activities increased by 35.9% to €637.0 million in 2004 from €429.8 million in 2003. This increase was mainly due to (i) higher payments on tangible fixed asset acquisitions (€624 million in 2004 and €561 million in 2003), reflecting an increase in capital expenditures, (ii) lower receipts from disposals of tangible fixed assets (€36 million in 2004 and €116 million in 2003), due to the fact that in 2003 a main building owned by PT Comunicações was disposed of, and (iii) lower receipts from other investing activities (€34 million in 2004 and €194 million in 2003), due to the reimbursement in 2003 of a TCO debenture subscribed by Portugal Telecom (€113 million) and receipts in 2003 from derivatives contracts entered into by Global Telecom in previous years (€75 million), which were partially offset by lower payments on the acquisition of financial investments (€323 million in 2004 and €403 million in 2003).

**2003.** Net cash used for investing activities decreased by 54.5% to €429.8 million in 2003 from €1,003.5 million in 2002. The decrease was due to (i) lower cash advances for the acquisition of financial investments (€42.6 million in 2003 compared with €947.5 million in 2002) largely due to the €944.9 million advance made to Global Telecom in 2002, (ii) a decrease in payments resulting from the

acquisition of fixed assets (€560.7 million in 2003 compared with €856.0 million in 2002) reflecting the reduction in capital expenditures during 2003, and (iii) a decrease in payments resulting from the acquisition of intangible assets (€55.0 million in 2003 compared with €358.6 million in 2002) resulting from the acquisition of the ownership of the basic network by PT Comunicações in 2002 for €348 million. The decrease in cash used for investing activities was offset by the decrease in the cash receipts, reflecting lower inflows from the sale of financial investments (€3.6 million in 2003 compared with €1,311.6 million in 2002), and the payment by Global Telecom in 2002 of intra-group loans granted in previous years totaling € 917 million.

#### ***Cash from Financing Activities***

Cash flows from financing activities include borrowings and repayments of debt and payments of dividends to shareholders.

**2004.** Net cash used for financing activities increased by 20.2% to €1,987.5 million in 2004 from €1,654.1 million in 2003. This increase was mainly due to our focus on increasing shareholder remuneration, including (i) an increase in treasury shares acquired under the 10% share buyback announced in September 2003 (€495 million in 2004 and €235 million in 2003) and (ii) an increase in dividends paid to our shareholders (€297 million in 2004 and €228 million in 2003).

**2003.** Net cash used for financing activities was €1,654.1 million in 2003 compared with €486.1 million in 2002. This evolution resulted mainly from the fact that in 2003 the loans repaid exceeded the loans obtained by €619.9 million, whereas in 2002 this difference was €15.5 million; from the increase in dividends paid (from €129.0 million in 2002 to €227.5 million in 2003); and from the increase in cash used in the acquisition of treasury shares in 2003 (from €42.2 million in 2002 to €235.0 million in 2003).

#### ***Indebtedness***

Our total consolidated indebtedness decreased by 11.9% to €5,063.1 million at the end of 2004, compared with €5,746.7 million at December 31, 2003. Our total indebtedness at the end of 2002 was €6,313.5 million.

Our net indebtedness was €3,123.0 million at December 31, 2004, 2.9% less than at the end of 2003. Our net indebtedness was €3,215.6 million at December 31, 2003 compared with €4,037.0 million at the end of 2002.

***Changes in Structure and Amount of Indebtedness.*** The decrease in our net indebtedness is mainly the result of the free cash flow we generate each year, taking into consideration the amounts used to remunerate shareholders. The free cash flow available to reduce net debt in 2004 was lower than in 2003, primarily due to the increase in shareholder remuneration, through dividends paid (€69 million in excess of the amount paid in 2003) and execution of the share buyback program announced in September 2003 (€260 million in excess of the amount repurchased in 2003), and also due to an extraordinary cash inflow in 2003 resulting from the reimbursement of income taxes paid on account in 2002 and amounting to €201 million. The level of our net indebtedness decreased by 20.3% at the end of 2003 from December 31, 2002, principally as a result of strong cash flow generation and gains obtained on certain foreign currency derivatives. See " *Debt Instruments and Repayment and Refinancing of Indebtedness*".

In addition to the decrease in our net indebtedness during 2004, the composition of our indebtedness also changed over that period, with medium- and long-term loans decreasing from 79.3% to 72.4% of our total indebtedness. With the recent issue of new bonds totaling €2 billion under our global medium term note program, the maturity of our loan portfolio was significantly extended. See " *Debt Instruments and Repayment and Refinancing of Indebtedness*" below.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In the table below, we have presented the composition of our consolidated indebtedness as of December 31, 2003 and 2004.

| Debt                        | As of December 31, 2003 |                         | As of December 31, 2004 |                         |
|-----------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                             | Euro millions           | % of total indebtedness | Euro millions           | % of total indebtedness |
| <b>Short term</b>           | 1,191.1                 | 20.7%                   | 1,396.8                 | 27.6%                   |
| Exchangeable bond loans     | 450.5                   | 7.8%                    |                         |                         |
| Bond loans                  | 124.7                   | 2.2%                    | 585.0                   | 11.6%                   |
| Bank loans                  | 293.8                   | 5.1%                    | 473.9                   | 9.4%                    |
| Other loans                 | 322.1                   | 5.6%                    | 338.0                   | 6.7%                    |
| <b>Medium and long term</b> | 4,555.6                 | 79.3%                   | 3,666.2                 | 72.4%                   |
| Exchangeable bond loans     | 440.3                   | 7.7%                    | 390.3                   | 7.7%                    |
| Other bond loans            | 2,669.1                 | 46.4%                   | 1,848.2                 | 36.5%                   |
| Bank loans                  | 1,363.6                 | 23.7%                   | 1,337.0                 | 26.4%                   |
| Other loans                 | 82.5                    | 1.4%                    | 90.7                    | 1.8%                    |
| <b>Total indebtedness</b>   | 5,746.7                 | 100.0%                  | 5,063.1                 | 100.0%                  |
| Cash and cash equivalents   | 2,531.1                 | 44.0%                   | 1,940.1                 | 38.3%                   |
| <b>Net debt</b>             | 3,215.6                 | 56.0%                   | 3,123.0                 | 61.7%                   |

**Maturity.** Of the total indebtedness outstanding as at December 31, 2004, €1,396.8 million is due before the end of December 2005. The remaining €3,666.2 million is medium and long term debt. The average maturity of our net debt is 3.5 years.

**Interest rate.** As at December 31, 2004, 55.2% of our total indebtedness (or 89.5% of our net debt) was in fixed rates, as a result of certain derivatives we entered into in order to reduce our exposure to increases in interest rates.

**Credit Ratings.** As at the date of this report, our credit ratings were as follows:

| Rating Agency     | Credit Rating | Last Update    |
|-------------------|---------------|----------------|
| Moody's           | A3            | April 28, 2005 |
| Standard & Poor's | A-            | June 10, 2005  |

As at the date of this report, the only loans of Portugal Telecom with rating triggers (in the event Portugal Telecom is downgraded to below BBB+) are four loans from the European Investment Bank (EIB) totaling €400 million.

### ***Debt Instruments and Repayment and Refinancing of Indebtedness***

As part of our strategy to diversify our funding base and increase our presence in international capital markets and to strengthen the capital structure of our company, we have established a global medium term note program providing for the issuance of bonds in an amount of up to €5 billion. The program allows for the bonds to be issued in a range of currencies and forms, including fixed and floating rates, zero coupon and index linked. On April 7, 1999, we issued €1 billion in bonds under the program at a fixed interest rate of 4.625% per annum. These bonds mature in 2009. In February 2001, we issued another €1 billion in notes under the program at a fixed interest rate of 5.75%. These bonds mature in 2006. On November 16, 2001, we issued €600 million in notes under the program at a floating rate of 0.75% over the Euro interbank offered rate. These bonds matured in February 2005. During 2002 and 2003, we repurchased a portion of these bonds, which we cancelled in 2004. As of December 31, 2004, the outstanding amounts of the bonds maturing in 2005, 2006 and 2009 were €585 million, €900 million and €880 million, respectively.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

On March 24, 2005, we issued €1 billion in bonds under our global medium term note program at a fixed interest rate of 3.75% per annum, maturing in 2012. On the same day, we issued €500 million in bonds under the program at a fixed interest rate of 4.375% per annum, maturing in 2017. On June 16, 2005, we issued €500 million in bonds under the program at a fixed interest rate of 4.5% per annum, maturing in 2025.

On June 7, 1999, we issued €509.4 million in exchangeable bonds. These bonds carried a fixed interest rate of 1.5% per annum and matured in June 2004. In 2000 and 2001, 76 of these exchangeable bonds were converted into shares of Portugal Telecom. During 2003, we repurchased in the market, and subsequently cancelled, 11,710 of the remaining 35,431 of these bonds. The notional amount of these bonds that were converted or cancelled prior to maturity totaled €58.6 million. On June 7, 2004, we repaid the remaining outstanding exchangeable bonds, amounting to €450.5 million.

On December 6, 2001, we issued €550 million in exchangeable bonds. These bonds carry an interest rate of 2% per annum and mature in December 2006. They may be converted into an aggregate of 44,360,205 of Portugal Telecom's ordinary shares at a price of €12.40 per share. As of December 31, 2004, the amount of these bonds outstanding, after the cancellation of €159.7 million of these bonds that we repurchased in the market during 2002, 2003 and 2004, was €390.3 million.

In July 2001, we entered into a three-year syndicated loan that amounted to €510 million. The proceeds from this loan and from the bonds issued in 2001 under our global medium term note program were used to restructure the debt of Telesp Celular and Global Telecom. In January 2003, we cancelled this syndicated loan, and in February 2003, we entered into a bilateral loan that amounted to €500 million, maturing in February 2005. This loan includes financial covenants that are substantially more favorable to Portugal Telecom than the ones included in the €510 million syndicated loan. In 2004, the terms of the bilateral loan were renegotiated. The spread over Euribor was reduced and the maturity was extended so that 50% of the loan is payable in 2007 and the remainder in 2008.

In 2004, we entered into three multi-currency revolving credit facilities totaling €400 million, one in June 2004, in the amount of €150 million and with a maturity of four years; the second in October 2004, in the amount of €100 million and with a maturity of three years; and a third in October 2004, in the amount of €150 million and with a maturity of three years and six months. As of December 31, 2004, we had borrowed €75 million under these facilities.

As of the date of this report, the maturity of the June 2004 €150 million multi-currency credit facility and the October 2004 €100 million multi-currency credit facility had been extended for two years.

We and Lusomundo Media have in place domestic commercial paper programs totaling €890 million, under which, as of December 31, 2004, there was indebtedness of €327.8 million outstanding.

**Covenants.** We are bound by certain covenants under our indebtedness. As of the date hereof, the main covenants are as follows:

**Credit rating.** If, at any time, the long term credit rating assigned by the rating agencies to Portugal Telecom is reduced to BBB+/Baa1, then Portugal Telecom must provide a guarantee acceptable to the EIB. This covenant is included in certain of our EIB loan agreements, amounting to €150 million as of December 31, 2004 and €400 million as at the date of this report. As of December 31, 2004, the €100 million credit facility agreement provided that Portugal Telecom must have a minimum rating of at least BBB-/Baa3. As at the date of this report, this covenant no longer exists.

**Control of subsidiaries.** Portugal Telecom must, directly or indirectly, maintain majority ownership and control of each material subsidiary. Material subsidiaries are those companies whose total assets are equal to or exceed 10% of total consolidated assets or whose total revenues are also equal to or exceed 10% of total consolidated revenues. This covenant is included in the €500 million bilateral loan agreement and in our EIB loan agreements, which amounted to €831 million as at the date of this report.

**Financial Ratios.** The €500 million bilateral loan agreement states that the consolidated ratio of Net debt/EBITDA should not be higher than 4.5. The October €150 million credit facility agreement states that the consolidated ratio of Net Debt/EBITDA should not be higher than 3.5. As of December 31, 2004, the €100 million credit facility agreement provided that, if the rating was downgraded, Portugal Telecom's consolidated ratio of Net Debt/EBITDA should not be higher than 3.5. As at the date of this report, the €100 million credit facility agreement no longer includes this clause, now stating that the consolidated ratio of Net Debt/EBITDA should not be higher than 4.0. In addition, the conditions (spread and maturity) of the €500 million bilateral loan and the June €150 million credit facility may be changed if the consolidated ratio of Net Debt/EBITDA is higher than 2.5 and 2.25, respectively. As of December 31, 2004, this ratio stood at 1.34.

In addition, as of December 31, 2004, the global medium term notes, the exchangeable bonds and the bilateral loan included certain restrictions on the granting of pledges over Portugal Telecom's consolidated assets in order to secure any loan or obligation to third parties.

We believe we are in full compliance with the covenants described above.

#### **Post Retirement Benefits**

The following table shows the amount of net liabilities for post retirement benefits recorded on our balance sheets at December 31, 2002, 2003 and 2004:

|   | As of December 31, |                |                |
|---|--------------------|----------------|----------------|
|   | 2002               | 2003           | 2004           |
|   | (EUR millions)     |                |                |
| Pension liabilities                                 | 590.1              | 730.9          | 713.8          |
| Post retirement healthcare liabilities              | 471.3              | 525.1          | 556.1          |
| <b>Total liability for post retirement benefits</b> | <b>1,061.4</b>     | <b>1,256.0</b> | <b>1,269.9</b> |

As of December 31, 2004, 2003 and 2002, and as permitted by IAS No. 19, we recognized our unfunded post retirement benefits liabilities net of the related deferred cost and income. These deferrals are mainly related to the transition obligation and actuarial losses and gains.

As of December 31, 2004, the projected benefit obligations, or PBO, of our post retirement benefits, including pensions, healthcare obligations and salaries to pre-retired employees (computed based on a 5.75% discount rate for pensions and healthcare benefits and 4% for obligations related to the payment of salaries to pre-retired and suspended employees and assuming a 3% annual salary increase), amounted to €4,294 million (€2,606 million for pensions, €702 million for healthcare benefits and €986 million for salaries to pre-retired and suspended employees). Compared to 2003, the PBO increased 6.1% equivalent to €247 million, mainly as a result of the increase of €164 million resulting from our workforce reduction program covering 651 employees in 2004, and the increase resulting from the change in certain actuarial assumptions (discount rate, which was reduced from 6% to 5.75%, and mortality tables). The Company's post retirement benefits (pension and healthcare plans), which have already been closed to new participants, cover approximately 34,500 employees, with 32% still in service.

According to the rules of the Instituto de Seguros de Portugal, or ISP, the pension plans for retired staff have to be fully funded, which is the case for Portugal Telecom's pension funds. Regarding funding of the pension funds for pre-retired staff and staff still in service, it can currently be funded up until retirement age. The estimated average working life of staff still in service is 14 years.

In Portugal there is no legislation covering the establishment of funds to cover post retirement healthcare benefits and obligations regarding the payment of salaries to pre-retired and suspended employees. Portugal Telecom will only have to pay for these benefits when the healthcare services are rendered to related employees and a corresponding claim is charged to the company, and when the salaries are paid to pre-retired and suspended employees. Accordingly, there is no requirement to fund these benefits (€702 million and €986 million, respectively) at present. However, Portugal Telecom has set up a vehicle, PT Prestações, to allow for a tax efficient funding of its healthcare post retirement liabilities, and in March 2005 Portugal Telecom contributed €300 million to this vehicle, which will be managed in accordance with the same guidelines as its pension funds.

The market value of the pension funds amounted to €1,973 million at December 31, 2004, an increase of €145 million from 2003, resulting primarily from the strong performance of the pension funds (actual returns of 8.1% in 2004, through a diversified portfolio including 35% in equities). Accordingly, as of December 31, 2004 we had unfunded post retirement benefits obligations amounting to €2,321 million. The net deferred costs related to post retirement benefits amounted to €1,051 million, and the net balance of unfunded obligations and net deferred costs as of December 31, 2004 was €1,270 million as reflected in Portugal Telecom's balance sheet in accordance with the requirements of IAS No. 19.

The deferred costs related to post retirement benefits correspond to: (i) €65 million related to the Initial Transition Obligation (obligation on the initial date for recognition of post retirement liabilities, which was January 1, 1993), that is being amortized over an 18-year period corresponding to the expected working life of employees on that date; and (ii) €993 million related to net actuarial losses, which correspond to differences between the assumptions considered in the actuarial studies and the actual results related to those benefits (including differences in the return of pension fund assets, salary increases and healthcare costs), that are being amortized over a 14-year period corresponding to the average working life of employees.

The net periodic post retirement benefit cost includes the service cost for staff still in service and covered by the plans, the interest cost associated with the PBO less the expected return on fund assets, and the amortization and deferral of actuarial losses and gains. In 2004, the service cost amounted to €24 million and the interest cost amounted to €213 million. The expected return on the pension funds assets for 2004, calculated based on a 6% rate of return assumption, was estimated at €111 million and recorded as a deduction to this interest cost. The amortization and deferral of actuarial losses amounted to €80 million in 2004. In addition, in 2004 there was a gain of €67 million related to the change in the calculation of the pension benefit to 90% of the employee's last year of salary (previously 100%), which was recorded in the income statement as a reduction to the 2004 costs of post retirement benefits. Thus, the net periodic post retirement benefit costs for 2004 was €139 million. Our cash outflow in 2004 associated with post retirement benefits amounted to €299 million, of which (i) €126 million related to contributions to the pension funds; (ii) €30 million related to healthcare services rendered to pensioners and pre-retired employees; and (iii) €143 million related to salaries paid to pre-retired employees.

### *Equity*

Our total equity amounted to €2,705 million at December 31, 2004, compared with €2,941 million at December 31, 2003 and €3,111 million at December 31, 2002.

The decrease in total equity in 2004 primarily reflects the acquisition of treasury stock (€481 million), the dividend distribution made in May 2004 (€267 million), the effect of currency translation adjustments mainly due to the appreciation of the Brazilian Real against the Euro in 2004 (€21 million) and the distribution of shares to our employees (€6 million), which was offset by the increase in total equity resulting from the net income for the period (€500 million).

The decrease in total equity in 2003 primarily reflects the acquisition of treasury stock (€210 million) and the dividend distribution made in May 2003 (€201 million), which was offset by the increase in total equity resulting from the net income for the period (€240 million).

Our total equity as a percentage of total assets was reduced from 23% at the end of 2002 to 22% at the end of 2003 and to 21% at the end of 2004. Our gearing ratio, calculated as the ratio of net debt to total equity plus minority interest plus net debt, was 53.2%, 47.3% and 48.7% as of the end of 2002, 2003 and 2004, respectively.

We make adjustments to equity in response to fluctuations in the value of the foreign currencies in which we have made investments, including the Brazilian Real. Cumulative foreign currency translation adjustments related to investments in Brazil were negative, €2,259 million at the end of 2002, €2,234 million at the end of 2003 and €2,204 million at the end of 2004. See "Item 3 Key Information Risk Factors We Are Exposed to Exchange Rate and Interest Rate Fluctuations" and "Exchange Rate Exposure to the Brazilian Real".

### Contractual Obligations and Off-balance Sheet Arrangements

#### Contractual Obligations and Commercial Commitments

The following table presents our contractual obligations and commercial commitments as of December 31, 2004:

|   | Payments due by period in millions of Euros |                     |                |                |                      |
|---|---|---------------------|----------------|----------------|----------------------|
|   | Total                                       | Less than<br>1 year | 1 - 3<br>years | 3 - 5<br>years | More than<br>5 years |
| <b>Contractual obligations:</b>               |   |                     |                |                |                      |
| Indebtedness                                  | 5,063.1                                     | 1,396.8             | 1,983.0        | 1,466.2        | 217.1                |
| Net post retirement benefits                  | 2,321.2                                     | 163.9               | 309.6          | 289.7          | 1,558.0              |
| Capital lease and operating lease obligations | 1,012.8                                     | 74.6                | 138.1          | 199.8          | 600.2                |
| Unconditional purchase obligations            | 214.6                                       | 89.7                | 20.9           | 18.6           | 85.4                 |
| <b>Total contractual cash obligations</b>     | <b>8,611.7</b>                              | <b>1,725.1</b>      | <b>2,451.6</b> | <b>1,974.3</b> | <b>2,460.7</b>       |

Our capital lease obligations and operating leases relate to the acquisition of fixed assets such as buildings and transportation equipment. These contractual obligations are generally entered into with financial institutions. Capital leases are accounted for as fixed assets and the amount due to the third party is accounted for as a liability. Operating leases are accounted for as a cost in the period that the corresponding expense is incurred. Our intention is to fulfill these commitments from our operating cash flow generated in each of those years.

Unconditional purchase obligations arise generally from contractual agreements with our fixed asset suppliers (including all amounts related to the acquisition of network assets, telecommunications equipment and terminal equipment) or from contractual rental agreements entered into by our businesses, including those obligations related to the rental of cinema rooms in our multimedia business amounting to €135 million, which according to the rental agreement must be paid unless a new lessor is identified. We also entered into certain agreements related to the maintenance of our network. We expect that our operating cash flow will be sufficient to fulfill all of our unconditional purchase commitments.

**Off-balance Sheet Arrangements**

In the course of our business we grant certain guarantees to third parties. These guarantees are given to ensure the proper performance of contractual obligations by Portugal Telecom or its consolidated subsidiaries in the normal course of their business. As of December 31, 2004, we had given the following guarantees to third parties:

|   | Guarantees by period in millions of Euros |                     |                |                |                      |
|---|---|---------------------|----------------|----------------|----------------------|
|   | Total                                     | Less than<br>1 year | 1 - 3<br>years | 3 - 5<br>years | More than<br>5 years |
| Bank guarantees given to Portuguese courts for outstanding litigation | 9.0                                       | 9.0                 |                |                |                      |
| Bank guarantees given to other entities:                              |   |                     |                |                |                      |
| By PT Comunicações  | 18.3                                      | 18.3                |                |                |                      |
| By TMN to ANACOM  | 3.2                                       | 3.2                 |                |                |                      |
| By PT Multimédia and subsidiaries                                     | 9.3                                       | 7.7                 | 0.7            | 0.3            | 0.6                  |
| Other bank guarantees   | 1.5                                       | 1.5                 |                |                |                      |
|   | 32.3                                      | 30.7                | 0.7            | 0.3            | 0.6                  |
| Comfort letters and other bank guarantees                             | 116.7                                     | 39.0                | 67.4           | 10.2           |                      |

As of December 31, 2004, the bank guarantees given by PT Multimédia and its subsidiaries were given to Alta Autoridade para a Comunicação Social (the Portuguese media regulator), in connection with the broadcasting of television shows. The bank guarantees given by PT Comunicações to third parties relate mainly to the Portuguese tax authorities in respect of certain tax contingencies.

We have issued comfort letters and other bank guarantees in order to guarantee loans obtained by associated companies. On September 1, 2004, PT Multimédia and PPTV Publicidade de Portugal e Televisão, S.A. (the other shareholder of Sport TV) granted to Sport TV a guarantee amounting to €70 million to cover a loan obtained by Sport TV to acquire the rights to broadcast the games of the Portuguese football league for the 2004-2005 to 2007-2008 seasons.

In addition to the guarantees indicated in the table above, Portugal Telecom group companies have provided the guarantees described below.

In October 2000, Medi Telecom entered into medium and long term loans totaling €1,000 million with a consortium led by International Finance Corporation, or the IFC, and the banks ABN Amro and Société Générale. The loans have an average term of 8 years and serve to refinance the short term loan obtained to finance the acquisition of the mobile telecommunications license for Morocco in August 1999 and to cover the investment relating to the installation and development of the GSM network. Under the provisions of the contracts, Medi Telecom is required to attain certain financial performance levels. In accordance with the financing operation, the major shareholders of Medi Telecom (Portugal Telecom, through PT Móveis (32.18%), Telefónica Intercontinental S.A. (32.18%) and Banque Marocaine du Commerce Exterior (18.06%)) signed a Shareholders Support Deed according to the terms of which they committed to make future capital contributions to Medi Telecom (in the form of capital or shareholders' loans), if necessary, to cover possible shortfalls in the agreed financial targets. As a result of loans already granted to Medi Telecom by PT Móveis and Telefónica Intercontinental, the maximum amount of this liability, as of December 31, 2004, was limited to an additional maximum of €84 million and ends as soon as Medi Telecom reaches a Net Debt/EBITDA ratio of less than 3.0 during four consecutive quarters.

Portugal Telecom signed a Shareholders' Agreement with the other shareholders of Sportinveste Multimédia in which Portugal Telecom committed to provide additional paid in capital contributions to

Sportinveste Multimédia up to a maximum of €40 million. As of December 31, 2004, Portugal Telecom has already granted loans to Sportinveste Multimédia amounting to €30 million.

Finally, as part of cross-leasing transactions ("QTE leases") with different third parties, Portugal Telecom has leased out and then leased back certain telecommunications equipment. The crossed flow of lease payments and Portugal Telecom's remuneration were prepaid at the outset of the contracts and, for this reason, are not shown in the table concerning minimum future lease payments. The remuneration is recognized as income over the period of the transaction. In connection with this transaction, we have provided a guarantee corresponding to a bank deposit of €840.5 million that is equivalent to the net present value of the future lease payments under the contract. We estimate that the risk of the guarantee being called upon is negligible.

### Capital Investment and Research and Development

#### Capital Investment

**Capital expenditures and financial investments.** During the year ended December 31, 2004, we made capital expenditures and financial investments totaling €1,092.5 million, including primarily expenditures in connection with the growth in broadband accesses and Vivo's investment in capacity expansion.

The table below sets out our total capital investment for the years 2002, 2003 and 2004, on the basis of full consolidation of TCP in 2002 and proportional consolidation of Vivo in 2003 and 2004, in millions of Euro:

|                       | Year ended December 31, |                |                |
|-----------------------|-------------------------|----------------|----------------|
|                       | 2002                    | 2003           | 2004           |
| Capital expenditures  | 1,124.4                 | 651.6          | 783.0          |
| Financial investments | 329.2                   | 464.3          | 309.5          |
| <b>Total</b>          | <b>1,453.6</b>          | <b>1,115.9</b> | <b>1,092.5</b> |

#### Capital Expenditures

From January 1, 2004 through December 31, 2004, we made capital expenditures totaling €783.0 million, primarily relating to our mobile businesses in Portugal and Brazil and our wireline business in Portugal. The table below sets forth our capital expenditures on tangible and intangible assets, excluding goodwill, for the years 2002, 2003 and 2004 on the basis of full consolidation of TCP in 2002 and proportional consolidation of Vivo in 2003 and 2004, in millions of Euro:

|                  | Year ended December 31, |              |              |
|------------------|-------------------------|--------------|--------------|
|                  | 2002                    | 2003         | 2004         |
| Wireline         | 604.7                   | 165.3        | 206.4        |
| Domestic Mobile  | 282.7                   | 168.5        | 158.8        |
| Brazilian Mobile | 88.2                    | 164.6        | 264.5        |
| Multimedia       | 78.9                    | 57.4         | 80.5         |
| Other            | 69.9                    | 95.8         | 72.8         |
| <b>Total</b>     | <b>1,124.4</b>          | <b>651.6</b> | <b>783.0</b> |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Capital expenditures reached €783.0 million in 2004, equivalent to 13.0% of total operating revenues, as a result of the strong growth in broadband accesses in our wireline business; capital expenditures at TMN in connection with the rollout of UMTS; and Vivo's investment in capacity expansion, the rollout of 1xRTT and the launch of EV-DO and the fact that TCO was only fully consolidated by Vivo as of May 2003.

### *Financial Investments*

Investment in financial assets (including goodwill) in 2004 amounted to €309.5 million and was mainly related to the acquisition of an additional interest in TCO, Tele Sudeste Celular Participações, Tele Leste Celular Participações and CRT Celular Participações. Our investment in financial assets (including goodwill) in 2003 and 2002 was €464.3 million and €329.2 million, respectively. See "Cash for Investing Activities" above.

### *Acquisitions and Divestitures of Companies*

**2004.** Set forth below are the main changes that occurred during the year ended December 31, 2004 to our interests in the companies consolidated in our financial statements.

#### *Acquisitions*

During 2004, Portugal Telecom acquired 1,600,000 shares of Media Capital, corresponding to 1.93% of its share capital, for €6.9 million.

During 2004, PT Conteúdos acquired 250,000 shares of Sport TV, equivalent to 16.67% of its share capital, for €16.3 million. This acquisition generated goodwill amounting to €22.1 million and increased PT Conteúdos' ownership of Sport TV to 50%.

During 2004, Portugal Telecom acquired 325,920 shares of Previsão for €2.1 million, increasing its ownership of Previsão to 78.12%.

In May 2004, Vivo acquired the remaining 10.5% of the share capital of Sudeste Celular Participações, S.A. for €20.6 million.

On May 13, 2004, Global Notícias acquired 99.98% of the share capital of Ocasão-Edições Periódicas, Lda for €4.7 million. This acquisition generated goodwill amounting to €4.7 million.

During the second half of 2004, Global Notícias increased its interest in Naveprinter from 38.47% to 90.98%, through the acquisition of 393,846 shares for €5 million. As a result of this acquisition, Naveprinter's results were fully consolidated in our results for the year ended December 31, 2004.

In the second half of 2004, PT Multimédia acquired the remaining 50% of Diverfun and now owns 100% of the share capital of this company.

On October 8, 2004, TCP concluded a tender offer for the acquisition of an additional interest in TCO. TCP paid R\$902 million for this acquisition and increased its ownership in TCO from 29.3% to 51.4% (excluding treasury shares).

On October 8, 2004, Avista, which is wholly owned by Vivo, concluded a tender offer for the acquisition of interests in the share capital of Tele Sudeste, Tele Leste and CRT Celular. Vivo paid approximately R\$607 million for these operations and acquired an additional 4.2%, 22.7% and 15.8% of Tele Sudeste, Tele Leste and CRT Celular, respectively.

At the end of 2004, Portugal Telecom increased its interest in Web-Lab from 36% to 92% of its share capital through the acquisition of shares from several different entities.





*Sales*

On October 28, 2004, Portugal Telecom sold its interest in Banco1.net for R\$14 million.

In September 2004, the Botswana authorities granted approval for the sale of, and we disposed of, Mascom Wireless for the amount of €45.6 million. As a result, we recorded a gain of €24.7 million in connection with this transaction.

*Other operations*

On September 16, 2003, Portugal Telecom announced its intention to buyback 10% of its share capital by the end of 2004, subject to financial and market conditions. Pursuant to our share buyback program, we reduced our share capital on December 28, 2004 by 7% through the cancellation of 87,799,950 treasury shares acquired during 2003 and 2004, at an average price of €7.87 per share. In addition to treasury shares repurchased directly by us, we entered into equity swap contracts to buy 21,551,006 shares during 2004. During the first quarter of 2005, we entered into new equity swap contracts to buy 16,077,544 shares, in order to complete the 10% share buyback program. The remaining 37,628,550 shares to complete the 10% share buyback program were acquired by Portugal Telecom in May 2005, through the execution of such equity swaps and will be cancelled by the end of 2005.

**2003.** Set forth below are the main changes that occurred during the year ended December 31, 2003 to our interests in the companies consolidated in our financial statements.

*Acquisitions*

In September 2003, PT Multimédia acquired the remaining 50% of Warner Lusomundo, the owner of the largest cinema multiplex circuit in Portugal, from Warner Bros. Entertainment Inc. The total consideration for this transaction was €21 million.

On April 25, 2003, TCP acquired 61.1% of the voting capital stock of TCO from the Brazilian company, Fixcel. The purchase price was R\$1,529 million, which corresponds to R\$19.5 per each lot of 1,000 common shares acquired. On November 18, 2003, TCP acquired an additional 25.5% of the common shares of TCO in a tender offer to TCO minority shareholders for R\$538.8 million. Following the tender offer, TCP now holds 86.6% of the voting capital stock and 28.9% of the total capital stock of TCO, including treasury shares held by TCO.

In November 2003, PT Multimédia entered into an agreement to purchase, through PT Conteúdos, an additional 16.67% stake in Sport TV from RTP for €16.3 million, thereby increasing its ownership in Sport TV to 50%.

On July 20, 2003, Portugal Telecom signed an agreement with SIBS for the acquisition of its 12.5% stake in PT Prime for €39 million. The transfer to Portugal Telecom of the remaining 12.5% of PT Prime's shares that PT Prime SGPS did not already own was completed on October 6, 2003 and PT Prime SGPS' shares in PT Prime were transferred to Portugal Telecom in the fourth quarter of 2003. PT Prime is now wholly owned directly by Portugal Telecom.

During the second half of 2003, Portugal Telecom acquired 5.94% of the share capital of Lusomundo Media for €9 million.

*Capital increases*

On February 7, 2003, Banco Best increased its share capital from €43 million to €55 million, which was paid for and fully subscribed by its shareholders. PTM.com paid €4 million for its portion of the shares, thereby maintaining its 34% stake in Banco Best.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

During the fourth quarter of 2003, Médi Télécom increased its share capital in the amount of 500 million Dirhams through the issuance of 4,999,999 shares of 100 Dirhams each. PT Móveis paid in cash 230,861,200 Dirhams (approximately €21.2 million) for its portion of the shares and, as a result, now holds 32.18% of the share capital of Médi Télécom.

### *Sales*

On July 7, 2003, Portugal Telecom entered into an agreement with Citizens to sell its 50.01% interest in Mascom Wireless for 250 million Botswana Pulas (approximately €46 million). Portugal Telecom received an initial payment of 200 million Botswana Pulas (approximately €41 million), which was held in escrow pending regulatory approval of completion of the transaction in September 2004.

### *Other operations*

On October 31, 2003, TCP attempted to acquire the remaining share capital of TCO that it did not already own by means of a merger of TCO shares into TCP shares. The exchange ratio was fixed at 1.27 TCP shares for each TCO share held. This merger was cancelled on January 12, 2004 following the issue of an opinion by the Brazilian Securities and Exchange Commission that the merger did not fully comply with current Brazilian law.

On September 16, 2003, Portugal Telecom announced its intention to buy back 10% of its share capital by the end of 2004, subject to financial and market conditions. Pursuant to our share buyback program, as of June 25, 2004, Portugal Telecom had repurchased on the Euronext Stock Exchange a total of 54,225,108 of its treasury shares, or 4.32% of its share capital, at an average price of €8.01 per share. In addition to treasury shares repurchased directly by us, we have entered into other equity swap contracts as of June 2004, according to the terms of which we have the option to acquire up to 2.19% of our share capital at an exercise price of €7.77 per share.

**2002.** Set forth below are the main changes that occurred during the year ended December 31, 2002 to our interests in the companies consolidated in our financial statements.

### *Acquisitions*

On April 12, PT Multimédia increased its interest in PTM.com to 100% of its share capital through a public tender offer for the remaining shares held by minority shareholders; PT Multimédia acquired 4,186,593 shares of PTM.com for a total consideration of €8.1 million.

On June 30, Lusomundo Serviços subscribed for one quota of the capital of Vasp representing 33.33% of its quota capital. The total cost of this acquisition was €3.5 million.

In the last quarter, PT Sistemas de Informação acquired 15% of the share capital of Megamédia from BES for €1,287,900 and the remaining 21.39% from Megamédia's other shareholders for €1.3 million.

During the second half, Portugal Telecom acquired 2.4% of the share capital of PT Multimédia in stock market transactions, totaling €27.6 million. As of December 31, 2002 Portugal Telecom held 88,617,454 PT Multimédia shares, which corresponds to 56.48% of its share capital.

On December 27, after obtaining the approval from ANATEL, TCP acquired the controlling position in the holding companies that controlled Global Telecom. This transaction corresponded to an indirect acquisition of 17% of Global Telecom's share capital, which is now fully owned by TCP. The total consideration paid for this acquisition was €79 million.



*Capital increases*

On July 1, BUS Serviços de Telecomunicações, S.A. changed its name to PrimeSys-Soluções Empresariais, S.A. In December 2002 this company increased its share capital from R\$43,112,840 to R\$109,438,121.

During the second half, Medi Telecom increased its share capital from 6,500,000,000 Moroccan Dirhams, or "MAD", to MAD 8,333,837,600, paid and subscribed for by the shareholders; as a result of this capital increase, PT Ventures (formerly PT Internacional) increased its ownership of Medi Telecom to 31.34%. The total amount paid for this capital increase was €17.1 million.

On September 9, TCP concluded a capital increase. Portugal Telecom subscribed for 76.6% of the issued shares, and subsequently sold 172,016,089 thousand shares to Telefónica Móviles, S.A., representing 14.68% of the share capital of TCP. After this operation Portugal Telecom increased its ownership in TCP from 41.23% to 50.44%.

*Sales*

PT Prime SGPS sold 6,500,000 shares of Telefónica for a total consideration of €181.7 million.

PT Ventures sold 16.4% of Mascom for a total consideration of € 2.2 million.

In June, Lusomundo Serviços sold its 100% investment in Deltapress to Vasp for a total consideration of €3.2 million.

***Research and Development***

In 2002, 2003 and 2004, we invested approximately €17.4 million, €14.3 million and €10.6 million, respectively, in research and development. Our research and development programs are focusing on intelligent networks, network management systems, advanced services and systems and network integration. Our research and development activities, carried out primarily through PT Inovação, have been responsible for the introduction of innovative products and services and for the development of in-house technology. These activities have allowed our employees to remain up-to-date in terms of technology and technological development in the telecommunications sector on both a European and a worldwide level. PT Inovação's activities have been a driving force behind the development of new products and services, telecommunications infrastructures and information systems. See "*Item 4 Information on the Company Our Businesses*".

Since 1998, we have developed narrow and broadband network access solutions for network operators and for large customers and intelligent network solutions and services for fixed and mobile operators. One of our most successful products has been the Next Generation Intelligent Network platform, which uses ISDN lines to connect, together with intelligent network-based services, to customers in both the domestic and international markets.

We participate in a number of EU research and development programs, including projects in the Information Society Technologies, ACTS and Telematics programs, with Eurescom, a joint venture with our European operators and the SURESCOM Institute. In addition, we work to develop programs in partnership with domestic research and development institutes.

**Exchange Rate Exposure to the Brazilian Real**

The composition of our assets and revenue base expose us to significant exchange rate risk in respect of the Brazilian Real. We make adjustments to equity in response to fluctuations in the value of the foreign currencies in which we have made investments, including the Brazilian Real. See "*Liquidity and Capital Resources Equity*" above.

**Currency composition of our assets.** The table below shows the amounts of our consolidated assets held in Euro and Brazilian Reais as of December 31, 2003 and 2004.

| Consolidated Assets | As of December 31, 2003 |                   | As of December 31, 2004 |                   |
|---------------------|-------------------------|-------------------|-------------------------|-------------------|
|                     | EUR millions            | % of total assets | EUR millions            | % of total assets |
| Euro                | 9,483                   | 69.9%             | 8,669                   | 66.9%             |
| Brazilian Real      | 3,871                   | 28.5%             | 4,164                   | 32.1%             |
| Other               | 205                     | 1.5%              | 130                     | 1.0%              |
|                     | 13,558                  | 100.0%            | 12,963                  | 100.0%            |

**Currency composition of our indebtedness.** The table below shows the amounts of our total consolidated indebtedness denominated in Euro, Brazilian Real and U.S. dollars at December 31, 2003 and 2004. The amounts presented take into account the derivative agreements we have entered into. For further information, see Note 13 to our audited consolidated financial statements included in this Form 20-F.

| Indebtedness     | As of December 31, 2003 |                 | As of December 31, 2004 |                 |
|------------------|-------------------------|-----------------|-------------------------|-----------------|
|                  | EUR millions            | % of total debt | EUR millions            | % of total debt |
| Euro             | 4,840                   | 84.2%           | 4,285                   | 84.6%           |
| Brazilian Real   | 748                     | 13.0%           | 658                     | 13.0%           |
| U.S. dollar      | 119                     | 2.1%            | 118                     | 2.3%            |
| Other currencies | 40                      | 0.7%            | 1                       | 0.0%            |
|                  | 5,747                   | 100.0%          | 5,063                   | 100.0%          |

**Exposure to exchange rate risk.** Our Brazilian Real-denominated debt enables us to hedge against exchange rate risk concerning our Brazilian Real-denominated assets. As of December 31, 2004, Vivo's consolidated debt (the majority of which is either Brazilian Real-denominated or has been swapped into Brazilian Reais) represented 14.2% of our total consolidated indebtedness. Taking into account inter-company loans, Vivo's debt represented 15.1% of our total consolidated indebtedness.

For more detailed information as at December 31, 2004 concerning our market exposure to exchange rate risk, as well as our market exposure to interest rate risk, see "Item 11 Quantitative and Qualitative Disclosures About Market Risk".

**Fluctuations to the Brazilian Real can affect the value of our investments in Brazil.** A substantial portion of our balance sheet and financial results is represented by our investments in Brazil. As of December 31, 2004, our 50% interest in Vivo's net assets, which includes an economic interest of 65.1% in TCP, 50.6% in Tele Leste Celular Participações, 90.9% in Tele Sudeste Celular Participações and 67.0% in CRT Celular Participações, amounted to €2,206 million, at the year end Euro/Real exchange rate. Our investments in Brazil therefore are a substantial part of our assets.

Given the substantial investments we have in Brazil, the devaluation of the Brazilian Real in recent years has had a significant impact on our balance sheet and financial results, as discussed throughout this "Item 5". In the last three years the economic situation in Brazil has improved and in 2004 Brazil's real GDP increased by 5.2% and the Real has stabilized and even appreciated against the Euro and the U.S. Dollar. By the end of 2004, the exchange rate between the Euro and the Real was R\$3.61949 = €1.00. Nevertheless, we cannot be sure that the value of the Real will remain stable and if economic growth in Brazil were to slow further, this could also have a significant impact on the growth prospects of the companies in which we have invested. We provide more information about the fluctuations in the Brazilian Real in "Item 3 Key Information Exchange Rates Brazilian Real". See also "Item 3 Key Information Risk Factors We Are Exposed to Exchange Rate and Interest Rate Fluctuations".

**ITEM 6 DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

**Directors and Senior Management**

***Management Structure***

The Board of Directors of Portugal Telecom is responsible for its management and affairs. Portugal Telecom's officers are either in charge of our various business and administrative departments and report directly to the Board of Directors or are in charge of Portugal Telecom's subsidiaries. The Statutory Audit Board examines Portugal Telecom's accounts on at least a monthly basis and issues opinions on its budget, inventory and annual accounts. The Audit Committee advises the Board of Directors and the Executive Committee with regard to the quality and integrity of financial reporting; the independence and performance of our external auditors; the quality of our internal control systems; the performance of our internal auditors; and compliance with applicable laws, regulations, recommendations and guidelines issued by the SEC, NYSE, the Comissão do Mercado de Valores, or CMVM, and the Euronext Lisbon Stock Exchange. In addition, the Audit Committee defines and implements policies necessary to ensure our compliance with these laws, regulations, recommendations and guidelines.

Portugal Telecom's articles of association provide for a Board of Directors consisting of any odd number of 15 to 23 directors, including the Chairman. The directors are elected by a majority of the votes cast at the annual shareholders meeting following the expiration of their term. In addition, a majority of votes cast by holders of A shares is required to elect one third of the members of the Board of Directors, including the Chairman of the Board. A minority of the shareholders representing, in the aggregate, at least 10% of Portugal Telecom's share capital, has the right to elect a director to substitute for the director previously elected by the fewest number of votes. The term of office of the directors is three calendar years, with the year of election or appointment considered a full calendar year. There is no restriction on the re-election of directors.

A quorum for a meeting of the Board of Directors is a simple majority of directors. All directors have equal voting rights, and all resolutions of the Board of Directors are adopted by a majority of the votes cast. The Chairman has the deciding vote in the event of a tie.

The articles of association provide for an Executive Committee of the Board to which the Board of Directors can delegate the management of Portugal Telecom's affairs and the monitoring of the daily operation of Portugal Telecom's activities. However, the Board of Directors remains responsible for Portugal Telecom's overall management and operations. The Executive Committee may be comprised of five or seven directors selected by a majority of the Board of Directors. Pursuant to an amendment to the articles of association approved at the general meeting of shareholders on April 23, 2002, the offices of Chairman of the Board and President of the Executive Committee are no longer required to be filled by the same individual. From among the directors elected with the approval of a majority of holders of A shares, at least one or two must be appointed to the Executive Committee (depending on whether the Executive Committee is composed of five or seven directors). The vote of a majority of the members of the Executive Committee is necessary for the taking of an action by the Executive Committee. All members have equal voting rights, and the President has the deciding vote in the event of a tie.

***Board of Directors and the Executive Committee***

Portugal Telecom's Board of Directors currently consists of twenty two directors, following the resignation of Pedro Malan in November 2004, and the Executive Committee is currently composed of five directors. The Board of Directors expects to appoint a new member to replace Mr. Malan in the near future, bringing the total number of directors back up to 23. The names and offices of current members of Portugal Telecom's Board of Directors, their principal past affiliations and certain other information are set forth below.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following directors are also members of the Executive Committee:

*Miguel António Igrejas Horta e Costa.* First elected 1995. Term expires December 31, 2005. Aged 56. Chief Executive Officer of Portugal Telecom, SGPS, S.A. since May 28, 2002; Chairman of the Board of Directors of Portugal Telecom Ásia, Lda since July 2004; Chairman of the Board of Directors of Portugal Telecom Investimentos Internacionais Consultoria Internacional, S.A. since April 2004; Chairman of the Board of Directors of PT Prime, SGPS, S.A. since February 2004; Chief Executive Officer of PT Comunicações, S.A. since January 2004; Chairman of the Board of Directors of PT Sistemas de Informação, S.A. since January 2004; Chairman of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since June 2003; Chairman of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. since May 2003; Chairman of the Board of Directors of Fundação Portugal Telecom since March 2003; Chairman of the Board of Directors of PT Ventures, SGPS, S.A. (ex-Portugal Telecom Internacional, SGPS, S.A.) since December 2002; Chairman of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. since August 2002; Chairman of the Board of Directors of Portugal Telecom Brasil, S.A. since July 2002; Chairman of the Board of Directors of PT Móveis, SGPS, S.A. and TMN Telecomunicações Móveis Nacionais, S.A. since June 2002; Chairman of the Board of Directors of PT Comunicações, S.A. since May 2002; Vice-Chairman of the Executive Committee of Portugal Telecom, SGPS, S.A. from April 2000 until May 2002; Vice-Chairman of the Board of Directors of PT Investimentos, SGPS, S.A. from 1999 until June 22, 2001; Vice-Chairman of the Board of Directors of Telesp Celular Participações S.A. from 1998 until November 2000; Vice-Chairman of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. from 2000 until 2002; Member of the Board of Directors of Telesp Participações S.A. from 1998 until November 2000; Member of the Board of Directors of Telesp, S.A. from 1998 until November 2000; Chairman of the Board of Directors of Portugal Telecom Internacional, SGPS, S.A. from 2000 until 2002; Chief Executive Officer of Portugal Telecom Internacional, SGPS, S.A. from 1998 until 2000; Member of the Board of Directors of Telefónica, S.A. since 1998; Member of the Board of Directors of SIC, S.A. from 1998 until 2000; Member of the Board of Directors of Aliança Atlântica Holdings since 1997; Vice-Chairman of the Board of Directors of Portugal Telecom Internacional, SGPS, S.A. from 1996 until 1997; Vice-Chairman of the Board of Directors of Companhia Portuguesa Rádio Marconi S.A. from 1994 until 1995; Non-executive member of the Board of Directors of Portugália-Companhia de Transportes Aéreos, S.A. since 1993; Vice-Chairman of the Board of Directors of Banco ESSI, S.A. from 1992 until 1994; Non-executive Member of the Board of Directors of BES Investimento, S.A. since 1999; Chairman and member of the Board of Directors of SIBS-Sociedade Interbancária de Serviços, S.A. from 1991 until 1995; Chairman of the Board of Directors of Euroges-Aquisição de Créditos a Curto Prazo, S.A. since 1991; Member of the Board of Directors of Banco Espírito Santo e Comercial de Lisboa from 1990 until 1992; Vice-Chairman of Associação Industrial Portuguesa from 1990 until 1994; Secretary of State for Foreign Trade from 1987 until 1990; Vice-Chairman of the Board of Directors of CTT and TLP from 1984 until 1987; Chairman of the Board of Directors of Companhia Portuguesa Rádio Marconi S.A. from 1982 until 1984; Director-General of CTT from 1981 until 1982.

*Zeinal Abedin Mahomed Bava.* First elected 2000. Term expires December 31, 2005. Aged 39. Chief Financial Officer of Portugal Telecom, SGPS, S.A. since 2000; Member of the Board of Directors of PT Sistemas de Informação, S.A. since May 2004; Member of the Board of Directors of Portugal Telecom Investimentos Internacionais Consultoria Internacional S.A. since April 2004; Chairman of the Board of Directors of TV Cabo Portugal, S.A. since March 2004, Executive Vice-Chairman of the Board of Directors of PT Comunicações, S.A. since January 2004; Member of the Board of Directors of Páginas Amarelas, S.A. since January 2004; Member of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since June 2003; Chief Executive Officer of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. since May 2003; Member of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. since May 2003;

Chairman of the Board of Directors of Previsão Sociedade Gestora de Fundos de Pensões, S.A. since March 2003; Chairman of the Board of Directors of PT PRO Serviços de Gestão, S.A. since February 2003; Member of the Board of Directors of Tele Sudeste Participações, S.A. since 2003; Member of the Board of Directors of CRT Celular Participações, S.A. since 2003; Member of the Board of Directors of Tele Leste Participações S.A. since 2003; Member of the Board of Directors of Tele Centro Oeste Celular Participações, S.A. since 2003; Member of the Board of Directors of Brasilcel, N.V. since December 2002; Vice-Chairman of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. since November 2002; Member of the Board of Directors of Portugal Telecom Brasil, S.A. since July 2002; Member of the Board of Directors of BEST Banco Electrónico de Serviço Total, S.A. since May 2001; Member of the Board of Directors of Telesp Celular Participações S.A. since April 10, 2001; Vice-Chairman of the Board of Directors of PT Ventures, SGPS, S.A. (formerly Portugal Telecom Internacional, SGPS, S.A.) from 2000 until 2002; Director and Relationship Manager for Portugal of Merrill Lynch International from 1998 until 1999; Executive Director of Deutsche Morgan Grenfell from 1996 until 1998; Executive Director of Warburg Dillon Read from 1989 until 1996.

*Carlos Manuel de Lucena e Vasconcellos Cruz.* First elected 2002. Term expires December 31, 2005. Aged 47. Member of the Board of Directors of DirectMedia Ásia, Lda since December 2004; Member of the Board of Directors of Portugal Telecom Ásia, Lda since July 2004; Chairman of the Board of Directors of Directel Listas Telefónicas Internacionais, Lda since May 2004; Member of the Board of Directors of PT Sistemas de Informação, S.A. since May 2004; Vice-Chairman of the Board of Directors and Chief Executive Officer of Portugal Telecom Investimentos Internacionais Consultoria Internacional S.A. and PT Ventures, SGPS, S.A. since April 2004; Member of the Board of Directors of CTM Companhia de Telecomunicações de Macau, S.A.R.L. since March 2004; Member of the Board of Directors of BEST Banco Electrónico de Serviço Total, S.A. since June 2003; Member of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since June 2003; Member of the Board of Directors of Páginas Amarelas, S.A. from March 2003 until May 2005; Chief Executive Officer of PT Comunicações, S.A. from May 2002 until January 2004; Chief Executive Officer of PT Prime, SGPS, S.A. from 2002 until January 2004; Chairman of the Board of Directors of PT Prime, SGPS, S.A. from 2002 until January 2004; Chairman of the Board of Directors of PT Contact Telemarketing e Serviços de Informação, S.A. from 2002 until January 2004; Chief Executive Officer of PTM.com, SGPS, S.A. from May 2003 until January 2004; Member of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. since May 2003; Member of the Board of Directors of Fundação Portugal Telecom since March 2003; Member of the Board of Directors of Tele Sudeste Participações, S.A. since 2003; Member of the Board of Directors of CRT Celular Participações, S.A. since 2003; Member of the Board of Directors of Tele Leste Participações, S.A. since 2003; Member of the Board of Directors of Tele Centro Oeste Celular Participações S.A. since 2003; Member of the Board of Directors of Brasilcel, N.V. since December 2002; Member of the Board of Directors of Portugal Telecom Brasil, S.A. since July 2002; Member of the Board of Directors of TMN Telecomunicações Móveis Nacionais, S.A. from June 2002 until May 2003; Member of Board of Directors of Telesp Celular Participações S.A. since April 2001; Vice-Chairman of Telesp Celular Participações S.A. since 2001; Chairman and Chief Executive Officer of Telesp Celular S.A. from May 2001 until May 2002; President and Chief Executive Officer of Tradecom, SGPS, S.A. from 2000 until 2001; Executive Board Member of PT Prime, SGPS, S.A. from 2000 until 2001; Invited Professor of Universidade Católica Portuguesa and ISCTE for Post-Graduate Courses and MBA Program from 2000 until 2001; Member of World Board of Dun & Bradstreet Corporation, Executive Vice-President of Dun & Bradstreet Corporation, President and Chief Executive Officer of D&B GMC, Executive Vice President of D&B Europe, President and Chief Executive Officer of D&B Iberia, Vice President of Trans Union España Credit Burear S/A from 1997 until 1999; Senior Vice-President of Dun & Bradstreet Corporation, Senior Vice-President of Dun & Bradstreet Europe, President and Chief Executive Officer of D&B Iberia &



Middle West, Vice-President of A.P.E.I.N. (Associação Portuguesa de Empresas de Informação de Negócio) in 1996; President & Chief Executive Officer of Dun & Bradstreet Ibéria in 1995; President and Chief Executive Officer of Dun & Bradstreet Portugal, Vice-President of Associação Portuguesa para a Qualidade from 1990 until 1993; President of "European Customer Service group" of Dun & Bradstreet in 1992; General Director of Dun & Bradstreet France in 1989; General Director of Sales of Dun & Bradstreet France in 1988; Commercial Director of Dun & Bradstreet Portugal in 1987; National Director of Sales of Dun & Bradstreet Portugal in 1986; Director of Sales Department of Dun & Bradstreet Portugal in 1985; Senior Economist of LEASEINVEST from 1983 until 1985; Economist of Finance Ministry of Portugal from 1978 until 1983.

*Iriarte José Araújo Esteves.* First elected 2000. Term expires December 31, 2005. Aged 56. Member of the Board of Directors of PT Sistemas de Informação, S.A. since 2004; Executive Vice-Chairman of the Board of Directors of PT Comunicações, S.A. since January 2004; Chairman of the Board of Directors of PT Prime Soluções Empresariais de Telecomunicações e Sistemas, S.A. since February 2004; Chairman of the Board of Directors of PT Acessos de Internet WiFi, S.A. since January 2004; Member of the Board of Directors of BEST Banco Electrónico de Serviço Total, S.A. since June 2003; Member of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since June 2003; Member of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. from May 2003 until May 2004; Member of the Board of Directors of Fundação Portugal Telecom since March 2003; Member of the Board of Directors of Tele Sudeste Participações, S.A. since 2003; Member of the Board of Directors of CRT Celular Participações, S.A. since 2003, Member of the Board of Directors of Tele Leste Participações, S.A. since 2003; Member of the Board of Directors of Tele Centro Oeste Celular Participações, S.A. since 2003; Member of the Board of Directors of Brasilcel, N.V. since December 2002; Member of the Board of Directors of Portugal Telecom Brasil, S.A. since July 2002; Member of the Board of Directors of PT Prime, SGPS, S.A. since 2002; Member of the Board of Directors of Telesp Celular Participações, S.A. since April 10, 2001; Vice-Chairman of the Board of Directors of Portugal Telecom Internacional, SGPS, S.A. from 2000 until 2002; Chief Executive Officer of PT Móveis, SGPS, S.A. since 2000; Chief Executive Officer of TMN-Telecomunicações Móveis Nacionais, S.A. since 1998; Chairman of the Board of Directors of Telepac from 1991 until 1997; Vice-Chairman of the Board of Directors of TMN Telecomunicações Móveis Nacionais, S.A. from 1991 until 1992; Member of the Board of Directors of CTT from 1989 until 1992; Director-General of Telecommunications of CTT from 1986 until 1989; Deputy General Manager of Telecommunications of CTT from 1983 until 1986; Manager of the Telecommunications Business Planning Department of CTT from 1982 until 1983; Regional Telecommunications General Manager of CTT from 1981 until 1982.

*Paulo Jorge da Costa Gonçalves Fernandes.* First elected 2000. Term expires December 31, 2005. Aged 39. Chairman of the Board of Directors of Simarc-Promoções Imobiliárias, S.A. since March 2004; Member of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since June 2003; Chief Executive Officer of PT Sistemas de Informação, S.A. since May 2003; Chief Executive Officer of PT Compras Serviços de Consultoria e Negociação, S.A. since May 2003; Member of the Board of Directors of Fundação Portugal Telecom since March 2003; Member of the Board of Directors of Tele Sudeste Participações, S.A. from January 2003 until July 2003; Member of the Board of Directors of CRT Celular Participações, S.A. from January 2003 until July 2003; Member of the Board of Directors of Tele Leste Participações, S.A. from January 2003 until July 2003; Member of the Board of Directors of Tele Centro Oeste Celular Participações, S.A. from January 2003 until July 2003; Member of the Board of Directors of Brasilcel, N.V. from December 2002 until July 2003; Vice-Chairman of the Board of Directors of PT Ventures, SGPS, S.A. since December 2002; Member of the Board of Directors of Portugal Telecom Brasil, S.A. since July 2002; Member of the Board of Directors of Telesp Celular Participações, S.A. since April 10, 2001; Chairman of the Board of Directors of PT Sistemas de Informação, S.A. since 2000; Partner of McKinsey & Company from 1997 until 2000; Member of McKinsey & Company's Leadership World

Groups for the areas of telecommunications and transportation from 1997 to 2000; Senior Advisor of McKinsey & Company from 1991 until 2000; Partner and Manager of Spades, Lda from 1990 to 1991.

The following directors are not members of the Executive Committee:

*Ernâni Rodrigues Lopes.* First elected 2003, as Chairman. Term expires December 31, 2005. Aged 63. Chairman of the Board of Directors of SESC Sociedade de Estudos Superiores de Contabilidade, S.A. since 2003; Ambassador of Portugal in Bonn from 1975 until 1979; Ambassador of Portugal in Brussels near CEE from 1979 until 1983; Minister of Finance from 1983 until 1985; Managing Partner of SaeR Sociedade de Avaliação de Empresas e Risco, Lda. since 1998; Managing Partner of Ernâni R. Lopes & Associados, Lda. since 1997; Member of the Consultive Council of Bank of Portugal from 1997 until 2003; Member of the Consultive Council of Instituto de Crédito Público from 1997 until 2003; Member of the European Convention in representation of the Portuguese Government from 2002 until 2003; Chairman of the Board of Bio 21, from 1995 until 2001; President of the General Assembly of Gestifer, SGPS, S.A. from 1997 until 2003; President of the General Assembly of Morate Sociedade de Investimentos Imobiliários, S.A. from 1989 until 2003; President of the General Assembly of Lusotur Sociedade Financeira de Turismo, S.A. from 1991 until 1998; President of the General Assembly of Inogí Inovação Imobiliária, Gestão e Investimento, S.A. since 1989; President of the General Assembly of Socifa Sociedade de Prestação de Serviços Financeiros e de Administração e Gestão, S.A. from 1988 until 1991; Member of the General Board of Telecel from 1991 until 1994; Member of the General Board of Espírito Santo Group from 1996 until 2003; Member of the Board of Directors of Espírito Santo Resources Ltd from 1990 until 2003; Vice-President of the Board of Directors of ESPART Participações Financeiras, SGPS, S.A. from 1990 until 1992; Chairman of the Board of Directors of Escopar Sociedade Gestora de Participações Sociais, S.A. from 1995 until 2003; Chairman of the Board of Directors of Espírito Santo Irmãos Sociedade Gestora de Participações Sociais, S.A. from 1994 until 2003; Chairman of the Board of Directors of Espírito Santo Property Holding (Portugal) from 1994 until 2003; Chairman of the Board of Directors of GESTRES Gestão Estratégica Espírito Santo, S.A. from 1990 until 2003; Chairman of the Board of Directors of SFIR Sociedade de Financiamento e Investimento de Risco, S.A. from 1988 until 1995; Chairman of the Board of Directors of Alcatel Portugal, Sistemas de Comunicação, S.A. from 1988 until 1995; Chairman of the Board of Directors of CPR Companhia Portuguesa de Rating, S.A. from 1969 until 2003.

*Joaquim Aníbal Brito Freixial de Goes.* First elected 2000. Term expires December 31, 2005. Aged 38. Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. since August 2002; Member of the Board of Directors of Companhia de Seguros Tranquilidade-Vida, S.A. since 2002; Member of the Board of Directors of BEST Banco Electrónico de Serviço Total, S.A. since May 2001; Member of the Board of Directors of Banco Espírito Santo, S.A. since 2000; Member of the Board of Directors of BES.COM, SGPS, S.A. since 2000; Chairman of the Board of Directors of E.S. INTERACTION, Sistemas de Informação Interactivos, S.A. since 2000; Member of the Board of Directors of E.S. Tech Ventures, SGPS, SA since 2000; Member of the Board of Directors of ESDATA, Espírito Santo Data, SGPS, S.A. since 1999; Member of the Board of Directors of CREDIFLASH, SA since 1999; Head of the Strategic Marketing Department of Banco Espírito Santo, S.A. from 1995 until 1999; Head of the Strategic Planning Department of CIMPOR Cimentos de Portugal, S.A. from 1994 until 1995; Senior Consultant of Roland Berger & Partner from 1992 until 1993; Consultant of Roland Berger & Partner from 1989 until 1992.

*Henrique Manuel Fusco Granadeiro.* First elected 2003. Term expires December 31, 2005. Aged 61. Member of the Board of Directors of OPCA Obras Públicas e Cimento Armado, S.A. since 2005; Executive Member of the Board of Directors of PT Multimédia-Serviços de Telecomunicações e Multimedia, SGPS, S.A. since September 2004; Chief Executive Officer of Lusomundo Media, SGPS, S.A. from 2002 until September 2004; Chief Executive Officer of Diário de Notícias from 2002 until

September 2004; Chief Executive Officer of Jornal de Notícias from 2002 until September 2004; Chief Executive Officer of TSF from 2002 until September 2004; Chief Executive Officer of Jornal do Fundão from 2002 until September 2004; Chief Executive Officer of Açoreana Ocidental from 2002 until September 2004; Chief Executive Officer of DN da Madeira from 2002 until September 2004; Chairman of the Board of Directors of Aleluia- Cerâmica Comercio e Indústria S.A since 2001; Member of the Board of Directors of Parfil SGPS S.A. since 2001; Member of the Strategic Council of Banco Finantia since 2001; Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. since 2001; Chairman of the Board of Directors of Margrimar Mármore e Granitos S.A since 1999; Chairman of Marmetal Mármore e Materiais de Construção S.A. since 1999; President of the Supervisory Board of Seguros e Pensões Gere, SGPS, S.A. (BCP Group) and subsidiary companies (Império-Bonança, Ocidental, Companhia Portuguesa de Seguros de Saúde, Correctorgeste, Luso Atlântico e Seguro Directo Gere) of Fortis Bank Group-Bank Millennium since 1993; Member of the Board of Directors of Fundação Eugénio de Almeida during 1992; Member of the Board of Directors of Controljornal SGPS S.A. from 1990 until 2001; Member of the Board of Directors of Sojornal Sociedade Jornalística e Editorial S.A from 1990 until 2001; Member of the Board of Directors of Marcepor-Mármore e Cerâmicas de Portugal S.A during 1990; Chairman of Fundação Eugénio de Almeida from 1989 until 1992; President of IFADAP Instituto Financeiro de Apoio ao Desenvolvimento da Agricultura e Pescas from 1987 until 1990; Delegate Chairman of Fundação Eugénio de Andrade from 1981 until 1987; Member of the Board of Directors of M.N. Tiago, Construções S.A. during 1981; Member of the Board of Directors of Standart Eléctrica during 1981; Ambassador of Portugal near O.C.D.E and Chief of the Civil House of the President of Portugal from 1976 until 1979.

*Carlos Alberto de Oliveira Cruz.* First elected 2002. Term expires December 31, 2005. Aged 64. Chairman of the Board of Directors of Caixa Brasil, SGPS, S.A. from 2001 until May 2005; Vice-Chairman of the Board of Directors of Caixa Geral de Depósitos, S.A. from 2000 until April 2004; Vice-Chairman of the Board of Directors of Caixa-Banco de Investimento, S.A. from 2000 until April 2004; Member of the Board of Directors of Unibanco Holdings, S.A. from 2000 until 2004; Member of the Board of Directors of Banco de Portugal from 1996 until 2000; Representative of Banco de Portugal at Economic Policy Committee from 1996 until 1998; Member of the Board of Directors of Imoleasing from 1989 until 1996; Member of the Board of Directors of Caixa Geral de Depósitos, S.A. from 1984 until 1989; Head of International Relations Department of Banco Pinto & Sotto Mayor, S.A. from 1982 until 1983; Member of the Board of Directors of the Portuguese Electricity Company from 1977 until 1982; Secretary of State for Economic Coordination from 1976 until 1977; Delegate to OECD Economic Policy Committee from 1973 until 1975.

*Jorge Humberto Correia Tomé.* First elected 2002. Term expires December 31, 2005. Aged 50. Chief Executive Officer of Caixa Banco de Investimentos, S.A. since 2002; Chairman of the Board of Directors of TREM II Aluguer de Material Circulante, ACE since 2002; Member of the Board of Directors of Caixa Banco de Investimentos, S.A. since 2001; Member of the Board of Directors of Caixa Gestão de Patrimónios since 2001; Member of the Board of Directors of Insurance Companies of BANIF Group: Açoreana, O Trabalho, O Trabalho Vida and Pension Fund Companies from 1996 until 2001; Partner of Coopers & Lybrand from 1995 until 1996; Manager of International Division of Banco Pinto & Sotto Mayor, S.A. in 1995; Member of the Board of Directors of Banco Pinto & Sotto Mayor, S.A. from 1994 until 1995; Member of the Board of SULPEDIP / PME Investimentos from 1989 until 1994; Junior Manager and Principal Manager of Capital Market Division of Banco Pinto & Sotto Mayor, S.A from 1983 until 1989; Senior Auditor with Coopers & Lybrand from 1980 until 1983; Junior Economist in IAPMEI (Institute for Small and Medium Companies) from 1979 until 1980.

*Fernando Maria Costa Duarte Ulrich.* First elected 1998. Term expires December 31, 2005. Aged 53. Chairman of the Board of Directors of Banco de Fomento SARL (Angola) since April 2005; Chairman of the Board of Directors of SOLO, Investimentos em Comunicação, SGPS, S.A. from 2004

until 2005; Chief Executive Officer of Banco BPI, S.A. since 2004; Chairman of the Board of Directors BPI Madeira, SGPS, Unipessoal, S.A. since 2004; Director of Petrocer, SGPS, S.A. since 2004; Member of the National Counsel of CIP (The Portuguese Industrial Confederation) since 2004; Member of the Board of Directors of Banco de Fomento SARL (Angola) from 2002 until 2005; Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. from August 2002 until September 2004; Member of the Adviser Board of CIP (The Portuguese Industrial Confederation) from 2002 until 2004; Vice-Chairman of the Executive Board of Directors of BPI, S.A. from 2002 until 2004; Member of the Board of Directors of Banco BPI Cayman, Ltd since 2002; Member of the Board of Directors of SIC from 2000 until 2003; Member of the Board of Directors of Impresa from 2000 until 2003; Member of the Board of Directors of Allianz Portugal from 1999 until 2004; Vice-Chairman of the Board of Directors of BPI-SGPS, S.A. from 1999 until 2002; Vice-Chairman of the Executive Board of Directors of BPI-SGPS, S.A. from 1999 until 2002; Chairman of the Managing Board of Investec SGPS, S.A. from March 2000 until December 2000; Vice-Chairman of the Board of Directors of Banco BPI, S.A. since 1998; Chief Executive Officer of BPI Pensões, S.A. since 1998; Vice-Chairman of the Board of Directors of Banco de Fomento SARL (Mozambique) from 1998 until 2003; Member of the Board of Directors of Inter Risco (Private Equity) since 1997; Chairman of the Board of Directors of BPI Capital Finance, Ltd since 1996; Member of the Board of APDMC since 1995; Chief Executive Officer of BPI Pensões, S.A. from 1995 until 1996; Chairman of the Board of Directors of BPI Global Investment Fund Management Company, S.A. since 1994; Chief Executive Officer of BPI Vida, S.A. since 1991; Chief Executive Officer of BPI Fundos, S.A. since 1990; Vice-Chairman of the Board of Directors of Banco Português de Investimento, S.A. since 1989; Member of the Specialized Committee for Capital Markets since 1988; Vice-Chairman of the Board of Directors of Banco de Fomento & Exterior, SA from 1996 until 1998; Vice-Chairman of the Board of Directors of Banco Borges & Irmão, SA from 1996 until 1998; Executive Director of Banco FONSECAS & Burnay from 1991 until 1996; Vice-Chairman of the Board of Directors of Banco FONSECAS & Burnay, SA from 1988 until 1996; Executive Director of BPI-Banco Português de Investimento, SA from 1985 until 1989; Deputy Manager of SPI-Sociedade Portuguesa de Investimentos from 1983 until 1985; Chief of the Cabinet of the Minister of Finance from 1981 until 1983; Member of the Secretariat for the External Economic Cooperation of the Ministry of Foreign Affairs from 1979 until 1980; Portuguese Delegation to the OECD, from 1975 until 1979; Head of the Financial Markets Unit of the weekly newspaper "Expresso" from 1973 until 1974.

*Fernando Abril-Martorell.* First elected 2001. Term expires December 31, 2005. Aged 43. Member of the Board of Directors of CINTRA since October 2004; Independent Advisor of Forestry Telecom since September 2003; Member of the Board of Directors of Telecomunicações de São Paulo Telesp since 2001; Chief Operating Officer of Telefónica S.A. from 2000 until 2003; Chief Executive Officer of Telefónica Publicidad e Información from 1999 until 2000; Chief Financial Officer of Telefónica, S.A. from 1997 until 1999; Director-General of Corporate Finance of Telefónica Publicidad e Información from 1997 until 1999; Head of Treasury Department of JP Morgan from 1987 until 1997.

*António Pedro de Carvalho Viana Baptista.* First elected 2000. Term expires December 31, 2005. Aged 47. Member of the Board of Directors of Telesp Celular Participações, S.A., Tele Leste Celular Participações, S.A., Tele Sudeste Celular Participações, S.A., Tele Centro Oeste Participações, S.A. and Celular CRT Participações, S.A. since 2003; Member of the Board of Directors of Telefónica de Argentina, S.A. since 2003, Chairman of the Board of Directors of Telefónica Móviles España, S.A. since 2003; Member of the Board of Directors of Brasilcel, N.V. since December 2002; Chief Executive Officer of Telefónica Móviles, S.A. since 2002; Member of the Board of Directors of Telesp, S.A. since 2001; Supervisory Board Director of Emergia Holding N.V. since 2000; Member of the Board of Directors of Telefónica de España, S.A. since December 2000; Member of the Board of Directors of Telefónica, S.A. since 2000; Member of Patronato of Fundación Telefónica since 1999; Member of the Board of Directors of Telefónica Datacorp, S.A.U. since 1998; Member of the Board of Directors of Telefónica Perú Holding since 1998; Member of the Board of Directors of CTC Chile since 1998;

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Member of the Board of Directors of Telefónica Internacional, S.A. since 1998; Member of the Board of Directors of BPI from 1991 until 1996; Principal partner of McKinsey & Company from 1985 until 1991 (Madrid/Lisbon office).

*Luís de Mello Champalimaud.* First elected 2004. Term expires December 31, 2005. Aged 53. Chairman of the Board of Directors of Banco Totta & Açores, S.A. and Crédito Predial Português, S.A. from January 1997 until January 2000; Chairman of the Board of Directors of Banco Totta e Sotto Mayor de Investimentos, S.A., from March 1996 until January 2000; Chairman of the Board of Directors of Banco Pinto & Sotto Mayor, S.A. from January 1995 until January 2000; Chairman of the Board of Directors of Companhia de Seguros Mundial-Confiança, S.A. from March 1993 until March 1995; Member of the Board of Directors of Companhia de Seguros Mundial-Confiança, S.A. from June 1992 until March 1993; Chief Executive Officer of Soeicom, S.A. from September 1982 until April 1992; Sales Director of Soeicom, S.A. from June 1975 until September 1982.

*Patrick Monteiro de Barros.* First elected 2002. Term expires December 31, 2005. Aged 60. Chairman of the Board of Directors of Telexpress Investments Limited since 2002; Member of the Board of Directors of Tosco Corporation from 1995 until 2001; Member of the Board of Directors of Petrogal, Petróleos de Portugal from 1995 until 2000; Member of the Board of Directors of Espírito Santo Financial Group since 1992; Member of the Board of Directors of Vodafone Portugal from 1992 until 1998; Member of the Board of Directors of Petrocontrol from 1991 until 2000; Chairman and Chief Executive Officer of Argus Resources Ltd. Since 1988; President and Chief Executive Officer of Sigmoid Resources from 1985 until 1988; Senior Vice President of Philipp Brothers from 1985 until 1988; Chairman of the Board of Directors of Protea Holdings Inc. since 1981; Member of the Board of Directors of Sociedade Nacional de Petróleos (SONAP) from 1971 until 1975; General manager Supply of Sociedade Nacional de Petróleos (SONAP) from 1967 until 1971; Chairman of Fundação Monteiro de Barros since 1966.

*Jorge Maria Bleck.* First elected 2002. Term expires December 31, 2005. Aged 50. Chairman of the General Shareholders' Meeting of Crédito Predial Português since 2000; Vice-Chairman of the General Shareholders' Meeting of Banco Santander de Negócios Portugal, S.A. since 2000; Vice-Chairman of the General Shareholders' Meeting of Banco Santander, S.A. since 1999; Member of the Board of Directors of Foggia SGPS, S.A. since 2000.

*Carlos Manuel de Almeida Blanco de Morais.* First elected 2003. Term expires December 31, 2005. Aged 47. Professor of the of Lisbon University of Law since 1997; Member of the Board of Fundação D. Pedro IV since 1995; Principal Legal Adviser of the Legal Center near the Portuguese Government since 1993.

*João Manuel de Mello Franco.* First elected 1998. Term expires December 31, 2005. Aged 58. Chairman of the Audit Committee of Portugal Telecom since January 2004; Chairman of the Board of Directors of CTT IMO since September 2004; Member of the Board of Directors of José de Mello Participações, SGPS, S.A. since 2002; Vice-Chairman of the Board of Directors of José de Mello Imobiliária since 2002; Chairman of the Board of Directors of José de Mello Residências e Serviços since 2001; Chairman of the Board of Directors of Imópolis (SGFII) since 2001; Chairman of the Board of Directors of Engimais since 2001; Member of the Board of Directors of International Shipowners Reinsurance Co since 1998; Member of our Superior Board from 1996 until 1997; Chairman of the Board of Directors of Soponata-Sociedade Portuguesa de Navios Tanques, S.A. from 1997 until 2001; CEO and Vice-Chairman of the Board of Directors of LISNAVE from 1995 until 1997; Chairman of the Board of Directors of Marconi from 1994 until 1995; Chairman of the Board of Directors of Guiné Telecom from 1994 until 1995; Chairman of the Board of Directors of Companhia Santomense de Telecomunicações from 1994 until 1995; Member of the Board of Directors of CN-Comunicações Nacionais S.A. from 1993 until 1995; Chairman of the Directorate of the Portuguese Association for the Development of Communications from 1993 until 1995; Chairman of the Board of

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Directors of TMN Telecomunicações Móveis Nacionais, S.A. from 1991 until 1994; Chairman of the Board of Directors of TLP-Telefones de Lisboa e Porto S.A. from 1989 until 1994; Director of TDC-Tecnologia das Comunicações, Lda. from 1986 until 1989.

*Gerald S. McGowan.* First elected 2003. Term expires December 31, 2005. Aged 58. Member of the Board of Directors of the Center for Innovative Technology since 2004; Member of the Board of Directors of Boston Communications Group, Inc. since 2002; United States Ambassador to Portugal from 1999 until 2001; Member of the Board of Directors of the Overseas Private Investment Corporation (OPIC) in 1996; Member of the Board of Directors of Virginia Port Authority in 2002; Member of Board of Directors of Cellular Telecommunications Industry Association from 1990 until 1998.

*Peter Eugene Golob.* First elected 2003. Term expires December 31, 2005. Aged 48. Managing Partner of Anchor Partners since April 2004; Head of the Merrill Lynch Global Communications Group for Europe from 1998 until 2001; Head of the Telecoms Media Technology Team and Investment Banking Operating Committee of Deutsche Morgan Grenfell from 1995 until 1998; Head of the Telecoms Industry Investment Banking of S.G.Warburg from 1992 until 1995.

*Nuno João Francisco Soares de Oliveira Silvério Marques.* First elected 2003. Term expires December 31, 2005. Aged 48. Member of the Audit Committee of Portugal Telecom since January 2004; Vice President of CIDOT Estúdio de Comunicação, S.A. since April 2004; Partner of CIDOT, Comunicação e Imagem, Lda. since 2002; Partner of Fundaments from 2000 until 2002; Member of the Board of Directors of Telecel, Comunicações Pessoais, S.A from 1992 until 2000; Member of the Board of Directors of Telechamada S.A from 1994 until 1995; Member of the Board of Directors of Quimigal from 1988 until 1991; Manager of Quimibro, Comércio Internacional de Metais e Mercadorias Lda. from 1980 until 1988.

*Thomaz de Mello Paes de Vasconcellos.* First elected 2003. Term expires December 31, 2005. Aged 47. Member of the Audit Committee of Portugal Telecom since January 2004; Managing Partner of TPV, Lda. since 1998; Member of the Board of Directors of Grupo Santogal from 1989 until 1998; Controller of Hubbard Group from 1988 until 1989; Senior manager and CPA of Arthur Andersen from 1980 until 1988.

### *Executive Officers*

Portugal Telecom has 16 officers who are in charge of our various business and administrative departments and report directly to the Board of Directors or who are in charge of Portugal Telecom's subsidiaries. The names, offices, principal past affiliations and certain other information for certain of our key executive officers are set forth below:

*Luís Manuel da Costa de Sousa de Macedo.* Secretary-General and Company Secretary of Portugal Telecom, SGPS, S.A. Appointed 2002. Aged 56. Member of the Board of Directors of Portugal Telecom Investimentos Internacionais Consultoria Internacional S.A. since April 2004; Member of the Board of PT Ventures, SGPS, S.A. (ex- Portugal Telecom Internacional, SGPS, S.A.) since 2000; Manager of Image and Communication Department of Portugal Telecom Group from 1999 until 2003; Member of the Board of Directors of Banco Espírito Santo do Oriente since 1996; Member of the Board of Directors of AMSCO African Management Services Company since 1996; Member of Management and Executive Board of Portuguese-Angolan Chamber of Commerce and Industry since 1996; Member of the Fiscal Board of UCCLA-União das Cidades e Capitais de Língua Portuguesa since 1996; Chairman of ELO (Associação Portuguesa para o Desenvolvimento Económico e a Cooperação) since 1996; Assistant Senior Manager of the Board of Directors of Marconi responsible for the Company's Communication Office from 1995 until 1999; Secretary of State of Portuguese Communities from 1992 until 1995; Chef de Cabinet of Minister of the "Quality of Life" from 1981

until 1982; Management Consultant, Manager of Human Resources, General Secretary and Manager of Central International Corporate Department of Marconi in 1982; Legal Advisor of CIP Confederation of Portuguese Industry and several other companies and employers' associations from 1974 until 1982.

*Francisco José Meira Silva Nunes.* Chief Accounting Officer and Manager of the Financial Reporting and Consolidation Department of Portugal Telecom. Appointed 2003. Aged 41. Member of the Board of Directors of Previsão Sociedade Gestora de Fundos de Pensões, S.A. since March 2003; Member of the Board of Directors of PT PRO, S.A. since February 2003 and Member of its Executive Committee since March 2004; Member of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. since May 2003; Partner of Audit and Business Advisory Services of Andersen from 1999 until 2002; Manager of Audit and Business Advisory Services of Andersen from 1992 until 1999.

*Carlos Manuel Mendes Fidalgo Moreira da Cruz.* Manager of the Financing and Treasury Department of Portugal Telecom. Appointed 2001. Aged 38. Managing Director of Portugal Telecom International Finance BV since 2002; Member of the Portuguese Privatization Commission from 1999 until 2001; Advisor to the Secretary of State for Treasury and Finance since 1996 until 1998; Lecturer of Financial Strategy from 1996 until 2001 at MBA Program IEP/EGP; Assistant Lecturer of Corporate Finance and Macroeconomics at Oporto University from 1987 until 1996; Assistant Lecturer of Firm Valuation from 1994 to 1997 at IESF; Analyst of the Mergers and Acquisitions Department of BPI from 1990 until 1994.

*Nuno Bernardo Ramires Leiria Fialho Prego.* Manager of the Investor Relations Department of Portugal Telecom. Appointed 2004. Aged 32. Head of Equity Research and Telecoms Analyst at BCP Investimento from 2001 until 2004; Portfolio Manager of BPI Fundos from 1999 until 2000; Deputy Director in the Research Department of Banco Finantia from 1996 until 1999.

*Miguel Augusto Chambel Rodrigues.* Manager of the Planning and Control Department of Portugal Telecom. Appointed 2004. Aged 35. Manager and Project Leader of the Strategy and Business Development Department of Portugal Telecom, SGPS, S.A. from 2000 until 2004; Member of the Board of Directors of PT Sistemas de Informação, S.A. from 2003 until 2004; Member of the Board of Directors of PT Ventures, SGPS, S.A. from 2002 until 2004; Project Leader and Consultant at Boston Consulting Group from 1998 until 2000; Analyst at McKinsey and Company from 1993 until 1996.

*António Manuel Robalo de Almeida.* Coordinator of Regulatory Affairs of Portugal Telecom. Appointed 2005. Aged 49. Manager of Regulatory Department of Portugal Telecom, SGPS, S.A. from 2002 until 2005; Manager of Economic and Regulatory Coordination of PT Comunicações, S.A. since 2000; Manager of Regulation Department of Portugal Telecom, S.A. from 1997 until 2000; Member of the Board of Main Road/Optimus during 1997; Director of New Telecommunications Business of Sonae Group from 1996 until 1997; Member of the Board of Directors of ICP Instituto das Comunicações de Portugal from 1989 until 1996; Director of Planning and Development of CTT Correios e Telecomunicações de Portugal, S.A. from 1986 until 1988; Director of Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1985 until 1986; Deputy Director of Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1984 until 1985; Head of Training Department of CTT Correios e Telecomunicações de Portugal, S.A. from 1983 until 1984; Head of Human Resources Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1982 until 1983.

*Rita de Sampaio Nunes.* Manager of the Competition Department of Portugal Telecom. Appointed 2004. Aged 41. Head of European Community Affairs of ICP-ANACOM Autoridade Nacional de Comunicações from 2003 until April 2004; Member of the Regulatory Department of Portugal Telecom, SGPS, S.A. from January 2000 until September 2003; Member of the Regulatory Department of Portugal Telecom, S.A. from October 1998 until December 1999; Seconded National Expert in the European Commission DG Enterprise and DG Information Society from

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

September 1995 until September 1998; Internal Legal Adviser of the Board of Directors of CN Comunicações Nacionais, SGPS, S.A. from April 1993 until August 1995.

*Miguel Dias Amaro.* Manager of the Internal Audit Department of Portugal Telecom. Appointed 2004. Aged 38. Assistant to the CEO of Portugal Telecom, SGPS, S.A. from 2003 to 2004; Equity Analyst (telecommunications sector) in Espírito Santo ByM (Madrid office) from November 2000 until December 2002; Assistant to the Secretary of State for Treasury and Finance from November 1999 until October 2000; Equity Analyst (Retail and Pulp and Paper sectors) in Espírito Santo Research from December 1997 until October 1999 (Lisbon office); Head of Sales for Roca Cerâmica e Comércio S.A. from 1994 until 1996; Sales Delegate for Roca Cerâmica e Comércio S.A. from 1991 until 1994.

*Abílio Cesário Lopes Martins.* Manager of the Communication Department of Portugal Telecom. Appointed 2003. Aged 33. Head of Corporate Communication of Portugal Telecom from 2002 until 2003; Media Relations Advisor for Portugal Telecom's Chief Executive Officer and Head of Corporate Communication for PT Brasil from 2000 until 2002.

*Luís Filipe Nunes Cabral Moura.* Manager of the Human Resources Department of Portugal Telecom. Appointed 2000. Aged 47. Manager of Human Resources Department of Portugal Telecom, SA from 1998 until 2000; Manager of Banking Supervision Department of Monetary Authority of Macao from 1995 until 1998; Manager of Financial and Human Resources Department of Monetary Authority of Macao from 1993 until 1995; Manager of Human Resources Division of Monetary Authority of Macao from 1991 until 1993; Manager of Macao's Government Land Department from 1990 until 1991; Manager of Macao's Government Projects Analysis Department from 1989 until 1990; Operations Research High School Assistant from 1986 until 1989; Economist of a Portuguese Group (SOTRIL) from 1985 until 1986; Economist of Azores' Planning Department from 1983 until 1985; Adviser of Energy's Secretary of State from 1983 until 1984; Manager of Plan and Production of Moore Paragon in 1983.

In addition, the names, principal past affiliations and certain other information for the Chief Executive Officers of our major subsidiaries, PT Comunicações, TMN, PT Multimédia, PT Investimentos Internacionais, S.A., Vivo, PT Sistemas de Informação S.A., PT Inovação S.A., PT PRO, S.A., PT Comprás, S.A. and PT Contact, S.A., are set forth below:

*Miguel António Igrejas Horta e Costa.* Chief Executive Officer of PT Comunicações, S.A. See " *Board of Directors and the Executive Committee*".

*Iriarte José Araújo Esteves.* Chief Executive Officer of TMN Telecomunicações Móveis Nacionais, S.A. See " *Board of Directors and the Executive Committee*".

*Zeinal Abedin Mahomed Bava.* Chief Executive Officer of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. See " *Board of Directors and the Executive Committee*".

*Carlos Manuel de Lucena e Vasconcellos Cruz.* Chief Executive Officer of PT Investimentos Internacionais, S.A. See " *Board of Directors and the Executive Committee*".

*Francisco José Azevedo Padinha.* Chief Executive Officer of Vivo. Appointed 2002. Aged 58. Chief Executive Officer of each of Tele Sudeste Celular Participações S.A., Tele Leste Celular Participações S.A., Celular CRT Participações S.A., Telerj Celular S.A., Telest Celular S.A., Telebahia Celular S.A., Telergipe Celular S.A., Celular CRT S.A., Telesp Celular S.A. and Global Telecom S.A. since April 2003; Chief Executive Officer of Telesp Celular Participações, S.A. since 2001; Chairman of the Board of Directors of Primesys Soluções Empresariais do Brasil, S.A. from 2001 until 2003; Chairman of the Board of Directors of PT Prime, SGPS, S.A. from 2000 until 2002; Chairman of the Board of Directors of Tradecom, SGPS, S.A. from 2000 until 2001; Chairman of the Board of Directors of PT Prime Tradecom Soluções Empresariais do Comércio Electrónico, S.A. from 2000 until 2001; Chairman



of the Board of Directors of Megamédia Soluções Multimedia, S.A. from 2000 until 2001; Member of the Board of Directors of PT Comunicações, S.A. from 2000 until 2001; Member of the Board of Directors of Telesp Celular Participações, S.A. from 1999 until 2003; Vice-Chairman of the Board of Directors of Portugal Telecom Internacional, SGPS, S.A from 1999 until 2002; Chairman of the Board of Directors of PT Prime Soluções Empresariais de Telecomunicações e Sistemas, S.A. from 1999 until 2001; Member of the Scientific Committee of Taguspark Parque da Ciência e Tecnologia since 1996; Manager of the central department for research and development of Companhia Portuguesa Rádio Marconi, S.A. from 1989 until 1992; Chairman of the Board of Directors of Telecom Portugal, S.A. from 1992 until 1994; Chairman of the Board of Directors of each of Cabo TV Açoreana, S.A. from 1993 until 1996; INESCTEL from 1996 until 1999; Member of the Board of Directors of Taguspark Parque da Ciência e Tecnologia from 1994 until 1998; Chairman of the Board of Directors of each of PT Inovação, S.A. and PT Sistemas de Informação, S.A from 1999 until 2000; Member of the Board of Directors of Portugal Telecom from 1994 until 2002.

*Paulo Jorge da Costa Gonçalves Fernandes.* Chief Executive Officer of PT Sistemas de Informação, S.A. and PT Compras, S.A. See "*Board of Directors and the Executive Committee.*"

*Paulo Manuel Namorado Nordeste.* Chief Executive Officer of PT Inovação, S.A. Appointed 1999. Aged 51. Infrastructure General Manager from 1998 until 1999; Deputy member of the Board of Directors of INESCTEL from 1995 until 1998; Portugal Telecom's representative in the Executive Commission of the Telecommunications Institute from 1993 until 1998; Chairman of the Shareholders General Meetings of Instituto Electrotécnico Português (IEP) from 1993 until 1998; Deputy Member of the Board of Directors of MEGASIS from 1993 until 1994; Development and Investigation Manager/CET from 1990 until 1998; National Deputy of the European Union RACE and ACTS program from 1990 until 1998; Scientific Employee at DGXIII-F of the European Union, RACE program, in Brussels from 1986 until 1990; Chief of the Traffic Engineering Division (CET) of Portugal Telecom, S.A. in Aveiro from 1976 until 1986.

*Miguel Nuno Piedade Moreira.* Chief Executive Officer of PT PRO, S.A. Appointed 2003. Age 45. Team Leader for Shared Services Initiative at Portugal Telecom, SGPS, S.A. from 2002 until 2003; Senior Manager at PricewaterhouseCoopers Lisbon from 2000 until 2002; Senior Manager at PricewaterhouseCoopers Madrid from 1997 until 2000; Manager at Coopers & Lybrand Lisbon from 1992 until 1997; Consultant at Andersen Consulting Lisbon from 1988 until 1992; Industrial Engineer at General Motors from 1983 until 1988.

Joaquim Aníbal Freixial de Goes, a non-executive member of our Board of Directors, is the son-in-law of Ernâni Rodrigues Lopes, the chairman of our Board of Directors.

For information regarding arrangements with major shareholders pursuant to which any person referred to above was selected as a member of our Board of Directors, see "*Item 7 Major Shareholders and Related Party Transactions Related Party Transactions.*"

### Compensation

In the year ended December 31, 2004, we paid aggregate compensation of €9.2 million to our directors and €3.2 million to our executive officers and to the chief executive officers of our major subsidiaries. Of the total amount of compensation paid in 2004, €3.8 million was based on performance and the ability of individual directors and executive officers to reach certain pre-defined goals that contribute to the strategic goals of the Portugal Telecom group. See "*Share Ownership and Share Option Plans*", below.

For information regarding pension, retirement or similar benefits, see "*Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Post Retirement Benefits.*"

### Board Practices

Portugal Telecom is required by its articles of association and Portuguese law to maintain a statutory audit board consisting of a chairman, two acting officers and one alternate officer. One of the acting officers and the alternate officer must be statutory auditors or statutory audit companies. Pedro João Reis de Matos Silva is chairman, Gonçalo Vaz Botelho is an acting officer and Ascensão, Gomes, Cruz & Associado, represented by Mário João de Matos Gomes, is the other acting officer and the statutory auditor of our statutory audit board. José Vieira dos Reis is the alternate officer and statutory auditor of our statutory audit board.

Portugal Telecom's Compensation Committee was initially created at its General Meeting of August 1995, with the objective of fixing the remuneration of its statutory bodies. It must be reestablished, and its members appointed, periodically by the General Meeting of Shareholders. It is currently made up of the following members: Armando Manuel Marques Guedes (Chairman), Augusto Athayde d'Albergaria and João Manuel de Mello Franco.

Portugal Telecom, as a foreign private issuer listed on the New York Stock Exchange, must be in compliance with the new audit committee standards of Rule 10A-3 of the U.S. Securities Exchange Act of 1934, as amended, which was promulgated pursuant to requirements of the U.S. Sarbanes-Oxley Act, by July 31, 2005. Although Portugal Telecom has a statutory audit board, as required by Portuguese law, it also created, in December 2003, a separately designated audit committee consisting of independent members of its board of directors in compliance with U.S. requirements. As of January 1, 2005, the members of our audit committee are: João Mello Franco (Chairman), Nuno Silvério Marques and Thomaz Paes de Vasconcellos.

We are required to disclose whether our board of directors has determined that we have an audit committee financial expert serving on our audit committee, as defined by the U.S. Securities and Exchange Commission. Our board of directors has determined that Thomaz Paes de Vasconcellos and Nuno Silvério Marques are Portugal Telecom's audit committee financial experts.

According to our audit committee charter, the audit committee must consist of three independent members of the board of directors, appointed by the board of directors. A majority of the members of the audit committee must meet at least once every two months of the year. In addition, the audit committee will meet quarterly, and separately, with the Executive Committee, the statutory audit board and the independent auditors. The audit committee may also meet, as necessary, with any of our officers, employees or consultants.

Among other things, our audit committee charter provides that:

the audit committee shall be directly responsible for the appointment, compensation, retention and oversight of the work of the outside auditors engaged to prepare or issue an audit report or to perform other audit, review or attest services (including resolution of disagreements between management and the auditor regarding financial reports);

the audit committee is required to pre-approve all audit and non-audit services;

the outside audit firm must report directly to the audit committee;

the audit committee must establish procedures for receiving, retaining and addressing complaints regarding accounting, internal accounting controls or auditing matters, as well as the confidential, anonymous submission by employees of any concerns regarding questionable accounting or auditing matters;

the audit committee has the authority to engage independent counsel and other advisers necessary to carry out its duties; and

Portugal Telecom will provide appropriate funding for the audit committee.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In addition, the audit committee monitors our compliance with all applicable laws, regulations, recommendations and guidelines issued by the SEC, NYSE, CMVM, and the Euronext Lisbon Stock Exchange and defines and implements policies necessary to ensure our compliance with these laws, regulations, recommendations and guidelines.

### Employees

We had a total of 15,105 employees in our domestic businesses on December 31, 2004, 15,222 on December 31, 2003 and 16,893 on December 31, 2002. We have not experienced material work stoppages over the last five years. Management believes that relations with labor unions and most of our employees are good.

The table below sets forth the breakdown in the total number of our employees in the years 2002 through 2004. It does not include employees seconded to other entities, but does include temporary workers with fixed-term contracts.

|                     | At December 31, |        |        |
|---------------------|-----------------|--------|--------|
|                     | 2002            | 2003   | 2004   |
| Wireline            | 11,183          | 9,075  | 8,311  |
| TMN                 | 1,192           | 1,109  | 1,133  |
| Vivo(1)             | 2,063           | 3,500  | 3,175  |
| PT Multimédia       | 2,903           | 2,588  | 2,523  |
| Other Businesses(2) | 5,768           | 8,600  | 14,340 |
| TOTAL(3)            | 23,109          | 24,872 | 29,483 |

- (1) The number of employees corresponds to 50% of the employees of Vivo in 2004 and 2003 and to 100% of the employees of TCP in 2002.
- (2) The increases in 2002 and 2003 and 2004 resulted primarily from employees working in call center operations in Brazil (Mobitel), which were outsourced externally in previous years. Mobitel had 7,991 employees at December 31, 2004, 4,768 at the end of 2003 and 2,855 at the end of 2002.
- (3) Of this total, we employed 16,893, 15,222 and 15,107, respectively, in 2002, 2003 and 2004 in our domestic businesses and 6,216, 9,650 and 14,430 respectively, in 2002, 2003 and 2004 in our international businesses.

### Work Force Reductions

The net reduction in the number of our employees since 2001 in the wireline business has resulted primarily from voluntary severance arrangements, retirement programs and suspension of employment contracts. We reduced our fixed line telephone service workforce by 651 employees in 2004. The total costs of these reductions during 2004 were approximately €170.8 million. See "Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Post Retirement Benefits".

### Share Ownership and Share Option Plans

There are no share option plans currently in place.

As of June 15, 2005, our directors and executive officers as a group beneficially owned 23,138,539 ordinary shares, representing around 1.98% of our share capital.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following table provides the number of ordinary shares held by our directors.

| Director  | As of June 15, 2005 |  |
|---|---------------------|--|
|   | Ordinary shares     | Percent of ordinary shares outstanding |
| Ernâni Rodrigues Lopes                                  |                     |  |
| Miguel António Igrejas Horta e Costa                    | 23,395              | 0.002%                                 |
| Zeinal Abedin Mahomed Bava                              | 63,061              | 0.005%                                 |
| Carlos Manuel de Lucena e Vasconcellos Cruz             | 13,649              | 0.001%                                 |
| Iriarte José de Araújo Esteves                          | 5,682               | 0.000%                                 |
| Paulo Jorge da Costa Gonçalves Fernandes                | 100                 | 0.000%                                 |
| Joaquim Aníbal Brito Freixial de Goes                   | 2,437               | 0.000%                                 |
| Henrique Manuel Fusco Granadeiro                        |                     |  |
| Carlos Alberto de Oliveira Cruz                         | 134                 | 0.000%                                 |
| Jorge Humberto Correia Tomé                             |                     |  |
| Fernando Maria da Costa Duarte Ulrich                   | 265                 | 0.000%                                 |
| Fernando Abril-Martorell                                |                     |  |
| António Viana Baptista                                  | 9,008               | 0.001%                                 |
| Luís de Mello Champalimaud                              |                     |  |
| Patrick Monteiro de Barros(1)                           | 23,000,000          | 1.972%                                 |
| Jorge Maria Bleck                                       |                     |  |
| Carlos Manuel de Almeida Blanco de Morais               |                     |  |
| João Manuel de Mello Franco(2)                          | 13,308              | 0.001%                                 |
| Gerald S. McGowan                                       |                     |  |
| Peter Eugene Golob                                      | 7,500               | 0.001%                                 |
| Nuno João Francisco Soares de Oliveira Silvério Marques |                     |  |
| Thomaz de Mello Paes de Vasconcellos                    |                     |  |

(1) Patrick Monteiro de Barros holds, through Telexpress Investments Limited, a company indirectly controlled by him, 23,000,000 ordinary shares.

(2) Joint ownership with spouse.

## ITEM 7 MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

## Major Shareholders

The following table sets forth certain information regarding the beneficial ownership of Portugal Telecom's share capital for each shareholder which owns 2% or more of Portugal Telecom's share capital.

|                                       | Amount Owned as of<br>June 15, 2005(1) | Percent<br>of Class |
|---------------------------------------|--|---------------------|
| Telefónica                            | 113,085,650 ordinary shares            | 9.7%                |
| Banco Espírito Santo Group            | 107,593,232 ordinary shares            | 9.2%                |
| Brandes Investments Partners L.P(2)   | 37,584,435 ordinary shares             | 3.2%                |
|                                       | 45,987,742 ADSs                        | 3.9%                |
| Capital Group Companies               | 63,193,870 ordinary shares             | 5.4%                |
| Caixa Geral de Depósitos Group        | 58,514,926 ordinary shares             | 5.0%                |
| Banco Português de Investimento Group | 28,741,615 ordinary shares             | 2.5%                |
| Cinveste, SGPS, S.A.                  | 28,338,141 ordinary shares             | 2.4%                |
| Fidelity Group                        | 23,592,185 ordinary shares             | 2.0%                |

(1)

In accordance with Rule 13d-3 under the Securities Exchange Act of 1934, as amended, a person is deemed a "beneficial owner" of a security if he or she has or shares the power to vote or direct the voting of such security or the power to dispose or direct the disposition of such security. A person is also deemed to be a beneficial owner of any securities which that person has the right to acquire beneficial ownership of within 60 days. More than one person may be deemed to be a beneficial owner of the same securities.

(2)

A U.S. registered investment adviser holding shares through its investment management clients.

Portugal Telecom's major shareholders do not have different voting rights than other Portugal Telecom ordinary shareholders or ADS holders.

Currently, the Portuguese government directly holds (through the Direção-Geral do Tesouro, or the Directorate General of Treasury, a department of the Ministry of Finance administered by Secretaria de Estado do Tesouro e das Finanças, the Secretary of State of Treasury and Finance) 500 of Portugal Telecom's A shares and indirectly holds (through Parpública-Participações Públicas, SGPS, S.A., a Portuguese holding company, and other public institutions) 21,276,744 of Portugal Telecom's ordinary shares. These A shares and ordinary shares together represent 1.8% of Portugal Telecom's share capital. The Directorate General of Treasury acts according to instructions from the Minister of Finance and the Minister of Social Equipment, when taking actions as a shareholder of our company.

So long as the Portuguese government holds a majority of Portugal Telecom's A shares, it will have the right, under Portugal Telecom's articles of association, to veto a number of important actions, including, among other things, the declaration of dividends in excess of 40% of distributable net income in any year and capital increases and other amendments to the articles of association. In addition, so long as the Portuguese government holds a majority of Portugal Telecom's A shares, its vote will be required to elect one third of the directors, including the chairman of the Board of Directors. See "Item 6 Directors, Senior Management and Employees Directors and Senior Management". The Portuguese government has stated that it will allow us the independence necessary for the future development of our company in a competitive market.

Under the terms of our strategic agreement with Telefónica, we may acquire up to 1.5% of Telefónica's share capital and Telefónica may increase its ownership interest in our ordinary share capital up to 10%. See "Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Telefónica". On April 22, 2004 and April 23, 2004, Telefónica acquired 37,128,112 and

5,063,480 of our shares, respectively, in the open market. As a result of these acquisitions, Telefónica increased its ownership interest in our ordinary share capital from 4.8% to 8.2%. After the April acquisitions, Telefónica acquired an additional 10,629,271 of our shares. As a result of this additional acquisition of shares and our share capital reduction on December 28, 2004, Telefónica increased its ownership interest in our ordinary share capital from 8.2% to 9.7%.

In November 2003, Capital Group announced that it had increased its holding in Portugal Telecom from 2.2% to 5.0%. As a result of our share capital reduction on December 28, 2004, Capital Group increased its holding in Portugal Telecom from 5.0% to 5.4%.

In August 2004, Fidelity Group announced that it had decreased its holding in Portugal Telecom from 2.1% to 1.9%. As a result of our share capital reduction on December 28, 2004, Fidelity Group increased its holding in Portugal Telecom from 1.9% to 2.0%.

As of June 15, 2005, approximately 26% of our issued share capital was held of record in the form of ordinary shares by approximately 150 U.S. residents. As of June 15, 2005, approximately 6% of our issued share capital was held in the form of ADSs by 124 holders of record, including the Depositary Trust Company.

### Related Party Transactions

In the ordinary course of business, we enter into transactions with numerous businesses, including companies in which we hold ownership interests, three of our major shareholders, which are financial institutions, and companies with which some of the members of our Board of Directors hold positions of significant responsibility. See Note 33 to our audited consolidated financial statements.

In June 2005, Banco Espírito Santo Group, or BES, Caixa Geral de Depósitos Group, or Caixa, and Banco Português de Investimento Group, or BPI, held, directly and indirectly, 9.2%, 5.0% and 2.5% of our issued voting ordinary shares, respectively. Joaquim Aníbal Freixial de Goes, a member of the Board of Directors of BES, is a non-executive member of our Board of Directors, and Patrick Monteiro de Barros, a member of the Board of Directors of the Espírito Santo Financial Group, which holds, directly or indirectly, 49.4% of BES, is a non-executive member of our Board of Directors. Jorge Humberto Correia Tomé, a member of the Board of Directors of a subsidiary of Caixa, is a non-executive member of our Board of Directors. Fernando Maria Costa Duarte Ulrich, CEO and a member of the Board of Directors of BPI, is a non-executive member of our Board of Directors. From time to time, BES and Caixa provide investment banking, financial advisory and insurance services to us. In April 2000, we signed a strategic partnership agreement with BES and Caixa to develop "new economy" initiatives. See "Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Banco Espírito Santo and Caixa Geral de Depósitos".

During 2004, we entered into equity swaps and options contracts with BES over PT Multimédia shares. See Note 31 to our audited consolidated financial statements and "Item 11 Quantitative and Qualitative Disclosure about Market Risk Equity Price Risk".

In June 2005, Telefónica held, directly or indirectly, 9.7% of our issued voting ordinary shares. Miguel António Igrejas Horta e Costa, the Chief Executive Officer of Portugal Telecom, is a non-executive member of the Board of Directors of Telefónica, and António Pedro de Carvalho Viana Baptista, an executive officer of Telefónica, is a non-executive member of the Board of Directors of Portugal Telecom. See "Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Telefónica".

**ITEM 8 FINANCIAL INFORMATION**

See "Item 18 Financial Statements," below.

**Legal Proceedings**

***Claims for Municipal Taxes and Fees***

Pursuant to a statute enacted on August 1, 1997, as an operator of a basic telecommunications network, we are exempt from municipal taxes and rights-of-way and other fees with respect to our network in connection with our obligations under our Concession. The Portuguese government has advised us that this statute confirms the tax exemption under our Concession. The Portuguese government has advised us it will continue to take the necessary actions in order for us to maintain the economic benefits contemplated by our Concession. At this time, we cannot be sure that the Portuguese courts will accept that this statute resolves claims for municipal assessments and taxes for the period prior to its enactment.

In 1999, the municipality of Oporto filed a lawsuit claiming the repayment of taxes and other fees in connection with Portugal Telecom's use of public rights-of-way in 1998. The Lower Tax Court of Oporto ruled in our favor on March 12, 2003, declaring the regulations of the Municipality of Oporto, under which such taxes and other fees were deemed to be owed by Portugal Telecom, to be unconstitutional. The Municipality of Oporto subsequently appealed this decision to the Administrative Central Court, and then Portugal Telecom submitted its response thereto. This appeal is pending before the Administrative Central Court.

If this claim is upheld against us, other municipalities might seek to make or renew claims against us. Portuguese law provides for a four-year statute of limitations for claims for taxes or other similar governmental charges. The statute of limitation for taxable events that occurred prior to January 1, 1998 is five years. Since the statute of limitations for such claims has expired, we do not expect that any further claims will be made against us, but we cannot be certain about this.

***Claims by a Consumer Protection Association***

A Portuguese consumer protection association, known as DECO, brought two claims against us in January 1998. These claims were brought in the Lisbon Civil Court. The claims concerned our proposal to introduce new call prices in February 1998, which were subsequently approved by the Portuguese telecommunications regulator, then known as the ICP and now ANACOM, and the DGCC, the Portuguese commerce and competition agency.

In the first of the two claims, DECO asked that we be enjoined from implementing our proposal and that ANACOM be barred from approving our proposal. DECO also asked that the court impose a fine of 1,000,000 Portuguese Escudos (approximately €5,000) per day for the period that our new call prices are in effect. In the second claim, a class action, DECO asked the court to declare the new call prices void. It also requested the court to order us to reimburse our customers all excess amounts charged to them as a result of the new call price increases from February 1, 1998, plus interest. We are unable to quantify our potential liability in any reliable way and we believe that DECO's claims are without merit. DECO has asserted that the amount claimed would equal approximately 50% of our income from our wireline telephone service during the period that the new call price increases have been in effect.

In both claims brought by DECO, the issue was the new call prices introduced by us and the introduction of a call set-up charge. DECO argued that increases to our call prices were illegal and that a call set-up charge, as opposed to a per-second charge, was a compulsory minimum charge outside the terms of the pricing convention and was therefore illegal. DECO also argued that the

increase in our call prices was an abuse of a dominant position by us and thus a breach of unfair competition law. Finally, DECO argued that the new call prices illegally doubled the line rental fee.

We opposed both claims. ANACOM also opposed the claim brought against it. We and ANACOM argued that the call prices are in line with the pricing convention and European and Portuguese laws. We argued that the opening of competition in the wireline telephone services market requires us to correct the existing imbalance between the price and the cost of wireline call prices. We also argued that the introduction of a call set-up charge does not seriously harm customers when compared with other methods of correcting the imbalance between the price and the cost of wireline call prices. Further, we showed that our other call prices, including our long distance call prices, decreased in accordance with the pricing convention. We and ANACOM argued that the call set-up charge corresponds to the original cost of the call and is the price of a call actually made, whereas the line rental fee is the price paid for access (active and passive) to the wireline telephone network. Finally, we pointed out that the prices were approved by ANACOM and the DGCC. In November 1998, the Lisbon Civil Court ruled that the claim for a fine and an injunction should be set aside until the class action claim for the declaration of nullity of the 1998 call prices and damages has been decided. In 2004, a hearing was scheduled for February 2005 in connection with the claims. However, on March 15, 2004, PT Comunicações reached a settlement with DECO. According to the terms of this settlement, PT Comunicações did not charge its customers for their national, regional and local calls on March 15, 2004 and on 13 consecutive Sundays between March 21, 2004 and June 13, 2004. PT Comunicações also agreed to reimburse any customer who makes a claim for his portion of the 1998 call set-up charges. Under the terms of the settlement, DECO agreed to withdraw both claims within 30 days of March 12, 2004. DECO waited to withdraw its claims until it received confirmation that PT Comunicações had fulfilled its part of the settlement. A request for withdrawal of both claims was finally submitted in June 2004 and was accepted and confirmed by the courts in July 2004 and September 2004, respectively.

In January 1999, DECO filed another claim in the Lisbon Civil Court. This time it sought an injunction against us and ANACOM in connection with the prospective new call prices we would introduce in 1999, to prohibit us from charging a call set-up charge. It also asked for a fine against us of €0.25 million. After we introduced our new 1999 call prices, DECO went back to the court and asked for an immediate suspension of the call set-up charge. It also requested that we be required to reimburse all consumers the amounts charged as call set-up charges. We and ANACOM opposed these claims on the same basis as DECO's previous claims.

On May 26, 1999, the Lisbon Civil Court rejected the claim for an injunction filed by DECO in January 1999. However, DECO filed an appeal to this decision, and on January 27, 2000, the Lisbon Appeals Court issued an injunction ordering us to suspend the call set-up charge. We and ANACOM lodged an appeal against the injunction with the Portuguese Supreme Judicial Court. On October 31, 2000, the Portuguese Supreme Judicial Court confirmed the injunction ordered by the Lisbon Appeals Court. We had, however, introduced new prices on January 1, 2000 that did not include a call set-up charge. Our new prices are based on charging calls by the second, although we charge for a minimum number of seconds for each call. The injunction of January 27, 2000 and the confirmation of the injunction on October 31, 2000 have no practical effect, therefore, on our price structure.

The Lisbon Civil Court, on December 3, 2001, accepted the principal action (upon which the injunction is contingent) brought by DECO in September 1999 and instructed us to return the amounts of the "connection charge" levied on customers in 1999. An appeal against this decision was filed with the Lisbon District Court on January 7, 2002.

The Lisbon District Court ruled in favor of the decision of the Lisbon Civil Court in November 2002. We appealed this ruling to the Portuguese Supreme Judicial Court in November 2002. On October 17, 2003, we were notified that the Portuguese Supreme Judicial Court had ruled to



uphold the decision of the lower courts and ordered PT Comunicações to refund the amounts of the "connection charge" levied on customers in 1999.

In an effort to discourage any private claims for repayment of the 1999 call set-up charges subsequent to the October 2003 court ruling, we reached the settlement with DECO described above, whereby we did not charge our customers for their national, regional and local calls on March 15, 2004 and on 13 consecutive Sundays between March 21, 2004 and June 13, 2004.

Although we believe that the settlement reached with DECO will prevent future legal claims by individual customers for repayment of the 1998 and 1999 call set-up charges, we cannot be certain that companies will not bring claims for compensation in the future. Consequently, we are unable to estimate the amount of any potential liability in connection with such claims because we cannot predict the number of companies who are able to bring such a claim, the number of calls in respect of which they would make such a claim, or whether they would be able to produce any necessary evidence in respect of such a claim.

### ***Regulatory Proceedings***

We are regularly involved in regulatory inquiries and investigations involving our operations. In addition, ANACOM, the European Commission and the Autoridade da Concorrência regularly make inquiries and conduct investigations concerning our compliance with applicable laws and regulations. Current inquiries and investigations include several investigations by the Autoridade da Concorrência relating to alleged (i) abuses of dominant position in the access to telecommunication ducts by PT Comunicações; (ii) predatory pricing in wireline telephone and Internet broadband services by PT Prime and PT.com, and (iii) refusal to supply media contents to cable TV competitors by PT Conteúdos and TV Cabo. We believe that the Portugal Telecom group has consistently followed a policy of compliance with all relevant laws. We continually review our commercial offers in order to reduce the risk of competition law infringement. We believe that most of the complaints that have resulted in such investigations will be dismissed due to the nature of the alleged abuses and the novelty of the relevant competition laws. However, even if we are found to be in violation of applicable laws and regulations, we do not expect the applicable penalties and fines to be disproportionate and therefore substantial. See "*Item 4 Information on the Company Regulation Portugal Regulatory Institutions*" and "*Item 3 Key Information Risk Factors Regulatory Investigations and Litigation May Lead to Fines or Other Penalties*".

On June 8, 2005, Portugal Telecom was informed through the press that Sonae.com had filed a complaint against it with the European Commission, under article 82 of the EU Treaty, alleging abuse of dominant position in the Portuguese market in connection with our provision of both cable television and fixed line services, respectively, through our subsidiaries, PT Multimédia and PT Comunicações. We have not yet been served with the complaint. EU Regulation 1/2003, referred to as the "Antitrust Enforcement Regulation", has applied directly to EU member states since May 2004, and it gives the European Commission the authority to investigate and order remedies for violations of competition law, including abuse of dominant position. Sonae.com has requested that the European Commission require us to separate our cable television and fixed line telecommunications operations a so-called "structural remedy". However, the European Commission has never before ordered a structural remedy, because the legal pre-conditions for such a remedy are very restrictive and are satisfied only when there is a substantial risk of a lasting or repeated competition violation and where there is no other remedy available that would be equally effective. We believe that steps already taken to operate our cable television business in Portugal through PT Multimédia, which is a separate legal entity that has an independent Board of Directors and independent shareholders, should satisfy the requirements of all relevant EU regulations, including European Commission Directive No. 1999/64/EC of June 23, 1999, as implemented in Portugal, which requires member states to enact legislation directing incumbent telecommunications operators to separate their cable television and fixed line

telecommunications operations into distinct legal entities. However, there can be no assurance that the European Commission will not require us to change the current ownership structure or existing operational arrangements between PT Multimédia and other companies of the Portugal Telecom Group in response to Sonae.com's complaint or subject us to other penalties, fines, damages or sanctions. Sonae.com also claims that our actions unfairly impacted prices and stifled innovation. We do not believe that Sonae.com can succeed on these points as we offer some of the lowest retail and wholesale prices in the European Union and continually introduce new and innovative offers.

Sonae.com's complaint is at the first stage of review, which will entail the European Commission determining whether there are sufficient grounds to look into the complaint further. At this stage we are not able to predict the overall time frame for resolution of this issue or what the impact could be on our results of operations. However, the European Commission guidelines require that any behavioral or structural remedies should be proportionate to the infringement committed and necessary to bring the infringement effectively to an end. See "*Item 3 Key Information Risk Factors EU Regulation Regarding Abuse of Dominant Position Could Adversely Affect our Businesses*".

Sonae.com's complaint to the European Commission also involves allegations against the Portuguese government on the grounds of illegal "state aid" in connection with its sale of the basic telecommunications network to us in 2002 and the exemption from the payment of municipal taxes granted to PT Comunicações as part of its Concession Agreement. Sonae.com is claiming that the purchase price for the basic network was below market value, thereby adversely affecting the Portuguese State. Sonae.com also claims that the absence of a public tender offer and the absence of independent valuations to set a minimum disposal price constituted "state aid". Pursuant to its Concession Agreement, PT Comunicações was exempted from the payment of municipal tax from 1995 until such exemption was revoked by law 5/2004 of February 10, 2004. This is in contrast to the situation affecting new telecommunications operators after the liberalization of the telecoms market in 2000. In order for new operators to build their infrastructure, they were required to pay municipal taxes for the use of municipal sub-soil. Sonae.com claims this discrimination against new operators represents a case of illegal "state aid" which harmed both new operators and the municipalities.

#### ***Other Legal Proceedings***

On April 23, 2001, PT Comunicações submitted a claim to the Lisbon administrative court, contesting the legality of an ANACOM administrative decision of February 21, 2001, which instructed PT Comunicações to change its billing structure for the connection of ISPs to its fixed line network from a model based on revenue sharing to one based on call origination charges and established maximum prices that PT Comunicações is permitted to charge ISPs for Internet interconnection service. PT Comunicações has claimed that ANACOM's administrative decision was issued in contravention of Portuguese and EU law. See "*Item 4 Information on the Company Regulation Portugal Interconnection*". If PT Comunicações is successful in its initial claim, it plans to request compensation for any losses suffered in connection with the implementation of its reference Internet access offer of March 1, 2001.

In April 2003, TVI Televisão Independente, S.A., or TVI, a television company, filed a claim against the Portuguese State and PT Comunicações in the Lisbon Administrative Court. In 1990, TVI and SIC, another television company, were awarded licenses for the provision of television channels pursuant to a public tender process. TVI claims that when it tendered for the television channel license, it chose not to use the publicly-owned backbone network to carry its signals but to build and operate its own network, and that it made this decision on the basis of the prices of the publicly-owned backbone network. TVI argues that when we subsequently took control over that network and became the provider of that network for carriage of television signals, we lowered the prices (on which TVI argues it based its decision) charged to SIC and RTP, the national television company, and that this violated several principles and provisions of Portuguese law. The price decreases are alleged to

have been made under the Pricing Convention entered into by us with the Portuguese State and the Portuguese telecommunications regulator in 1997, which regulated our network prices.

TVI is claiming an amount of about €64 million from the Portuguese State and PT Comunicações. TVI claims that this amount reflects the excess of the cost to it of building and operating its own network over the prices it would have paid had it chosen to use the publicly-owned backbone network, as well as loss of profit which it would have made had it used that network, which TVI argues is more extensive and more developed than its own. PT Comunicações strongly disagrees with TVI's claims. On June 20, 2003, PT Comunicações submitted its response to TVI's claim, arguing that (i) the statute of limitations on TVI's claim for compensation has run because the claim relates to events that occurred more than ten years ago, (ii) the decrease in prices charged by PT Comunicações for the use of the publicly-owned backbone network did not violate Portuguese law because it does not require that the prices charged for use of such network remain unchanged; and (iii) TVI's claim for damages and losses is neither legally nor factually sustainable. The Portuguese State has also submitted its response to TVI's claim, and we are currently waiting for the Lisbon Administrative Court to set a date for the preliminary hearing.

In September 2003, HLC Telemedia, SGPS, S.A., Horácio Luís de Brito Carvalho and HLC Engenharia e Gestão de Projectos, S.A. (collectively, "HLC") filed a law suit against PT Comunicações in the Lisbon Civil Court seeking to be compensated €15 million. HLC is arguing that PT Comunicações (i) ceased rendering fixed telephone services; (ii) ceased rendering interconnection services; and (iii) interrupted the rendering of PT Comunicações' leased line services and that these actions caused HLC to go bankrupt, injured HLC's image and resulted in Horácio Luís de Brito Carvalho becoming personally liable for certain of HLC's losses. PT Comunicações disagrees with HLC's claim and responded to it in November 2003. HLC answered this response in December 2003. The Lisbon Civil Court has determined which facts have been established in connection with this claim and which facts have yet to be established. PT Comunicações is now waiting for the court to set a date for the final hearing.

We are a party to a number of other pending legal proceedings whose outcomes, individually or in the aggregate, are not expected to have a material impact on our consolidated financial position. As at December 31, 2004, our provisions for all legal proceedings (including tax and labor matters) totaled €119.0 million.

## **Distributions to Shareholders**

### ***Dividend Information***

Portugal Telecom's policy has been to propose an annual dividend subject to its financial and economic condition, but in no event less than 40% of its distributable net income, excluding income from subsidiaries and affiliates that has not yet been distributed to Portugal Telecom. Should Portugal Telecom undertake to change this policy, the Board of Directors will submit its recommended changes to its shareholders for their approval at Portugal Telecom's Annual General Meeting. Portugal Telecom's Annual General Meeting has typically been held in April. This year, Portugal Telecom's Annual General Meeting scheduled for April 1, 2005 was suspended by the Portuguese government in its role as a holder of 500 Class A shares in order to provide additional time for consideration of certain issues on the agenda. The Annual General Meeting was rescheduled for April 29, 2005. At its Annual General Meeting on April 29, 2005, Portugal Telecom's shareholders approved a distribution of dividends, corresponding to a gross dividend of €0.35 per share or ADS.

Portugal Telecom's ordinary shares and A shares carry the same dividend rights. Portugal Telecom's Board of Directors decides whether to propose a dividend. Under Portugal Telecom's articles of association, Portugal Telecom must pay dividends of at least 40% of its annual distributable net income to shareholders, subject to the ability of a two-thirds majority of Portugal Telecom's shareholders to

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

vote to reduce the dividend or not to pay a dividend. Under Portuguese law and the articles of association, distributable net income is net income after covering accumulated losses and setting aside not less than 5% in the legal reserve, on an annual basis until this reserve represents 20% of share capital. Portuguese law also prohibits the payment of dividends if, following the dividend, a company's net worth would be less than the sum of its share capital, the legal reserve and other similar reserves established by Portuguese law or by the articles of association. The category of other similar reserves includes, among other things, the portion of the revaluation reserve related to assets not yet amortized and the reserve equivalent to the book value of treasury shares.

Dividends are payable from net income and free reserves (i.e., reserves other than the legal reserve). Portuguese law requires net income and free reserves to be applied against accumulated losses for the given financial year, and only thereafter may share issuance premium be applied against accumulated losses. This requirement was amended by Ministerial Order, dated February 19, 2003, so that companies listed on a stock exchange and under the supervision of the Portuguese Securities Commission are permitted to apply share issuance premium against accumulated losses after applying net income but before applying free reserves.

The following table presents dividends paid per ordinary share and A share for the years ended December 31, 2000, 2001, 2002, 2003 and 2004. U.S. dollar amounts have been calculated using the exchange rate in effect on the date on which each dividend was paid.

The ADS depositary converts Euros into U.S. dollars and pays the net proceeds to ADS holders.

| Fiscal Year | Number of shares considered | Dividends per share |      |      |
|-------------|-----------------------------|---------------------|------|------|
|             |                             | Payment Date        | €    | US\$ |
| 2000(1)     | 1,201,750,000               |                     |      |      |
| 2001        | 1,254,285,000               | May 23, 2002        | 0.10 | 0.09 |
| 2002        | 1,254,285,000               | May 2, 2003         | 0.16 | 0.18 |
| 2003        | 1,254,285,000               | April 30, 2004      | 0.22 | 0.26 |
| 2004        | 1,166,485,050               | May 2, 2005         | 0.35 | 0.43 |

(1) For the year ended December 31, 2000, no dividends were paid.

The general rate of withholding income tax on dividends in Portugal is currently 15% for Portuguese residents and 25% for non-residents. However, as a result of our privatization, under the Portuguese Statute of Tax Incentives, the withholding income tax in respect of dividends that we pay in 2005 will be reduced to 7.5% for Portuguese residents and 12.5% for non-residents. See "Item 10 Additional Information Taxation Dividends".

### Significant Changes

On February 28, 2005, PT Multimédia announced the disposal of its 100% interest in Lusomundo Serviços, SGPS, S.A., including an 80.91% shareholding in Lusomundo Media, through the execution of a promissory sale and purchase agreement with Controlinveste, SGPS, S.A. The Portuguese Media Authority (Alta Autoridade para a Comunicação Social) has issued a binding opinion in favor of the transaction, which now remains subject to the approval of the Portuguese Competition Authority (Autoridade da Concorrência). We can make no assurance that such approval will be granted and the other conditions to the sale will be satisfied. The parties to the transaction agreed upon an enterprise value of €300.4 million for 100% of Lusomundo Serviços, SGPS, S.A. and 100% of all of its subsidiaries. In order to simplify the acquisition, prior to closing, PT Multimédia will acquire the 5.94% stake in Lusomundo Media held by Portugal Telecom. Portugal Telecom acquired this stake from Fidelity Investments on October 16, 2003 for €9 million. The proceeds for PT Multimédia from the sale

will be equivalent to €173.8 million, of which €10.1 million will be paid to Portugal Telecom in connection with the acquisition of its 5.94% interest in Lusomundo Media.

On March 24, 2005, we issued €1 billion in notes under our global medium term note program at a fixed interest rate of 3.750% per annum, maturing in 2012. On the same day, we issued €500 million in notes under the program at a fixed interest rate of 4.375% per annum, maturing in 2017. On June 16, 2005, we issued €500 million in notes under the program at a fixed interest rate of 4.500% per annum, maturing in 2025.

On April 29, 2005, Portugal Telecom's shareholders approved at the AGM a reduction of Portugal Telecom's share capital in the nominal amount of up to €16,648,505 through the cancellation of up to 116,648,505 treasury shares, representing 10% of Portugal Telecom's share capital, and the corresponding amendment to its articles of association. This share capital reduction is being carried out pursuant to a further share repurchase program announced in September 2004, which expected to be completed by the end of December 2005. The corresponding amendment to the articles of association is expected to occur in December 2005.

Pursuant to our share buyback program, as of June 30, 2005, Portugal Telecom had repurchased, through over-the-counter transactions, a total of 37,628,550 treasury shares, or 3.23% of its share capital, at an average price of €8.57 per share. These transactions were executed in connection with the exercise of the physical settlement option provided for under the terms of the equity swap contracts entered into with ABN AMRO Bank, N.V. and CitiGroup Global Markets Limited on May 9, 2005.

## ITEM 9 THE OFFER AND LISTING

## Price History of the Company's Stock

The table below sets forth the reported high and low quoted closing prices for our ordinary shares on the Euronext Lisbon Stock Exchange and the high and low sales closing prices for our ADSs on the New York Stock Exchange for the years ended December 31, 2000, 2001 and 2002 and for each quarter of 2003 and 2004. Our ordinary shares are quoted in Euros. Our ADSs are quoted in U.S. dollars.

| Calendar Period | Euronext<br>Lisbon Stock<br>Exchange<br>Closing Price<br>Per Ordinary<br>Share |      | NYSE<br>Closing Price<br>Per ADS |       |
|-----------------|--|------|----------------------------------|-------|
|                 | High   | Low  | High                             | Low   |
|                 | €  |      | US\$                             |       |
| 2000            | 16.83  | 8.82 | 16.13                            | 7.35  |
| 2001            | 11.76  | 6.31 | 11.15                            | 6.14  |
| 2002            | 9.40   | 4.55 | 8.44                             | 4.62  |
| 2003            |  |      |                                  |       |
| First quarter   | 7.26   | 5.56 | 7.75                             | 6.06  |
| Second quarter  | 7.04   | 6.22 | 7.81                             | 6.81  |
| Third quarter   | 6.90   | 5.90 | 7.93                             | 6.65  |
| Fourth quarter  | 8.00   | 6.93 | 10.02                            | 8.11  |
| 2004            |  |      |                                  |       |
| First quarter   | 9.42   | 7.98 | 11.78                            | 10.02 |
| Second quarter  | 9.28   | 8.20 | 11.66                            | 9.76  |
| Third quarter   | 8.94   | 8.13 | 11.00                            | 9.98  |
| Fourth quarter  | 9.27   | 8.78 | 12.37                            | 11.19 |

The table below sets forth the reported high and low quoted closing prices for the ordinary shares on the Euronext Lisbon Stock Exchange and the high and low sales closing prices for the ADSs on the New York Stock Exchange for the most recent six months.

| Calendar Period   | Euronext<br>Lisbon Stock<br>Exchange<br>Closing Price<br>Per Ordinary<br>Share |      | NYSE<br>Closing Price<br>Per ADS |       |
|-------------------|--|------|----------------------------------|-------|
|                   | High   | Low  | High                             | Low   |
|                   | €  |      | US\$                             |       |
| December 31, 2004 | 9.25   | 8.78 | 12.37                            | 11.77 |
| January 31, 2005  | 9.50   | 9.03 | 12.38                            | 11.80 |
| February 28, 2005 | 9.73   | 9.17 | 12.51                            | 12.15 |
| March 31, 2005    | 9.28   | 8.90 | 12.28                            | 11.57 |
| April 30, 2005    | 9.23   | 8.50 | 11.93                            | 11.03 |
| May 31, 2005      | 9.05   | 8.30 | 11.41                            | 10.33 |

On June 15, 2005 the closing price of the ordinary shares on the Euronext Lisbon Stock Exchange was €8.00 per ordinary share. On June 15, 2005, the last reported sale price of the ADSs on the New York Stock Exchange was US\$9.75 per ADS.

## Markets

Portugal Telecom's ordinary shares are listed on the Eurolist by Euronext of the Euronext Lisbon Stock Exchange.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In the United States, the ordinary shares trade on the New York Stock Exchange under the symbol "PT" in the form of ADSs, each representing one ordinary share.

**ITEM 10 ADDITIONAL INFORMATION**

**Memorandum and Articles of Association**

***Organization, Register and Entry Number***

Portugal Telecom, SGPS, S.A., is a limited liability holding company organized under the laws of the Republic of Portugal. Portugal Telecom is registered in the Portuguese commercial registry under the entry number 3602.

***Object and Purpose***

Portugal Telecom's object and purpose, which is described in article three of its articles of association, is that of a holding company. Portugal Telecom manages ownership interests in operating companies. Portugal Telecom may, without restriction, acquire or hold quotas or shares in any company, as defined under Portuguese law, hold participations in European economic interest groupings of companies and form or participate in any temporary or permanent association with public or private companies.

***Certain Provisions with Respect to Board Members***

Agreements between Portugal Telecom and its directors must be authorized by a resolution of the board of directors and the statutory audit board. Portugal Telecom's directors are not permitted to vote on resolutions relating to agreements in which they are materially interested or with respect to which they have a conflict of interest. Portugal Telecom's directors do not have the power to vote compensation to themselves in the absence of an independent quorum. Portugal Telecom's directors may not receive loans from Portugal Telecom, except that directors may receive one month of compensation in advance. There are no age-limit requirements for the retirement of board members. No minimum shareholding is required for qualification as a member of the board.

***Dividends on the Ordinary Shares and the A Shares***

Ordinary shares and A shares each carry the same right to receive dividends. The holder of record of ordinary shares or A shares on the date of payment of any dividend is entitled to receive that dividend. The settlement of a trade, and the transfer of record ownership, of shares traded on the Euronext Lisbon Stock Exchange takes place on the third business day after the trade. As a result, any person making a trade for the purchase of ordinary shares during the three-day period prior to the record date for a dividend payment will not be entitled to receive such dividend.

The board of directors has sole discretion over the proposal of dividends. Under the articles of association, Portugal Telecom must pay dividends of at least 40% of its annual distributable net income to shareholders, subject to the ability of a two-thirds majority of its shareholders to decide to reduce the dividend or not pay a dividend.

Under Portuguese law and the articles of association, distributable net income is net income after covering accumulated losses and setting aside 5% in the legal reserve, until this reserve represents 20% of share capital. As of December 31, 2004, Portugal Telecom's legal reserve was equal to approximately 13.2% of share capital. As a result, deductions for the legal reserve will continue to be made for the foreseeable future. Although other reserves established under a company's articles of association are generally deducted from that company's distributable net income, our articles of association do not provide for any other reserves. Such reserves, however, could be established by amendment of the articles of association by a two-thirds majority of the votes cast at a shareholders' meeting.

Dividends are payable from net income and free reserves (i.e., reserves other than the legal reserve). Portuguese law requires net income and free reserves to be applied against accumulated losses



for the given financial year, and only thereafter may share issuance premium be applied against accumulated losses. This requirement was amended by Ministerial Order, dated February 19, 2003, so that companies listed on a stock exchange and under the supervision of the Portuguese Securities Commission are permitted to apply share issuance premium against accumulated losses after applying net income but before applying free reserves.

Portuguese law also prohibits the payment of dividends when a company's net worth is less than the sum of its share capital, the legal reserve and other similar reserves established by Portuguese law or by the articles of association of the company. The payment of a dividend would also be illegal under Portuguese law if, following the payment, the company's net worth would become smaller than such sum. The category of other similar reserves includes, among other things, the portion of the revaluation reserve related to assets not yet amortized and the reserve equivalent to the book value of treasury shares.

Any dividend in excess of 40% of Portugal Telecom's distributable net income in any year may be vetoed by a majority of the holders of the A shares, voting as a class. Each dividend must also be approved by a majority of the votes cast at a shareholders' meeting. At a shareholders' meeting, the shareholders may also authorize a dividend in excess of the amount proposed by the board of directors. A proposed dividend may also be reduced or canceled by a two-thirds majority of the votes cast at a shareholders' meeting. The board of directors, subject to certain conditions, including the consent of Portugal Telecom's statutory audit board and the certification of an independent auditor, may also authorize the payment of interim dividends.

#### ***Voting Rights of the Ordinary Shares and the A Shares***

Shareholders are entitled to one vote per the number of shares held whose nominal value equals €500. Except for the special voting powers of the A shares described below, matters are decided at a shareholders' meeting by a simple majority of votes. However, resolutions for the amendment of the articles of association, reorganization, dissolution or merger of Portugal Telecom and certain other matters mandated by Portuguese law, require the approval of two-thirds of votes cast at a shareholders meeting. A quorum of not less than one-third of the share capital entitled to vote must be present. If the quorum requirement is not met at the first meeting, then matters may be approved on a later day at a second call of such meeting by (i) a two-thirds majority of the votes cast at the meeting or (ii) a simple majority of the votes cast if at least one half of the share capital is represented.

The board of directors currently consists of twenty two directors. The directors are elected by a majority of the votes cast at the annual shareholders' meeting. In addition, a majority of the votes cast by holders of A shares is required to elect one third of the directors, including the chairman of the board. Of the directors elected by holders of A shares, at least one or two must be appointed to the executive committee (depending on whether the executive committee is composed of five or seven directors). Moreover, a minority of shareholders representing at least 10% of share capital has the right to elect a director to substitute for the director previously elected by the fewest number of votes. Members of the board of directors are elected for a three-year period and may be re-elected on one or more occasions.

Under the Portuguese Companies Code, a company may not vote its treasury stock. Treasury stock will not be counted towards a quorum or for purposes of determining a majority of votes cast. The purchase by Portugal Telecom of its own shares must be approved by its shareholders in accordance with the articles of association. Under Portuguese law, a Portuguese company may not, except under certain limited circumstances, purchase more than 10% of its nominal share capital as treasury stock.

Under Portuguese law and the articles of association, the voting rights exercised by a single shareholder, except those of the Portuguese government and certain entities owned by the Portuguese government, are limited to a maximum of 10% of Portugal Telecom's share capital. As a result, no

single shareholder other than the Portuguese government can exercise voting rights, in his own name or on behalf of other shareholders, representing more than 10% of Portugal Telecom's share capital. Holders of ADSs are treated as holders of the ordinary shares represented by the ADSs for purposes of determining the applicability of the 10% limitation on voting rights. Voting instructions of an individual ADS holder will not be accepted by Portugal Telecom as votes of the ordinary shares to the extent that such votes, together with any votes cast by such ADS holder as holder of ordinary shares, exceed 10% of the voting power of Portugal Telecom.

***Special Approval Rights of the A Shares***

The majority of Portugal Telecom's A shares must be held by either the Portuguese government or by an entity majority-owned and controlled by the Portuguese government. Under the articles of association, the holders of Portugal Telecom's A shares, based on a majority voting as a class, may veto a number of actions of the shareholders of Portugal Telecom, including the following:

election of one third of the directors, including the chairman of the board of directors;

authorization of a dividend in excess of 40% of Portugal Telecom's distributable net income in any year;

capital increases and other amendments to the articles of association;

issuance of bonds and other securities;

authorization of a shareholder that is performing an activity that is in competition with Portugal Telecom to hold more than 10% of ordinary shares;

altering Portugal Telecom's general objectives, strategy or policies; and

defining Portugal Telecom's investment policies, including the authorization of acquisitions and dispositions.

***Pre-emptive Rights***

Upon the issuance of additional ordinary shares by Portugal Telecom for cash, all holders of ordinary shares and A shares have a right to subscribe proportionately for such shares. Upon the issuance of additional A shares by Portugal Telecom, holders of A shares have a right to subscribe proportionately for such shares, and to the extent that all such shares are not sold, holders of ordinary shares may subscribe proportionately for the remainder of the shares. The pre-emptive rights of shareholders to subscribe for shares are freely transferable.

***Liquidation Rights***

The ordinary shares and A shares have pro rata rights to share in Portugal Telecom's assets upon its liquidation.

***Changes in Rights of Shareholders***

The rights of holders of Portugal Telecom shares may only be changed by a shareholder resolution amending the articles of association. Resolutions for the amendment of the articles of association require the approval of two-thirds of votes cast at a shareholders' meeting. A quorum of not less than one-third of the share capital entitled to vote must be present. If the quorum requirement is not met at the initial meeting, then such matters may be approved at a later date at a second call of such meeting by a two-thirds majority of the votes cast at the meeting or a simple majority of the votes cast if at least one half of the share capital is represented.

### ***Shareholders' Meetings***

Shareholders' meetings may be held at Portugal Telecom's principal office or at another location in Lisbon. Shareholders' meetings are called by publication of a notice in the *Diário da República*, the Portuguese official gazette, and in a Lisbon newspaper. An annual shareholders' meeting must be held before the end of May and must be convened on not less than one month's notice. At the annual shareholders' meeting, the annual accounts, including a report on our activities during the previous year and any proposal for the payment of dividends, are presented to the shareholders for approval. Meetings may also be called upon the request of the board of directors, the statutory audit board or shareholders holding at least 5% of share capital.

To attend a shareholders' meeting in person or by proxy or to vote by courier, shareholders must demonstrate that the ordinary shares they hold are registered in a securities account for ordinary shares at least 15 days in advance. Shareholders may appoint proxies in writing. No shareholder may be represented by more than one representative. Each shareholders' meeting is presided over by a chairman appointed by the shareholders.

### ***Transfer of Ordinary Shares, Limitations on Shareholdings***

There are no restrictions on the transferability of the ordinary shares, other than certain limitations on ownership. Under the Portuguese Securities Code, any person making a purchase or sale of shares that results in that person either owning or no longer owning at least 2%, 5%, 10%, 20%,  $\frac{1}{3}$ ,  $\frac{1}{2}$ ,  $\frac{2}{3}$  or 90% of Portugal Telecom's voting rights must notify Portugal Telecom, the managing entity of the Euronext Lisbon Stock Exchange and the Comissão do Mercado de Valores Mobiliários, or CMVM, the Portuguese Securities Market Commission, within three calendar days.

Both the articles of association and Portuguese law contain limitations on ownership. They also contain enforcement mechanisms designed to prevent an unauthorized change in control of Portugal Telecom. The articles of association provide that no shareholder performing, directly or indirectly, an activity which competes with any of Portugal Telecom's activities may hold or control ordinary shares representing in the aggregate more than 10% of Portugal Telecom's share capital, without the authorization of a shareholders meeting. An entity will be deemed to be performing an activity which competes with our activities if they, a company of which they own at least 10% of the share capital or a company that owns at least 10% of the share capital of them, (i) offers, in or outside of Portugal, "public use telecommunications services" (except "audiotext services") or "network services," as such terms are defined under Portuguese law or (ii) engages in any other activity of the same type and nature as that being performed by entities in which Portugal Telecom holds more than 50% of the share capital or voting power or has the power to appoint more than 50% of the governing body. The Bank of New York, as depositary, or its nominee, are excepted from this requirement.

If any such shareholder holds or controls ordinary shares in excess of 10% of Portugal Telecom's share capital, the shareholders may decide at a shareholders' meeting to require the cancellation of the ordinary shares held in excess of such 10% limit. In such case, Portugal Telecom must compensate the shareholder for the lesser of the nominal value of the canceled ordinary shares or their market value. However, within five days of receipt of notice of such a decision by the shareholders' meeting, a shareholder may request the permission of the board to reduce the number of ordinary shares held to 10% or less of Portugal Telecom's share capital by sale or other disposition of the excess ordinary shares within 30 days. By making such request, such shareholder must renounce, pending the conclusion of such sale or disposition, all voting and pre-emptive subscription rights connected to the excess ordinary shares.

Holders of ADSs will be treated as holders of the ordinary shares represented by the ADSs under these provisions.

In addition, according to Decree-Law 380/93, of November 15, 1993, no person may acquire ordinary shares representing more than 10% of Portugal Telecom's voting capital without prior authorization from the Ministry of Finance. Under such Decree-Law, if a person attempts to acquire more than 10% of Portugal Telecom's shares without such authorization, no additional ordinary shares may be registered in the name of such person by Portugal Telecom, the CMVM or any Portuguese financial intermediary. Holders of ADSs will be treated as holders of the ordinary shares represented by the ADSs under these provisions. However, a judgment of the EU Court of Justice (Case C-367/98) determined that the Portuguese state, by maintaining such Decree-Law in force, has failed to comply with the EC Treaty's prohibitions on restrictions on the movement of capital in the EU. This restriction has been removed following the revocation of Decree-Law 380/93 by Decree-Law 49/2004 of March 10, 2004

There are no restrictions under Portuguese law with regard to the percentage of shares that a non-Portuguese resident may own in Portugal Telecom.

#### ***Change of Control Provisions***

There are no provisions of the articles of association that would have the effect of delaying, deferring or preventing an authorized change in control of Portugal Telecom and that would operate only with respect to a merger, acquisition or corporate restructuring involving Portugal Telecom or any of its subsidiaries. However, as long as the Portuguese government holds a majority of Portugal Telecom's A shares, it will have the right, under the articles of association, to veto any actions concerning Portugal Telecom's investment policies, including the authorizations of acquisitions and dispositions. In addition, under Portuguese law and the articles of association, the voting rights exercised by a single shareholder, except the Portuguese government and certain entities owned by the Portuguese government, are limited to a maximum of 10% of Portugal Telecom's share capital. As a result, no single shareholder other than the Portuguese government can exercise voting rights, in his own name or on behalf of other shareholders, representing more than 10% of Portugal Telecom's share capital. Both the articles of association and Portuguese law contain limitations on ownership. They also contain enforcement mechanisms designed to prevent an unauthorized change in control of Portugal Telecom. The articles of association provide that no shareholder performing, directly or indirectly, an activity which competes with any of Portugal Telecom's activities may hold or control ordinary shares representing in the aggregate more than 10% of Portugal Telecom's share capital, without the authorization of a shareholders' meeting.

#### ***Disclosure of Shareholdings***

The articles of association do not require shareholders to disclose their shareholdings.

#### ***Changes in Capital***

With the approval of the statutory audit board, the board of directors may increase the share capital of Portugal Telecom on one or more occasions, up to a maximum of €360,000,000. Certain terms of the share capital increase, such as the maximum amount of the share capital increase, the class of shares to be issued and whether any limitations will be imposed on the subscription rights of shareholders, must be approved by the shareholders at a general meeting. The Portuguese Government, as a holder of a majority of our A shares, may veto capital increases.

### **Corporate Governance**

#### ***Portuguese Legal Framework***

The principal source of corporate governance standards in Portugal is the Portuguese Companies Code, which was enacted in 1987 and codified European Union directives on commercial law. The

Portuguese Securities Code and related legislation strengthen the corporate governance precepts contained in the Companies Code, by requiring immediate disclosure of all material information and that companies publish qualified shareholdings and certain periodic information, including financial statements; by establishing a general duty to inform; and by criminalizing insider trading and abuse and market manipulation.

In response to the heightened focus world-wide on corporate governance in recent years, the Comissão do Mercado de Valores Mobiliários, or CMVM, the Portuguese Securities Market Commission, amended its "Recommendations on Corporate Governance" and the complementary "Basic Text on Corporate Governance", or Regulation 7/2001, in November 2003. The Recommendations govern matters involving shareholder powers, rights and meetings, boards of directors and senior management, committees, board independence, internal control systems and disclosure. The full text of the CMVM's "Recommendations on Corporate Governance", including an English version thereof, is available at [www.cmvm.pt](http://www.cmvm.pt).

The Portuguese Companies Code is legally binding on any company listed on the Lisbon Stock Exchange. The Companies Code establishes corporate governance standards in respect of the following:

Shareholder pre-emptive rights, which are intended to protect shareholders and holders of securities convertible into shares against a decrease in equity value;

Share capital formation and capital increases, including the mandatory verification by independent auditors of non-cash inflows, such as fixed assets;

Dividends, which are subject to mandatory minimum distributions of 50%, except in limited circumstances;

Shareholders' meetings, including minimum notice requirements, minority rights and requirements that shareholders elect the chairman of the meeting and an autonomous body empowered to convene and conduct the meetings;

Annual reports of management to the shareholders' meeting;

Shareholder access to information, including the right to put questions to management and request information in general meetings and minority rights to request information regarding a company's performance;

Shareholder rights to request the judicial nullification of decisions made at a shareholders' meeting and to request prospectively the suspension of a scheduled shareholders' meeting;

Board structure, both two-tiered boards, with a management board and a supervisory or non-management board, and single-tiered boards, with one administrative body, are permissible under Portuguese law. Single-tiered boards distinguish between supervisory and management functions with the creation of an Executive Committee;

Appointment and remuneration of Board Members, which is a function of shareholders, including minority shareholders;

Audit function, which is conducted by a statutory audit board that is elected by shareholders and is entitled to participate in board meetings;

Conflict of interest, which is strictly regulated and includes a requirement that board members make their share transactions and significant shareholdings public and that they recuse themselves from participating and voting in any matters in which they have a personal interest; and

Fiduciary duty of board members to shareholders and the company.



***Summary of Significant Differences between Portuguese Corporate Governance Practices and the New York Stock Exchange's, or NYSE, Corporate Governance Standards***

The following paragraphs provide a brief, general summary of significant differences between the corporate governance practices followed by Portuguese companies, such as Portugal Telecom, and those required of domestic companies under NYSE listing standards.

***Composition of Board of Directors; Independence; Conflicts of Interest; Meetings of Non-Management Directors.*** The NYSE listing standards provide that the Board of Directors of a U.S. listed company must consist of a majority of independent directors and that certain committees must consist solely of independent directors. A director qualifies as independent only if the board affirmatively determines that the director has no material relationship with the company, either directly or indirectly. In addition, the listing standards enumerate a number of relationships that preclude independence. The listing standards do not specifically deal with the avoidance of conflicts of interest and related-party transactions. These matters are typically governed by the laws of the state in which the listed company is incorporated.

Portuguese law does not explicitly require that the members of management or board of directors of a Portuguese company be independent, but it does establish a number of principles of independence for board members which, in case of non-compliance, shall be disclosed. These principles are designed to strengthen independence, to avoid conflicts of interest and to establish procedures and standards for related-party transactions.

In Portugal Telecom's case, the function of the Chairman of its Board of Directors is independent from the function of its Chief Executive Officer. See "*Item 6 Directors, Senior Management and Employees*".

The NYSE listing standards provide that the non-management directors of each U.S. listed company must meet at regularly scheduled executive sessions without management in order to empower them to serve as a more effective check on management. There is no similar requirement or recommendation under Portuguese law.

***Committees.*** The NYSE listing standards require that a U.S. listed company must have a nominating/corporate governance committee and a compensation committee, and that all listed companies, including non-U.S. listed companies, must have an audit committee that satisfies the requirements of the U.S. Securities Exchange Act of 1934, or the Exchange Act. U.S. listed companies must have an audit committee that fulfills additional, NYSE-imposed requirements. The NYSE listing standards require each of these committees to consist solely of independent directors and to have a written charter that addresses certain matters specified in the listing standards.

Portuguese law does not require us to create any committees. However, the CMVM recommends that companies form committees at the supervisory board level to evaluate corporate governance structures and practices.

The NYSE listing standards contain detailed requirements for the audit committees of U.S. listed companies. Starting on July 31, 2005, the Exchange Act requirements regarding audit committees will apply to non-U.S. listed companies, such as Portugal Telecom.

Portugal Telecom established an Audit Committee in December 2003, consisting of independent members of its Board of Directors. The Audit Committee's primary function is to advise the Board of Directors and the Executive Committee with respect to (i) financial reporting quality and integrity, (ii) external auditor independence and capability and (iii) internal control system quality, integrity and efficiency and to supervise the external auditors and the performance of the statutory auditors.

The Audit Committee also monitors our compliance with legal provisions, regulations, recommendations and guidelines issued by the SEC, NYSE, CMVM, and the Euronext Lisbon Stock

Exchange and defines and implements policies to ensure our compliance with these laws, regulations, recommendations and guidelines.

Portugal Telecom created a corporate governance committee in July 2004. This committee is responsible for advising the Board of Directors on rules of conduct and corporate governance practices, including advising the Board as to its relationships with management, shareholders and the market in order to prevent conflicts of interest and ensure the flow of information.

**Disclosure.** The NYSE listing standards require U.S. listed companies to adopt, and post on their websites, a set of corporate governance guidelines. The guidelines must address: director qualification standards, director responsibilities, director access to management and, as necessary and appropriate, independent advisors, director compensation, director orientation and continuing education, management succession, and an annual performance evaluation of the Board of Directors. In addition, the CEO of a U.S. listed company must certify to the NYSE annually that he or she is not aware of any violations by the company of the NYSE's corporate governance listing standards. The certification must be disclosed in the company's annual report to shareholders.

Under Portuguese law, the executive management and board of directors are required to disclose either that they are in compliance with the recommendations set forth by the CMVM or which recommendations they have not followed and provide reasons therefore. This disclosure is located in our Corporate Governance Report, which is attached as an appendix to our Portuguese annual report.

**Code of Business Conduct and Ethics.** The NYSE listing standards require each U.S. listed company to adopt, and post on its website, a code of business conduct and ethics for its directors, officers and employees and promptly disclose any waivers of the code for directors or executive officers. There is no similar requirement or recommendation under Portuguese law. However, under the Exchange Act rules and regulations, all foreign private issuers, such as Portugal Telecom, must disclose in their annual reports on Form 20-F whether they have adopted a code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions or, if they have not adopted such a code, why they have not done so. In addition, they must either file a copy of the code with the U.S. Securities Exchange Commission as an exhibit to their annual reports; post the text of the code on their websites and disclose in their annual reports their Internet addresses and the fact that they have posted such a code on their websites; or undertake in their annual reports to provide a copy upon request to any person without charge. There is significant, though not complete, overlap between the code of ethics required by the NYSE listing standards and the code of ethics required by the Exchange Act rules.

Portugal Telecom has a code of ethics that complies with Exchange Act requirements and approved a separate code of ethics for financial officers in December 2004. See "*Item 16B Code of Ethics*".

**Shareholder Approval of Equity Compensation Plans.** The NYSE listing standards provide that shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions for employment inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and qualified plans, parallel excess plans and Section 423 of the U.S. Internal Revenue Code plans. Portuguese law also establishes that equity compensation plans shall be approved by shareholders. The CMVM recommends that the proposal submitted to the shareholders' meeting concerning the approval of schemes for allotment of shares and/or regarding options for the acquisition of shares for members of the administrative body and/or employees must include all details necessary for a correct evaluation of the scheme. The full text of the scheme, if available, must be attached to the proposal.

A summary of the significant differences between Portuguese corporate governance practices and the NYSE's corporate governance standards is also available on our website at [www.telecom.pt](http://www.telecom.pt).



### Material Contracts

On December 30, 2002, a new pricing convention for the fixed telephone service (Universal Service Convention) for 2002 and 2003 was agreed with ANACOM and the Directorate General for Competition (DGCC). The convention established price caps of CPI-3% and CPI-2.75% for 2002 and 2003, respectively, excluding international calls. Tariffs in 2002 were not updated, but inflation of 3.6% in 2002 means that Portugal Telecom has complied with its 2002 price cap obligations. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

On January 16, 2003, Vivo, through its subsidiary TCP, entered into an agreement with the Brazilian company Fixcel to acquire Tele Centro Oeste Participações, S.A., or TCO, the leading mobile operator in the Midwestern and Northern regions of Brazil, with approximately 3 million customers. On April 25, 2003 TCP completed the acquisition of a controlling interest in TCO (61.1% of common shares). The price of the controlling shares was R\$1,506 million, corresponding to R\$19.49 per 1,000 common shares acquired. On November 18, 2003, TCP acquired an additional 72.2% of the common shares of TCO in a tender offer to TCO minority shareholders for R\$538.8 million. Following the tender offer, TCP now holds 86.6% of the voting capital stock and 29.3% of the total capital stock of TCO, including treasury shares held by TCO. On October 31, 2003, TCP attempted to acquire the remaining share capital of TCO by means of a merger of TCO shares into TCP shares. The exchange ratio was fixed at 1.27 TCP shares for each TCO share held. This merger was cancelled on January 12, 2004 following the issue of an opinion by the Brazilian Securities and Exchange Commission that the merger did not fully comply with current Brazilian law. TCP increased its ownership of the total capital stock of TCO from 29.3% to 51.4% following participation in a tender offer for TCO shares on October 8, 2004. With the acquisition of its interest in TCO, Vivo provides services to approximately 21 million customers, with a market share of approximately 56% in its concession area. See "*Item 4 Information on the Company Our Businesses Brazilian Mobile Business*".

In May 2004, ANACOM and the DGCC approved the 2004 fixed telephone service prices proposed by PT Comunicações. These prices were set within the pricing convention, complying with the price cap of CPI-2.75%, in terms of average annual change and assuming an inflation range of 1.5% to 2.5% as per the Portuguese State Budget for 2004. The new prices became effective in August 2004, with a line rental increase of 2.9% and a decrease of 20.7% and 28.0% in the cost of regional and domestic long distance calls, respectively. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

### Exchange Controls

Since January 1, 1993, there have been no foreign exchange controls imposed on the Escudo by the Portuguese Government. None of the member countries of the European Union or the EU that have adopted the Euro, including Portugal, has imposed foreign exchange controls on the Euro. There are currently no foreign exchange control restrictions in Portugal on remittances of dividends on our ordinary shares or on the conduct of our operations.

### Taxation

The following is a summary of the material Portuguese and U.S. federal income tax consequences of the acquisition, ownership and disposition of ordinary shares or ADSs by U.S. Holders, as defined below. This discussion does not address all aspects of Portuguese and U.S. federal income taxation that may be relevant to a particular holder based on such holder's particular circumstances. For example, with respect to U.S. Holders, the following discussion does not address the U.S. federal income tax consequences to a U.S. Holder (i) which owns or has owned (directly, indirectly or through attribution) 10% or more of Portugal Telecom's voting power; (ii) which is a dealer in securities, an insurance company, a bank, a tax-exempt organization, or a partnership or other pass-through entity; (iii) which

holds Portugal Telecom's ordinary shares or ADSs as a part of an integrated investment (including a "straddle") comprised of the ordinary shares or ADSs and one or more other positions; or (iv) whose functional currency is not the U.S. dollar. This discussion generally applies only to U.S. Holders that hold the ordinary shares or ADSs as capital assets.

In addition, the following discussion does not address any aspect of state, local or non-U.S. tax laws (other than certain Portuguese tax laws). See "*Memorandum and Articles of Association Transfer of Ordinary Shares, Limitations on Shareholdings*" for a description of Portuguese taxes and other costs with respect to the transfer and sale of ordinary shares on the Lisbon Stock Exchange and the deposit of ordinary shares in exchange for ADSs or a withdrawal of ordinary shares in exchange for the cancellation of ADSs.

The description of the Portuguese and U.S. federal income tax laws and practices set forth below is based on the laws as in force and as applied in practice on the date of this Form 20-F, including the U.S. Internal Revenue Code of 1986, as amended, hereinafter referred to as the "Code," its legislative history, existing and proposed regulations thereunder, published rulings and court decisions, as well as the convention between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, including the protocol thereto, hereinafter referred to as the "Tax Treaty." These laws and practices and the Tax Treaty may be subject to change, possibly on a retroactive basis. This section is further based in part upon the representations of The Bank of New York as Depositary and on the assumption that each obligation in the Deposit Agreement and any related agreement will be performed in accordance with its terms.

As used in this section, the term "U.S. Holder" means a beneficial owner of ordinary shares or of ADSs that is:

a citizen or resident of the U.S.;

a corporation or other entity taxable as a corporation organized under the laws of the U.S. or of any state thereof or the District of Columbia;

an estate the income of which is included in gross income for U.S. federal income tax purposes regardless of source; or

a trust (a) the administration of which is subject to the primary supervision of a U.S. court and that has one or more U.S. persons who have the authority to control all substantial decisions of the trust or (b) that was in existence on August 20, 1996, was treated as a U.S. person under the Code on the previous day, and elected to continue to be so treated.

The application of the Tax Treaty, as described below, to U.S. Holders is conditioned upon, among other things, that the U.S. Holder:

is not a resident of Portugal for purposes of the Tax Treaty;

if the U.S. Holder is an individual, the holder has a substantial presence in the U.S.;

is entitled to the benefits of the Tax Treaty under the limitations of benefit provisions contained in Article 17 of the Tax Treaty; and

does not have a fixed place of business or a permanent establishment in Portugal with which its ownership of ordinary shares or ADSs is effectively connected.

For purposes of the Tax Treaty and for U.S. federal income and Portuguese tax purposes, a U.S. Holder of ADRs evidencing ADSs will be treated as the beneficial owner of the underlying ordinary shares represented by the ADSs.

We urge prospective investors to consult their own tax advisors as to the tax consequences of the acquisition, ownership and disposition of the ordinary shares and ADSs, including, in particular, whether they are eligible for the benefits of the Tax Treaty and any tax consequences arising under any other applicable tax laws of the United States or Portugal or any other jurisdiction.

### **Dividends**

**Portuguese Taxation.** The general rate of withholding tax on dividends in Portugal is currently 15% for Portuguese residents and 25% for non-residents. The Portuguese Statute of Tax Incentives provides an exemption from withholding tax of 50% of the dividends (net of other tax benefits or exclusions) paid on shares of corporations in a process of privatization occurring before the end of 2002. This benefit applies until the end of the fifth accounting and tax year ending after the date on which the company's privatization is completed. Since the privatization was completed in December 2000, this tax benefit will no longer be applicable in 2006.

Based upon the foregoing, dividends paid in 2005 to Portuguese residents are subject to withholding at a tax rate of 7.5%. In the case of non-residents, the dividends will be subject to withholding at a tax rate of 12.5%.

Our entitlement to the reduction discussed above, relating to shares of companies in the process of privatization, has been confirmed by an administrative ruling of the Treasury and Finance Secretary of State. The effective rate of withholding tax pursuant to domestic Portuguese law has changed periodically in recent years and may continue to change.

Under the Tax Treaty, the rate of withholding tax on dividends distributed to U.S. Holders may not exceed 15%. If the withholding tax rate exceeds the treaty rate referred to above, then The Bank of New York, as depositary, will use all reasonable efforts to follow the requisite procedures in a manner reasonably satisfactory to us to obtain reduced rates of withholding tax, as provided under the Tax Treaty, at the time dividends are paid and to facilitate the recovery by U.S. Holders of ADSs of amounts of Portuguese withholding tax withheld in excess of the Tax Treaty rate, if any.

**U.S. Federal Income Taxation.** Other than certain pro rata distributions discussed below, distributions paid by Portugal Telecom (including the amount of any Portuguese taxes withheld therefrom) will be includible in the gross income of a U.S. Holder as foreign source dividend income to the extent that such distributions are paid out of our current or accumulated earnings and profits, as determined under U.S. federal income tax principles. Distributions in excess of Portugal Telecom's current or accumulated earnings and profits as so determined will first be treated as a tax-free return of capital to the extent of the U.S. Holder's adjusted tax basis in our ordinary shares or ADSs, and thereafter as gain from the sale of ordinary shares or ADSs. U.S. Holders will not be entitled to claim a dividends received deduction with respect to dividends distributed by us.

The U.S. dollar value of any cash distribution paid in Euros, including the amount of any Portuguese taxes withheld therefrom, will be equal to the U.S. dollar value of the Euros calculated by reference to the spot exchange rate in effect on the date of receipt by The Bank of New York as depositary, regardless of whether the payment is in fact converted into U.S. dollars. A U.S. Holder should not recognize any foreign currency gain or loss if such Euros are converted into U.S. dollars on the day The Bank of New York as depositary receives the Euros. If The Bank of New York as depositary does not convert the Euros into U.S. dollars on the date of receipt, however, a U.S. Holder may recognize gain or loss upon a subsequent sale or other disposition of the Euros (including an exchange of the Euros for U.S. dollars). Such gain or loss, if any, will be ordinary income or loss for U.S. federal income tax purposes and will be U.S. source gain or loss.

Subject to certain conditions and limitations, Portuguese tax withheld with respect to dividend distributions in accordance with Portuguese law will be eligible for credit against a U.S. Holder's

federal income tax liability. A U.S. Holder will be denied a foreign tax credit with respect to Portuguese withholding tax on dividends from us if such U.S. Holder has not held the ADSs or ordinary shares for a minimum period or to the extent such U.S. Holder is under an obligation to make certain related payments with respect to substantially similar or related property. As an alternative to claiming a foreign tax credit, a U.S. Holder may claim a deduction for Portuguese withholding tax, but only for a year for which such U.S. Holder elects to do so with respect to all foreign income taxes. If a U.S. Holder is denied a foreign tax credit because of the holding period requirement described above, however, the U.S. Holder may claim a deduction for the taxes for which the credit is disallowed even if such U.S. Holder claimed the foreign tax credit for other taxes in the same taxable year. The overall limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income.

Dividends distributed by Portugal Telecom with respect to ordinary shares or ADSs generally should constitute "passive income" or, in the case of certain holders, "financial services income" for U.S. foreign tax credit limitation purposes (or, for tax years beginning after December 31, 2006, as "passive category income" or, in the case of certain U.S. Holders, as "general category income" for U.S. foreign tax credit purposes).

Foreign tax credits that were not used due to the foreign tax credit limitation may generally be carried back two years and forward five years, subject to the limitations referred to above. The rules relating to the determination of the foreign tax credit are complex, and therefore, each U.S. Holder is urged to consult with its tax advisor to determine whether and to what extent such holder would be entitled to this credit.

Dividends paid to a non-corporate U.S. Holder in taxable years beginning on or before December 31, 2008 that constitute qualified dividend income will be taxable to the holder at a maximum rate of 15%, provided certain holding period and other requirements are met. Dividends received from "qualified foreign corporations" will generally qualify as qualified dividend income. A non-U.S. corporation that is not a "passive foreign investment company" generally will be considered to be a qualified foreign corporation with respect to dividends paid on its shares (or ADSs issued in respect of the shares) if the shares (or ADSs) are readily tradable on an established securities market in the United States. Ordinary shares (or ADSs issued in respect of the shares) will be considered to be readily tradable on an established securities market in the United States if the ordinary shares (or ADSs) are listed on a nationally registered stock exchange (such as the New York Stock Exchange). Accordingly, unless we are treated as a "passive foreign investment company", the dividends that we pay in respect of our ADSs will generally be qualified dividend income. Special rules apply for purposes of determining the recipient's investment income (which limits deductions for investment interest) and foreign income (which may affect the amount of foreign tax credit) and to certain extraordinary dividends. We urge each non-corporate U.S. Holder to consult its own tax advisor regarding the possible applicability of the 15% rate and the related restrictions and special rules.

Pro rata distributions of ordinary shares or rights to our shareholders (including U.S. Holders of ADSs) generally should not be subject to U.S. federal income tax.

### **Capital Gains**

**Portuguese Taxation.** Capital gains derived by a U.S. Holder from the sale or other disposition of ADSs or ordinary shares (including deposits and withdrawals of ordinary shares in exchange for ADSs) will, under the Tax Treaty, not be subject to Portuguese capital gains tax.

**U.S. Federal Income Taxation.** Gains or losses realized by a U.S. Holder on the sale or other disposition of ordinary shares or ADSs will be subject to U.S. federal income taxation in an amount equal to the difference between the amount realized on such disposition and such U.S. Holder's tax basis in the ordinary shares or ADSs. Any gain or loss realized by a U.S. Holder on the sale or other

disposition of ordinary shares or ADSs generally will be a capital gain or loss and generally will be a long-term capital gain or loss if, on the date of sale, such shares or ADSs were held for more than one year. Net capital gain of a non-corporate U.S. holder that is recognized from the sale of shares through taxable years beginning on or before December 31, 2008 is generally taxed at a maximum rate of 15% where the holder has a holding period of more than one year. Any such gain or loss generally should be gain or loss from sources within the United States for foreign tax credit limitation purposes. The deductibility of capital losses is subject to limitations.

Any gain or loss realized by a U.S. Holder on the sale or other disposition of ordinary shares or ADSs generally should be from sources within the United States. Deposits and withdrawals of ordinary shares by U.S. Holders in exchange for ADSs should not be subject to U.S. federal income tax.

#### ***Reportable Transactions***

Under recently promulgated United States Treasury regulations, U.S. Holders that participate in "reportable transactions" (as defined in the regulations) must attach to their federal income tax returns a disclosure statement on Form 8886. U.S. Holders should consult their own tax advisers as to the possible obligation to file Form 8886 with respect to the acquisition, ownership or disposition of ordinary shares or ADSs, or any related transaction, including without limitation, the disposition of any Euros (or other foreign currency) received as a dividend or as proceeds from the sale of the ordinary shares or ADSs.

#### ***U.S. Back-up Withholding***

A U.S. Holder may be subject to back-up withholding at applicable rates with respect to dividends paid on or proceeds of the sale or other disposition of an ordinary share or ADS, unless the U.S. Holder is a corporation or otherwise establishes a basis for exemption. Any amounts withheld under the back-up withholding rules will generally be allowed as a refund or a credit against U.S. federal income tax liability, provided that the required information is furnished to the I.R.S.

#### **Documents on Display**

We are subject to the informational reporting requirements of the U.S. Securities Exchange Act of 1934, as amended, which requires that we file periodic reports and other information with the Securities and Exchange Commission. As a foreign private issuer, we file annual reports on Form 20-F as opposed to Form 10-K. We do not file quarterly reports on Form 10-Q but furnish reports in relation to material events on Form 6-K.

Our reports, proxy statements and other information filed by us with the Securities and Exchange Commission may be inspected and copied by the public at the public reference facilities maintained by the Securities and Exchange Commission at Station Place, 100 F Street, N.E., Room 1580, Washington, D.C. 20549 and are also available on the website of the Securities and Exchange Commission at <http://www.sec.gov>. In addition, reports and other information concerning us may be inspected at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005, on which our ADSs are listed.

We furnish The Bank of New York, as the depository of our ADSs, with annual reports in English, which include a review of operations and annual audited consolidated financial statements prepared under Portuguese GAAP, and our annual report on Form 20-F, which includes a reconciliation to U.S. GAAP of net income and shareholders' equity. We also furnish the depository with six month reports in English which include audited semi-annual consolidated financial information prepared under Portuguese GAAP. Upon our request, the depository will promptly mail such reports to all record holders of ADSs. We also furnish to the depository, in English, all notices of shareholders' meetings and other reports and communications that are made generally available to our shareholders. Upon our

request, the depositary will make such notices, reports and communications available to holders of ADSs and will mail to all record holders of ADSs a notice containing a summary of the information contained in any notice of a shareholders' meeting it receives.

As a foreign private issuer, we are exempt from the rules under the Securities Exchange Act of 1934 prescribing the furnishing and content of proxy statements. As a foreign private issuer, we are also exempt from the rules under the Securities Exchange Act of 1934 relating to short-swing profit disclosure and liability.

**ITEM 11 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Portugal Telecom's most significant market risk exposures are interest rate risk and exchange rate risk and, to a lesser extent, commodity risk. We actively manage interest rate risk and foreign currency exchange rate risk through our regular operating and financing activities as well as through financial derivative instruments.

Derivative contracts are entered into with major financial institutions, after careful analysis and approval from Portugal Telecom's Executive Committee. We regularly review their market value and risks in order to assess and manage our exposure to market risk.

***Interest Rate Risk***

Our policy is to manage interest rate risk through a combination of fixed and floating rate debt instruments and derivatives. In 2003, we unwound or cancelled several interest rate swaps, which resulted in an increase of the proportion of fixed rate debt and the simplification of our derivatives portfolio. During 2004, as some derivatives matured and others were unwound, the total notional amount of our interest rate swaps portfolio decreased.

As of December 31, 2004, approximately 55.2% of our total indebtedness carried fixed interest rates, compared to 74.9% at the end of 2003. The decrease in the proportion of our fixed rate debt is due to the unwinding of interest rate swaps and to debt reduction. However, since a significant portion of our floating rate debt matured in early 2005 and we issued fixed rate debt in the first half of 2005 in order to extend the average maturity of our debt, we expect the proportion of our fixed rate debt to increase in 2005. This should reduce the impact of an increase in interest rates on future interest costs.

The floating rate component of our total indebtedness is mainly subject to fluctuations in the European Interbank Offered Rate (EURIBOR), CDI (Brazil's interest rate), European Investment Bank (EIB) rates and London Interbank Offered Rate (LIBOR). The interest rates on EIB loans are determined by reference to the EIB's internal interest rates, typically set at quarterly intervals. The EIB's interest rates depend on its cost of funds rather than on any specific base rate. Accordingly, it is not possible to state average interest rates or average spreads over a reference base rate for the floating rate EIB debt. Nevertheless, we believe that the EIB's interest rates are generally competitive. EIB floating rates remained very close to EURIBOR flat rates during 2004.

***Exchange Rate Risk***

Portugal Telecom is exposed to exchange rate risk mainly due to investments in non-Euro countries, namely Brazil, and non-Euro denominated long-term debt.

We hold significant assets in Brazil. At the end of 2002, all our assets in mobile operations in Brazil were transferred to Vivo, a joint venture equally owned by Portugal Telecom and Telefónica. Most of Vivo's subsidiaries' debt is originally denominated in Euros and U.S. dollars. Vivo's policy is to hedge against this currency exchange risk and, as a result, the majority of the debt of Portugal Telecom's Brazilian subsidiaries was either Real denominated or had been swapped into Reais, as of December 31, 2004. We remain exposed to exchange rate risk between Brazilian Reais and Euros regarding our Brazilian assets that are not hedged by Brazilian Real-denominated debt.

We have maintained our policy of preventing significant exposure to exchange rate risk regarding long-term debt. As of December 31, 2004, approximately 2.3% of our total indebtedness was denominated in U.S. dollars, compared with 2.1% at the end of 2003 and 1.6% at the end of 2002 (taking into consideration cross-currency swaps). The slight increase in the proportion of our U.S. Dollar denominated debt is due to the decrease in our total consolidated indebtedness. Our total net exposure to the U.S. dollar, including certain free-standing derivatives, amounted to negative US\$165.1 million as of December 31, 2004.

**Equity Price Risk**

We face equity price risk with regard to our shares in Telefónica, BES and Media Capital. Under Portuguese GAAP, our interests in Telefónica, BES and Media Capital are recorded at their acquisition cost less a provision for estimated losses, where applicable. However, if the market value of such interests was to fall below the acquisition cost, the interests would be recorded at fair value. Under U.S. GAAP, our interests in Telefónica, BES and Media Capital are currently recorded at fair value, with a value of approximately €68.4 million as of December 31, 2004, which implies a potential gain of approximately €4.0 million when compared with the carrying value. See Note 38 to our audited consolidated financial statements.

In order to facilitate the completion of our share buyback program, we have entered into equity swaps over 21,551,006 of our own shares. Taking into consideration the difference between the exercise price of those derivatives (ranging from €7.14 to €8.99 per share) and the stock price as of December 31, 2004, we did not record any provision to cover estimated losses in connection with these equity swaps. These instruments had maturities ranging from 2 to 12 months.

In order to increase our exposure to PT Multimédia, we have entered into equity swaps over 15,287,545 PT Multimédia shares as follows: (i) 9,187,545 shares, with an exercise price of €17.74 and a maturity of 17 months and (ii) 6,100,000 shares, with an exercise price of €14.10 and a maturity of 5 months.

In addition, during 2004 we entered into the following options contracts with BES for the right to acquire shares representing 5% of the share capital of PT Multimédia:

Portugal Telecom purchased a call option from Banco Espírito Santo de Investimento, S.A., or BESI, for 6,063 thousand shares of PT Multimédia with a strike price of €26.513 at maturity, which is December 31, 2005. The option can be exercised at any time, but BESI can choose between physical and cash settlement, the latter of which has a 15% discount on the strike price;

Concurrently, BESI purchased a call option from Portugal Telecom over the 6,063 thousand shares of PT Multimédia with a strike price of €16 per share at maturity, which is December 31, 2005. This option can only be exercised for cash settlement if the stock price of PT Multimédia is higher than the strike price of the option purchased by Portugal Telecom, which would make the exercise of BESI's option automatic if Portugal Telecom exercises its call option; and

Portugal Telecom purchased a call option for 1.5 million PT Multimédia shares with a strike price of €23 at maturity, which is December 31, 2005. Portugal Telecom can exercise this option at any time, and BES has a choice between physical and cash settlement, the latter of which has a 20% discount on the strike price.

Except in the circumstances described below, we will receive a premium on the price of such options in the amount of €16,657 thousand, which is the difference between the acquisition prices of the options described above, 50% of which was paid on December 31, 2004 (€8,328,285), and 50% of which is to be paid on the exercise date of the option purchased by BESI or, if the option is not exercised, on December 31, 2005. We will only receive this premium if (i) BESI receives a premium on any options contracts it enters into with third parties to hedge its position on the call option over the 6,063 thousand PT Multimédia shares, and (ii) any such third party defaults on payment of the premium. Because BESI intends to hedge the call option on PT Multimédia shares, Portugal Telecom and BESI have agreed that BESI has the right to reduce such option to 3,469 thousand shares, with a proportional decrease in price and fees, if the counterparties to any of the hedge contracts do not comply with their contractual obligations. However, BESI is committed to ensuring that the hedging contracts are fully complied with.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following tables provide information about our debt instruments and derivative contracts as of December 31, 2004 that are sensitive to changes in interest rates and exchange rates. The tables present principal cash flows (unless otherwise stated) and average interest rates by expected maturity dates (taking into consideration associated derivatives). The amounts presented in the tables below are stated in Euro because the Euro is our reporting currency. The exchange rates used are those quoted by the Bank of Portugal for December 31, 2004.

The tables reflect our interest in Vivo's loans and derivatives. Regarding information about these instruments, all the amounts stated represent half of the notional amounts or fair value amounts of the instruments, because we proportionally consolidate Vivo's assets and liabilities in our balance sheet under Portuguese GAAP as of December 31, 2002, 2003 and 2004. See Note 36 to our audited consolidated financial statements.

The two final tables present additional information about all derivative contracts we have entered into, including those entered into by Vivo.

## Debt Sensitivity to Interest Rates

(Euro million)

## Expected Maturity Date

|  | Notes | 2005         | 2006         | 2007       | 2008       | 2009       | Thereafter | Total        | Fair Value(1) |
|--|-------|--------------|--------------|------------|------------|------------|------------|--------------|---------------|
| <b>Fixed Rate Debt</b>                                 |       |              |              |            |            |            |            |              |               |
| <b>EIB Fixed Rate Loans</b>                            |       |              |              |            |            |            |            |              |               |
| EIB Loans (€)  |       | 19           | 17           | 11         | 8          |            |            | 55           | 58            |
| Average Interest Rate                                  |       | 4.06%        | 3.98%        | 3.84%      | 3.77%      |            |            | 3.98%        |               |
| EIB Loans (€) with associated swaps                    |       | 61           | 52           | 72         | 68         | 63         | 187        | 503          | 537           |
| Average Interest Rate                                  |       | 4.43%        | 4.57%        | 4.98%      | 5.12%      | 5.16%      | 5.20%      | 4.86%        |               |
| <b>Total EIB Fixed Rate Loans</b>                      |       | <b>80</b>    | <b>69</b>    | <b>82</b>  | <b>76</b>  | <b>63</b>  | <b>187</b> | <b>558</b>   | <b>594</b>    |
| <b>Non-EIB Fixed Rate Loans</b>                        |       |              |              |            |            |            |            |              |               |
| Loans (€)  |       | 3            | 3            | 3          | 3          | 3          | 3          | 17           | 17            |
| Average Interest Rate                                  |       | 4.55%        | 4.53%        | 4.49%      | 4.44%      | 4.35%      | 3.08%      | 4.39%        |               |
| Bonds (€)  |       |              | 900          |            |            | 880        |            | 1,779        | 1,859         |
| Average Interest Rate                                  |       | 5.19%        | 5.19%        | 4.63%      | 4.63%      | 4.63%      |            | 4.95%        |               |
| Exchangeable bonds (€)                                 |       |              | 390          |            |            |            |            | 390          | 390           |
| Average Interest Rate                                  |       | 2.00%        | 2.00%        |            |            |            |            | 2.00%        |               |
| Loans (US\$)   |       | 8            | 0            | 42         | 0          | 0          | 0          | 51           | 61            |
| Average Interest Rate                                  |       | 5.26%        | 5.37%        | 5.38%      | 0.75%      | 0.75%      | 0.75%      | 5.29%        |               |
| Loans (US\$) with associated €/US\$ swaps              |       | 1            | 1            | 1          | 1          | 1          |            | 4            | 5             |
| Average Interest Rate                                  |       | 3.62%        | 3.62%        | 3.62%      | 3.62%      | 3.62%      |            | 3.62%        |               |
| Loans (BR\$)   |       |              |              |            | 0          |            | 2          | 2            | 2             |
| Average Interest Rate                                  |       | 0.00%        | 0.00%        | 0.00%      | 0.00%      | 0.00%      | 0.00%      | 0.00%        |               |
| Loans (Other currencies)                               |       | 0            | 0            | 0          | 0          | 0          | 0          | 0            | 0             |
| Average Interest Rate                                  |       | 0.75%        | 0.75%        | 0.75%      | 0.75%      | 0.75%      | 0.75%      | 0.75%        |               |
| <b>Total Non-EIB Fixed Rate Loans</b>                  |       | <b>12</b>    | <b>1,294</b> | <b>46</b>  | <b>4</b>   | <b>883</b> | <b>5</b>   | <b>2,244</b> | <b>2,334</b>  |
| <b>Total Fixed Rate Debt</b>                           |       | <b>93</b>    | <b>1,363</b> | <b>128</b> | <b>80</b>  | <b>946</b> | <b>192</b> | <b>2,802</b> | <b>2,928</b>  |
| <b>Floating Rate Debt</b>                              |       |              |              |            |            |            |            |              |               |
| <b>EIB Floating Rate Loans</b>                         |       |              |              |            |            |            |            |              |               |
| Loans (US\$) with associated €/US\$ swaps              |       | 10           | 10           | 10         | 10         | 10         | 20         | 70           | 69            |
| Average Interest Rate ref. EIB rates                   |       | 0.05%        | 0.05%        | 0.05%      | 0.05%      | 0.05%      | 0.05%      | 0.05%        |               |
| <b>Total EIB Floating Rate Loans</b>                   |       | <b>10</b>    | <b>10</b>    | <b>10</b>  | <b>10</b>  | <b>10</b>  | <b>20</b>  | <b>70</b>    | <b>69</b>     |
| <b>Non-EIB Floating Rate Loans</b>                     |       |              |              |            |            |            |            |              |               |
| Loans (€)  |       | 339          | 1            | 260        | 326        | 0          |            | 927          | 931           |
| Average Spread ref. Euribor                            |       | 0.21%        | 0.24%        | 0.24%      | 0.23%      | 0.00%      |            | 0.22%        |               |
| Floating Rate Notes (€)                                |       | 585          |              |            |            |            |            | 585          | 586           |
| Average Spread ref. Euribor                            |       | 0.75%        |              |            |            |            |            | 0.75%        |               |
| Loans (US\$)   |       | 9            | 2            | 2          | 10         |            |            | 22           | 23            |
| Average Spread ref. USD Libor                          |       | 1.57%        | 1.25%        | 1.26%      | 1.42%      |            |            | 1.41%        |               |
| Loans (US\$) with associated US\$/BR\$ swaps           | (2)   | 158          | 131          | 43         | 9          |            |            | 341          | 376           |
| Average Spread ref. % of CDI                           |       | 98.89%       | 100.02%      | 108.14%    | 118.16%    |            |            | 100.38%      |               |
| Loans (JPY) with associated JPY/BR\$ swaps             | (2)   | 25           |              |            |            |            |            | 25           | 27            |
| Average Spread ref. % of CDI                           |       | 103.43%      |              |            |            |            |            | 103.43%      |               |
| Loans (BR\$)   |       | 138          |              |            | 69         |            |            | 207          | 216           |
| Average Spread ref. % of CDI                           |       | 102.53%      | 104.40%      | 104.40%    | 104.40%    |            |            | 103.47%      |               |
| Loans (BR\$)   |       | 39           | 17           | 15         | 4          | 3          | 5          | 82           | 80            |
| Average Spread ref. TJLP (BRL long term interest rate) |       | 3.89%        | 3.95%        | 4.12%      | 4.56%      | 4.60%      | 4.60%      | 4.04%        |               |
| Loans (Other currencies)                               |       | 1            |              |            |            |            |            | 1            | 1             |
| <b>Total Non-EIB Floating Rate Loans</b>               |       | <b>1,294</b> | <b>152</b>   | <b>320</b> | <b>417</b> | <b>3</b>   | <b>5</b>   | <b>2,191</b> | <b>2,240</b>  |
| <b>Total Floating Rate Debt</b>                        |       | <b>1,304</b> | <b>162</b>   | <b>330</b> | <b>427</b> | <b>13</b>  | <b>25</b>  | <b>2,261</b> | <b>2,310</b>  |
| <b>Total Debt</b>                                      |       | <b>1,397</b> | <b>1,524</b> | <b>459</b> | <b>507</b> | <b>959</b> | <b>217</b> | <b>5,063</b> | <b>5,238</b>  |

- (1) Includes fair value of debt and associated swaps.
- (2) Includes exchange gains and losses from associated cross currency swaps.

## Derivatives Sensitivity to Interest Rate Risk

(Euro million)

## Expected Maturity Date(1)

|  | Notes | 2005    | 2006    | 2007    | 2008    | 2009    | Thereafter | Total   | Fair Value |
|--|-------|---------|---------|---------|---------|---------|------------|---------|------------|
| <b>Interest Rate Derivatives</b>                             |       |         |         |         |         |         |            |         |            |
| <b>Fixed Rate Payer</b>                                      |       |         |         |         |         |         |            |         |            |
| Pay fixed Euro, receive floating Euro swaps                  |       | 161     | 126     | 101     | 77      | 34      | 24         | 161     | (7)        |
| Average Rate Paid  |       | 4.36%   | 4.39%   | 4.40%   | 4.41%   | 4.42%   | 4.43%      | 4.39%   |            |
| Average Spread Received ref. Euribor                         |       | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%      | 0.00%   |            |
| Pay fixed Euro, receive floating Euro forward starting swaps |       |         | 64      | 220     | 241     | 216     | 164        | 311     | (17)       |
| Average Rate Paid  |       |         | 5.11%   | 5.24%   | 5.26%   | 5.28%   | 5.30%      | 5.26%   |            |
| Average Spread Received ref. Euribor                         |       |         | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%      | 0.00%   |            |
| Pay fixed Euro, receive floating U.S. dollar swaps           |       | 4       | 4       | 3       | 2       | 1       |            | 4       | (1)        |
| Average Rate Paid  |       | 3.62%   | 3.62%   | 3.62%   | 3.62%   | 3.62%   | 0.00%      | 3.62%   |            |
| Average Spread Received ref. US\$ Libor                      |       | 0.40%   | 0.40%   | 0.40%   | 0.40%   | 0.40%   | 0.00%      | 0.40%   |            |
| Pay fixed BRL, receive floating BRL swaps                    |       | 221     |         |         |         |         |            | 221     | 1          |
| Average Rate Paid  |       | 15.40%  |         |         |         |         |            | 15.40%  |            |
| Spread Received ref. % CDI                                   |       | 100.00% |         |         |         |         |            | 100.00% |            |
| <b>Floating Rate Payer</b>                                   |       |         |         |         |         |         |            |         |            |
| Pay floating Euro, receive floating U.S. dollar swaps        |       | 70      | 60      | 50      | 40      | 30      | 20         | 70      | (15)       |
| Average Spread Paid ref. Euribor                             |       | 0.05%   | 0.05%   | 0.05%   | 0.05%   | 0.05%   | 0.05%      | 0.05%   |            |
| Average Spread Received ref. US\$ Libor                      |       | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%      | 0.00%   |            |
| Pay floating Brazilian Real, receive fixed Euro swaps        |       | 13      |         |         |         |         |            | 13      | (1)        |
| Average Spread Paid ref. % CDI                               |       | 100.00% |         |         |         |         |            | 100.00% |            |
| Average Rate Received  |       | 1.41%   |         |         |         |         |            | 1.41%   |            |
| Pay floating Brazilian Real, receive fixed U.S. dollar swaps |       | 373     | 183     | 58      | 13      | 1       | 0          | 373     | (50)       |
| Average Spread Paid ref. % CDI                               |       | 104.02% | 104.40% | 102.87% | 100.00% | 100.00% | 100.00%    | 103.94% |            |
| Average Rate Received  |       | 5.16%   | 6.03%   | 7.80%   | 9.60%   | 6.63%   | 7.67%      | 5.75%   |            |
| Pay floating in U.S. dollar (US\$/R\$ hedge)                 |       | 103     | 103     |         |         |         |            | 103     | 47         |
| Average Spread Paid ref. % CDI                               |       | 38.00%  | 38.00%  |         |         |         |            | 38.00%  |            |
| Average Rate Received  |       | 0.00%   | 0.00%   |         |         |         |            | 0.00%   |            |
| Pay floating Brazilian, receive fixed Japanese Yen swaps     |       | 24      |         |         |         |         |            | 24      | (2)        |
| Average Spread Paid ref. % CDI                               |       | 105.14% |         |         |         |         |            | 105.14% |            |
| Average Rate Received  |       | 1.39%   |         |         |         |         |            | 1.39%   |            |

(1)

All the amounts refer to the notional amounts of derivatives at the beginning of each period.

## Debt Sensitivity to Exchange Rates

(Euro million)

## Expected Maturity Date

|   | Notes | 2005    | 2006    | 2007    | 2008    | 2009  | Thereafter | Total   | Fair Value(1) |
|---|-------|---------|---------|---------|---------|-------|------------|---------|---------------|
| <b>Liabilities exposure to Non-European Monetary Union currencies</b> |       |         |         |         |         |       |            |         |               |
| <b>Exposure to the Euro/U.S. dollar exchange rate</b>                 |       |         |         |         |         |       |            |         |               |
| Loans (US\$)  |       | 8       | 0       | 42      | 0       | 0     | 0          | 51      | 61            |
| Average Interest Rate   |       | 5.26%   | 5.37%   | 5.38%   | 0.75%   | 0.75% | 0.75%      | 5.29%   |               |
| Loans (US\$)  |       | 9       | 2       | 2       | 10      |       |            | 22      | 23            |
| Average Spread ref. USD Libor   |       | 1.57%   | 1.25%   | 1.26%   | 1.42%   |       |            | 1.41%   |               |
| <b>Exposure to the Euro/Brazilian Real exchange rate</b>              |       |         |         |         |         |       |            |         |               |
| Loans (US\$) with associated US\$/BR\$ swaps                          | (2)   | 158     | 131     | 43      | 9       |       |            | 341     | 376           |
| Average Spread ref. % of CDI  |       | 98.89%  | 100.02% | 108.14% | 118.16% |       |            | 100.38% |               |
| Loans (JPY) with associated JPY/BR\$ swaps                            | (2)   | 25      |         |         |         |       |            | 25      | 27            |
| Average Spread ref. % of CDI  |       | 103.43% |         |         |         |       |            | 103.43% |               |
| Loans (BR\$)  |       | 138     |         |         | 69      |       |            | 207     | 216           |
| Average Spread ref. % of CDI  |       | 102.53% | 104.40% | 104.40% | 104.40% |       |            | 103.47% |               |
| Loans (BR\$)  |       | 39      | 17      | 15      | 4       | 3     | 5          | 82      | 80            |
| Average Spread ref. TJLP (BRL long term interest rate)                |       | 3.89%   | 3.95%   | 4.12%   | 4.56%   | 4.60% | 4.60%      | 4.04%   |               |
| <b>Exposure to other currencies exchange rates</b>                    |       |         |         |         |         |       |            |         |               |
| Loans (Other currencies)  |       | 1       | 0       | 0       | 0       | 0     | 0          | 2       | 2             |

(1) Includes fair value of debt and associated swaps.

(2) Includes exchange gains and losses from associated cross currency swaps.

## Derivatives Sensitivity to Exchange Rate Risk

(Euro million)

## Expected Maturity Date(1)

|  | Notes | 2005    | 2006    | 2007    | 2008    | 2009    | Thereafter | Total   | Fair Value |
|--|-------|---------|---------|---------|---------|---------|------------|---------|------------|
| <b>Exchange Rates Derivatives</b>                                    |       |         |         |         |         |         |            |         |            |
| <b>Exposure to the Euro/U.S. dollar exchange rate</b> (2)            |       |         |         |         |         |         |            |         |            |
| Pay fixed Euro, receive floating U.S. dollar swaps                   |       | 4       | 4       | 3       | 2       | 1       |            | 4       | (1)        |
| Average Rate Paid  |       | 3.62%   | 3.62%   | 3.62%   | 3.62%   | 3.62%   | 0.00%      | 3.62%   |            |
| Average Spread Received ref. US\$ Libor                              |       | 0.40%   | 0.40%   | 0.40%   | 0.40%   | 0.40%   | 0.00%      | 0.40%   |            |
| Pay floating Euro, receive floating U.S. dollar swaps                |       | 70      | 60      | 50      | 40      | 30      | 20         | 70      | (15)       |
| Average Spread Paid ref. Euribor                                     |       | 0.05%   | 0.05%   | 0.05%   | 0.05%   | 0.05%   | 0.05%      | 0.05%   |            |
| Average Spread Received ref. US\$ Libor                              |       | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%   | 0.00%      | 0.00%   |            |
| Final exchange of former €/US\$ swaps                                |       | 200     | 200     | 200     | 200     | 200     |            | 200     | 20         |
| Pay U.S. dollar, Receive Euro €/US\$ Forwards                        |       | 212     | 200     | 200     | 200     | 200     |            | 212     | (21)       |
| Pay Euro, Receive U.S. dollar €/US\$ Calls                           |       | 200     | 200     | 200     | 200     | 200     |            | 200     | (41)       |
| <b>Exposure to the Euro/Brazilian Real exchange rate</b>             |       |         |         |         |         |         |            |         |            |
| Pay floating Brazilian Real, receive fixed Euro swaps                |       | 13      |         |         |         |         |            | 13      | (1)        |
| Average Spread Paid ref. % CDI                                       |       | 100.00% |         |         |         |         |            | 100.00% |            |
| Average Rate Received  |       | 1.41%   |         |         |         |         |            | 1.41%   |            |
| <b>Exposure to the U.S. dollar/Brazilian Real exchange rate</b> (3)  |       |         |         |         |         |         |            |         |            |
| Pay floating Brazilian Real, receive fixed U.S. dollar swaps         |       | 373     | 183     | 58      | 13      | 1       | 0          | 373     | (50)       |
| Average Spread Paid ref. % CDI                                       |       | 104.02% | 104.40% | 102.87% | 100.00% | 100.00% | 100.00%    | 103.94% |            |
| Average Rate Received  |       | 5.16%   | 6.03%   | 7.80%   | 9.60%   | 6.63%   | 7.67%      | 5.75%   |            |
| Pay floating in U.S. dollar (US\$/R\$ hedge)                         |       | 103     | 103     |         |         |         |            | 103     | 47         |
| Average Spread Paid ref. % CDI                                       |       | 38.00%  | 38.00%  |         |         |         |            | 38.00%  |            |
| Average Rate Received  |       | 0.00%   | 0.00%   |         |         |         |            | 0.00%   |            |
| <b>Exposure to the Japanese Yen/Brazilian Real exchange rate</b> (4) |       |         |         |         |         |         |            |         |            |
| Pay floating Brazilian, receive fixed Japanese Yen swaps             |       | 24      |         |         |         |         |            | 24      | (2)        |
| Average Spread Paid ref. % CDI                                       |       | 105.14% |         |         |         |         |            | 105.14% |            |
| Average Rate Received  |       | 1.39%   |         |         |         |         |            | 1.39%   |            |

(1) All the amounts refer to the notional amounts of derivatives at the beginning of each period.

(2) Most derivatives were entered into in order to hedge debt denominated in U.S. Dollars.

- (3) Most derivatives were entered into by Brazilian subsidiaries in order to hedge debt denominated in U.S. Dollars.
- (4) All derivatives were entered into by Brazilian subsidiaries in order to hedge debt denominated in Japanese Yen.

## Derivatives Sensitivity to Equity Price Risk

(Euro million)

## Expected Maturity Date(1)

|   | Notes | 2005  | 2006 | 2007 | 2008 | 2009 | Thereafter | Total | Fair Value |
|---|-------|-------|------|------|------|------|------------|-------|------------|
| <b>Equity Derivatives</b>                     |       |       |      |      |      |      |            |       |            |
| <b>Equity Swaps</b>                           |       |       |      |      |      |      |            |       |            |
| Equity Swaps on Portugal Telecom Shares       |       | 190   |      |      |      |      |            | 190   | 6          |
| Average Initial Price                         |       | 8.80  |      |      |      |      |            | 8.80  |            |
| Equity Swaps on PT Multimédia Shares          |       | 249   |      |      |      |      |            | 249   | 31         |
| Average Initial Price                         |       | 16.48 |      |      |      |      |            | 16.48 |            |
| <b>Call Options</b>                           |       |       |      |      |      |      |            |       |            |
| Call Options on PT Multimédia Shares (bought) |       |       |      |      |      |      |            |       | 16         |
| Average Strike Price                          |       | 16.00 |      |      |      |      |            |       |            |
| Call Options on PT Multimédia Shares (sold)   |       |       |      |      |      |      |            |       | (4)        |
| Average Strike Price                          |       | 26.51 |      |      |      |      |            |       |            |

(1)

All the amounts refer to the notional amounts of derivatives, at the beginning of each period.

## Fair Value of Derivatives Contracts in 2004

(EUR Million)

|  |        |
|--|--------|
| Fair value of contracts outstanding at December 31, 2003   | 56.5   |
| Contracts realized or otherwise settled during 2004  | (49.8) |
| Fair value of new contracts entered into during 2004   | 8.2    |
| Other changes in fair value (due to restructuring of existing contracts and change of market conditions) | (50.5) |
| Fair value of contracts outstanding at December 31, 2004   | (35.7) |

## Fair Value of Derivatives Contracts in 2004

(EUR Million)

## Expected Maturity Date

Fair Value of Contracts as of December 31, 2004 Expected Maturity

| Source of Fair Value                               | Less than 1 year | 1 - 3 years | 4 - 5 years | In excess of 5 years | Total Fair Value |
|--|------------------|-------------|-------------|----------------------|------------------|
| Prices provided by other external sources          | 42.9             | 53.0        | (44.0)      | (35.6)               | 16.3             |
| Prices based on models and other valuation methods | (36.2)           | (15.7)      | (0.1)       | 0.0                  | (52.0)           |
| Total  | 6.7              | 37.4        | (44.1)      | (35.6)               | (35.7)           |

164



**ITEM 12 DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

We are not required to provide the information called for by Item 12.

165

---

**PART II**

**ITEM 13 DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

**ITEM 14 MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

None.

**ITEM 15 CONTROLS AND PROCEDURES**

An evaluation was performed by Portugal Telecom's management, with the participation of Portugal Telecom's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of Portugal Telecom's disclosure controls and procedures (as defined in Exchange Act Rule 13a-14(c)) as of the end of the period covered by this Form 20-F. Based on that evaluation, Portugal Telecom's management, including the CEO and CFO, concluded that its disclosure controls and procedures were effective to ensure that material information relating to Portugal Telecom and its consolidated subsidiaries was made known to them by others within Portugal Telecom and its consolidated subsidiaries, particularly during the period in which this annual report on Form 20-F was being prepared.

Pursuant to the SEC guidance on disclosure controls and procedures, we established a Disclosure Committee in May 2003, with the goal of defining, documenting and communicating adequate disclosure procedures and financial reporting, as well as reviewing all public releases of information. As of June 2005, the Disclosure Committee was comprised of the following officers: Luís Sousa de Macedo (Secretary General of the Company and chairman of this committee), Francisco Nunes (Chief Accounting Officer), Carlos Moreira da Cruz (Financing and Treasury Officer), Miguel Chambel (Planning and Control Officer), Nuno Prego (Investor Relations Officer) and Miguel Amaro (Internal Audit Officer).

During 2004, there was no change in Portugal Telecom's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, Portugal Telecom's internal control over financial reporting. We are currently in the process of implementing a plan to align our internal control system with the requirements of Section 404 of the Sarbanes Oxley Act, or SOX. The rules promulgated by the SEC in connection with Section 404 of SOX require that management provide in our annual report for our 2006 fiscal year a report on Portugal Telecom's internal control over financial reporting, which is to be accompanied by an attestation report on management's assessment of Portugal Telecom's internal control over financial reporting of our external auditors. The alignment of our internal control system with the requirements of Section 404 of SOX may require certain changes to our internal control over financial reporting, which we expect to implement during 2005 and early 2006.

During 2004, we improved the operating processes of our shared services platform that is responsible for all back office activities of the Portugal Telecom group and which will continue to harmonize all processes and controls in the financial reporting function of the Portugal Telecom group during 2005. Most of these improvements resulted from the implementation of an SAP platform, which has contributed significantly to the general improvement in our control environment, particularly in relation to internal control over financial reporting.

**ITEM 16A AUDIT COMMITTEE FINANCIAL EXPERT**

Portugal Telecom's board of directors has determined that Thomaz Paes de Vasconcellos and Nuno Silvério Marques, members of its Audit Committee, are Audit Committee financial experts, as that term is defined in Item 16A of Form 20-F.

**ITEM 16B CODE OF ETHICS**

Portugal Telecom's board of directors has adopted a Code of Ethics that applies to all of its employees, including the Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer. In addition, in December 2004, the board of directors adopted a Code of Ethics applicable to its financial officers. Both Codes of Ethics are publicly available on our official website at *www.telecom.pt*. Written copies of the Codes of Ethics are available on request through our Investor Relations office.

**ITEM 16C PRINCIPAL ACCOUNTANT FEES AND SERVICES**

During 2003 and 2004, the remuneration of our independent auditors was as follows.

|                       | 2003             |             | 2004             |             |
|-----------------------|------------------|-------------|------------------|-------------|
|                       | €                | %           | €                | %           |
| Audit Fees            | 893,900          | 19%         | 1,559,391        | 37%         |
| Audit-Related Fees(1) | 503,535          | 11%         | 436,133          | 10%         |
| Tax Fees(2)           | 818,504          | 18%         | 443,141          | 10%         |
| All Other Fees(3)     | 2,445,741        | 52%         | 1,789,899        | 42%         |
| <b>Total</b>          | <b>4,661,680</b> | <b>100%</b> | <b>4,228,564</b> | <b>100%</b> |

- (1) The Audit Related Fees category mainly includes services related to (i) due diligence conducted in connection with mergers and acquisitions, and (ii) internal control reviews.
- (2) The Tax Fees category includes fees for tax compliance and tax advisory services.
- (3) In 2003, the All Other Fees category mainly included (i) € 393,801 in connection with a revenue assurance project at PT Comunicações, (ii) €773,072 related to a CRM implementation project at TMN, and (iii) €602,731 related to a CRM implementation project at PT Comunicações.
- In 2004, the All Other Fees category mainly included (i) €1,189,090 relating to a CRM project conducted at TMN, (ii) €195,470 relating to a revenue assurance project conducted at PT Comunicações, (iii) €130,809 relating to training services at PT Multimédia, and (iv) €93,220 relating to projects within the scope of TMN's UMTS license.

Portugal Telecom's Audit Committee is responsible for appointing (including the approval of all audit services), hiring and firing the independent auditors; pre-approving all non-audit services, including a review of the scope, planning and resources available for the performance of the audit and permissible non-audit services; and establishing the compensation of the independent auditors, including the fees, terms and conditions for the performance of audit and non-audit services.

Annually, Portugal Telecom's Audit Committee reviews a report of the independent auditors that details, among other things, all relationships existing between Portugal Telecom and its independent auditors, including a detailed description of all services rendered to Portugal Telecom.

All non-audit services provided by the independent auditors must be pre-approved by the Audit Committee, and all non-audit services provided in 2004 by our independent auditors were pre-approved by Portugal Telecom's Audit Committee. Portugal Telecom's Audit Committee does not provide for a *de minimis* exception to the pre-approval of non-audit services but pre-approves all services to be provided regardless of size.

When pre-approving non-audit services, our Audit Committee analyzes any potential conflicts of interest between the services to be provided and the existing audit services performed by the independent auditors. The Audit Committee issues an opinion to our Board of Directors regarding its findings in this regard.

**ITEM 16D EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.



## ITEM 16E PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

The following table sets forth certain information related to purchases made by Portugal Telecom of its equity securities.

| Period                                  | (a) Total<br>Number of<br>Ordinary<br>Shares<br>Purchased | (b) Average<br>Price Paid<br>per<br>Ordinary<br>Share | (c) Total<br>Number of<br>Ordinary Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs(1) | (d) Maximum<br>Number of<br>Ordinary Shares<br>that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs(1) |
|---|---|---|---|--|
| As of December 31, 2003                 | 28,644,509(2)   | 7.33  | 28,644,509  | 96,783,991   |
| January 1, 2004 to January 31, 2004     | 7,755,599(2)  | 8.51  | 36,400,108  | 89,028,392   |
| February 1, 2004 to February 29, 2004   | 2,610,000(2)  | 8.54  | 39,010,108  | 86,418,392   |
| March 1, 2004 to March 31, 2004         | 4,010,000(2)  | 9.08  | 43,020,108  | 82,408,392   |
| April 2, 2004 to April 30, 2004         | 5,195,000   | 9.08  | 5,195,000   | 120,233,500  |
| May 1, 2004 to May 31, 2004             | 6,010,000   | 8.68  | 11,205,000  | 114,223,500  |
| June 1, 2004 to June 30, 2004           | 43,020,108(3)   | 7.78  | 54,225,108  | 71,203,392   |
| July 1, 2004 to July 31, 2004           | 0   |   | 54,225,108  | 71,203,392   |
| August 1, 2004 to August 31, 2004       | 0   |   | 54,225,108  | 71,203,392   |
| September 1, 2004 to September 30, 2004 | 0   |   | 54,225,108  | 71,203,392   |
| October 1, 2004 to October 31, 2004     | 0   |   | 54,225,108  | 71,203,392   |
| November 1, 2004 to November 30, 2004   | 33,574,842  | 33,574,842  | 87,799,950  | 37,628,550   |
| December 1, 2004 to December 31, 2004   | 0   |   | 87,799,950  | 37,628,550   |
| <b>Total 2004</b>                       | <b>59,155,441</b>   | <b>8.13</b>   | <b>87,799,950</b>   | <b>37,628,550</b>  |

- (1) All these treasury transactions were under our share buyback program, announced on September 16, 2003, of up to 10% of our share capital (or 125,428,500 treasury shares). There is no expiration date for this share buyback program. On May 9, 2005, we purchased the remaining 37,628,550 treasury shares at an average price of €8.57 per share.
- (2) We sold all these shares, a total of 43,020,108 shares, on April 1, 2004 to ABN AMRO Bank, N.V. at an average price of €7.78 per share, the same average price for which the shares had been previously acquired. In addition, we entered into an equity swap with ABN AMRO Bank, N.V. over the 43,020,108 shares sold, under the terms of which we have the option to reacquire the shares at a future date.
- (3) This acquisition (a total of 43,020,108 shares, at an average price of €7.78 per share) was executed in connection with the physical settlement of the aforementioned equity swap entered into with ABN AMRO Bank, N.V. on April 1, 2004.

**PART III**

**ITEM 17 FINANCIAL STATEMENTS**

*See "Item 18 Financial Statements".*

**ITEM 18 FINANCIAL STATEMENTS**

See our Consolidated Financial Statements beginning at page F-1.

**ITEM 19 EXHIBITS**

- 1.1 Articles of Association of Portugal Telecom, SGPS, S.A., as amended on April 29, 2005, together with an English translation thereof.
- 2.1 Deposit Agreement, dated as of May 10, 1995, as amended and restated as of September 12, 1997, and as further amended and restated as of June 25, 1999, is incorporated by reference to Exhibit A of Portugal Telecom, S.A.'s Registration Statement on Form F-6 (Registration No. 333-10500) filed with the Commission on June 25, 1999.
- 2.2 Amended and Restated Programme Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated April 29, 2003, among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Bilbao Vizcaya Argentaria, S.A., Banco BPI, S.A., Banco Espírito Santo de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, J.P. Morgan Securities Ltd., Citigroup Global Markets Limited, Tokyo-Mitsubishi International plc and UBS Limited, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 2.3 Fourth Supplemental Trust Deed in respect of a €5,000,000,000 Global Medium Term Note Programme, dated April 29, 2003, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 2.4 Amended and Restated Programme Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Bilbao Vizcaya Argentaria, S.A., Banco Espírito Santo de Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, Salomon Brothers International Limited, Tokyo- Mitsubishi International plc and UBS A.G. acting through its business group UBS Warburg, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.
- 2.5 Third Supplemental Trust Deed in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.

- 2.6 Keep Well Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, between Portugal Telecom, SGPS, S.A. and Portugal Telecom International Finance B.V., is incorporated by reference to Exhibit 2.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.
- 2.7 Amended and Restated Programme Agreement in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, Salomon Brothers International Limited and UBS A.G. acting through its division UBS Warburg, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 2.8 Second Supplemental Trust Deed in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 2.9 Keep Well Agreement in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, between Portugal Telecom, SGPS, S.A. and Portugal Telecom International Finance B.V., is incorporated by reference to Exhibit 2.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 2.10 Subscription Agreement relating to the issuance by Portugal Telecom International Finance B.V. of €1,000,000,000 4.625% Notes due 2009, dated March 31, 1999, among Portugal Telecom International Finance B.V., Portugal Telecom, S.A., Merrill Lynch International, UBS A.G. acting through its division Warburg Dillon Read, Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Caixa Geral de Depósitos, S.A., CISF-Banco de Investimento, S.A., Banco Santander Negócios Portugal, S.A., Deutsche Bank A.G. London and Salomon Brothers International Limited, is incorporated by reference to Exhibit 10.15 of Portugal Telecom, S.A.'s Registration Statement on Form F-1 (Registration No. 333-10434) filed with the Commission on June 11, 1999.
- 2.11 Private Placement and Subscription Agreement, dated October 1, 1998, among Banco Nacional de Desenvolvimento Economico e Social, Telefonica Internacional, S.A., Iberdrola Energia, S.A. and Portugal Telecom, S.A., is incorporated by reference to Exhibit 10.16 of Portugal Telecom, S.A.'s Registration Statement on Form F-1 (Registration No. 333-10434) filed with the Commission on June 11, 1999.
- 2.12 Programme Agreement in respect of a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998, among Portugal Telecom, S.A., Portugal Telecom International Finance B.V., Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., Caixa Geral de Depósitos, S.A. Paris Branch, CISF-Banco de Investimento, S.A., Deutsche Bank A.G. London, Merrill Lynch International, Paribas, Salomon Brothers International Limited and UBS A.G. acting through its division Warburg Dillon Read, is incorporated by reference to Exhibit 2.11 of Portugal Telecom, S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999.

- 2.13 Deed of Purchase of Indebtedness relating to a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998 by Portugal Telecom, S.A., is incorporated by reference to Exhibit 2.12 of Portugal Telecom, S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999.
- 4.1 Consulting Agreement (Instrumento Particular de Prestação de Serviços de Consultoria), dated as of January 7, 1999, between Portugal Telecom, S.A. and Telesp Celular S.A. (English translation), is incorporated by reference to Exhibit 4.1 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 4.2 Joint Venture Agreement, dated as of January 23, 2001, among Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A., Telefonica, S.A. and Telefonica-Móviles, S.A. is incorporated by reference to Exhibit 4.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.
- 4.3 Shareholders Agreement, dated as of October 17, 2002, by and among Telefónica Móviles, S.A., Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A. and Brasilcel B.V., in relation to Brasilcel B.V., is incorporated by reference to Exhibit 4.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 4.4 Subscription Agreement, dated as of October 17, 2002, by and among Telefónica Móviles, S.A., Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A. and Brasilcel B.V., in relation to Brasilcel B.V., is incorporated by reference to Exhibit 4.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 4.5 English language summary of the Universal Service Convention, dated as of December 30, 2002, among PT Comunicações S.A., the Autoridade Nacional das Comunicações (ANACOM) and the Direcção Geral do Comércio e da Concorrência, is incorporated by reference to Exhibit 4.5 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 4.6 English language summary of the Contract for the Purchase and Sale of the Ownership of the Basic Telecommunications Network and the Telex Network, dated December 27, 2002, between the Portuguese Government and PT Comunicações, is incorporated by reference to Exhibit 4.6 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
- 8.1 List of Significant Subsidiaries.
- 12.1 Section 302 Certification of Chief Executive Officer.
- 12.2 Section 302 Certification of Chief Financial Officer.
- 13.1 Section 906 Certification.

---

There are omitted from the exhibits filed with or incorporated by reference into this Annual Report certain promissory notes and other instruments and agreements with respect to our long-term debt, none of which authorizes securities in a total amount that exceeds 10% of our total assets. We hereby agree to furnish to the Commission copies of any such omitted promissory notes or other instruments or agreements as the Commission requests.

**INDEX TO FINANCIAL STATEMENTS**

|  | <b>Page</b> |
|--|-------------|
| Report of Independent Auditors   | F-2         |
| Consolidated Balance Sheets as of December 31, 2004 and 2003   | F-3         |
| Consolidated Statements of Profit and Loss for the Years Ended December 31, 2004, 2003 and 2002      | F-4         |
| Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2002, 2003 and 2004 | F-5         |
| Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002           | F-6         |
| Notes to the Consolidated Financial Statements as of December 31, 2004                               | F-9         |

---

F-1

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders and Board of Directors of  
Portugal Telecom, SGPS, S.A.

We have audited the accompanying consolidated balance sheets of Portugal Telecom, SGPS, S.A. and its subsidiaries (together, the "Company") as of December 31, 2004 and 2003, the related consolidated statements of profit and loss, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States of America). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of Portugal Telecom, SGPS, S.A. and its subsidiaries as of December 31, 2004 and 2003 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in Portugal.

Accounting principles generally accepted in Portugal vary in certain significant respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected the determination of net income for each of the three years in the period ended December 31, 2004 and the determination of shareholders' equity as of December 31, 2004 and 2003 to the extent summarized in Notes 36, 37 and 38 to the consolidated financial statements.

Our audits also comprehended the translation of Euro amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 4. Such U.S. dollar amounts are presented solely for the convenience of readers in the United States of America.

Deloitte & Associados, SROC, S.A.  
Lisbon, Portugal  
March 3, 2005, except for Notes 37 and 38, as to which the date is June 30, 2005.

## PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2004 AND 2003

|  | Notes | 2004           | 2004           | 2003           |
|--|-------|----------------|----------------|----------------|
|  |       | U.S. Dollar    | Euro           | Euro           |
| <b>Current Assets:</b>   |       |                |                |                |
| Cash and cash equivalents  |       | 535,162,206    | 441,188,958    | 258,903,507    |
| Short-term investments and cash equivalents                      | 5     | 1,818,181,378  | 1,498,912,925  | 2,272,188,060  |
| Accounts receivable trade, net:                                  |       |                |                |                |
| Third parties  | 6     | 1,414,606,333  | 1,166,204,726  | 1,118,013,145  |
| Accounts receivable other, net:                                  |       |                |                |                |
| Third parties  | 7     | 512,358,482    | 422,389,515    | 365,374,895    |
| Affiliates   | 7     | 40,998,157     | 33,798,975     | 33,910,549     |
| Inventories, net   | 8     | 214,818,808    | 177,097,121    | 102,884,982    |
| Deferred Taxes   | 29    | 938,632,819    | 773,811,063    | 748,141,425    |
| Prepaid expenses and other current assets                        | 9     | 186,373,710    | 153,646,917    | 140,241,889    |
|  |       |                |                |                |
| Total current assets   |       | 5,661,131,893  | 4,667,050,200  | 5,039,658,452  |
|  |       |                |                |                |
| Investments, net   | 10    | 524,759,176    | 432,612,676    | 448,079,192    |
| Fixed Assets, net  | 11    | 4,928,249,515  | 4,062,860,276  | 4,267,958,038  |
| Intangible Assets, net Other                                     | 12    | 3,897,192,997  | 3,212,854,903  | 3,150,122,385  |
| Non-Current Deferred Taxes                                       | 29    | 596,769,964    | 491,978,536    | 583,471,389    |
| Other Non-Current Assets, net                                    | 7     | 116,511,766    | 96,052,569     | 68,525,804     |
|  |       |                |                |                |
| Total assets   |       | 15,724,615,311 | 12,963,409,160 | 13,557,815,260 |
| <b>Current Liabilities:</b>                                      |       |                |                |                |
| Short term debt and current portion of medium and long-term debt | 13    | 1,694,371,210  | 1,396,843,537  | 1,191,078,724  |
| Accounts payable trade:  |       |                |                |                |
| Third parties  |       | 863,213,729    | 711,635,391    | 672,392,961    |
| Affiliates   |       | 15,362,769     | 12,665,102     | 11,470,569     |
| Accounts payable other:  |       |                |                |                |
| Third parties  | 14    | 686,654,236    | 566,079,337    | 535,007,267    |
| Affiliates   |       | 132,428,420    | 109,174,295    | 7,007,560      |
| Accrued expenses   | 15    | 774,513,105    | 638,510,392    | 589,394,613    |
| Taxes payable  | 16    | 100,451,492    | 82,812,442     | 102,925,601    |
| Deferred Taxes   | 29    | 33,896,111     | 27,944,032     | 32,793,924     |
| Deferred income  | 17    | 288,068,874    | 237,484,645    | 212,413,495    |
|  |       |                |                |                |
| Total current liabilities  |       | 4,588,959,947  | 3,783,149,173  | 3,354,484,714  |
|  |       |                |                |                |
| Medium and Long-Term Debt  | 13    | 4,447,122,971  | 3,666,218,443  | 4,555,614,003  |
| Accrued Post Retirement Liability                                | 30.3  | 1,540,350,180  | 1,269,868,244  | 1,256,038,995  |
| Non-Current Deferred Taxes                                       | 29    | 350,225,067    | 288,726,354    | 300,731,656    |
| Provisions for other risks and costs                             | 18    | 559,042,963    | 460,876,309    | 361,379,666    |
| Other Non-Current Liabilities                                    | 18    | 253,236,596    | 208,768,834    | 144,771,333    |
|  |       |                |                |                |
| Total liabilities  |       | 11,738,937,724 | 9,677,607,357  | 9,973,020,367  |
|  |       |                |                |                |
| Minority Interests   | 19    | 704,782,877    | 581,024,631    | 643,967,968    |
| <b>Shareholders' Equity:</b>                                     |       |                |                |                |
| Share capital  | 20    | 1,414,946,366  | 1,166,485,050  | 1,254,285,000  |
| Capital issued premium   | 20    | 111,238,033    | 91,704,891     | 91,704,891     |
| Treasury shares  |       |                |                | (210,040,062)  |
| Legal reserve  | 20    | 187,075,016    | 154,225,075    | 144,184,287    |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   | <u>Notes</u> | <u>2004</u>           | <u>2004</u>           | <u>2003</u>           |
|---|--------------|-----------------------|-----------------------|-----------------------|
| Other reserves and retained earnings                |              | 3,678,613,859         | 3,032,657,757         | 3,682,035,130         |
| Cumulative foreign currency translation adjustments |              | (2,717,630,668)       | (2,240,420,996)       | (2,261,577,622)       |
| Net income  |              | 606,652,104           | 500,125,395           | 240,235,301           |
|   |              | <u>3,280,894,710</u>  | <u>2,704,777,172</u>  | <u>2,940,826,925</u>  |
| Total equity  |              | 3,280,894,710         | 2,704,777,172         | 2,940,826,925         |
|   |              | <u>15,724,615,311</u> | <u>12,963,409,160</u> | <u>13,557,815,260</u> |
| Total liabilities and shareholder's equity          |              | 15,724,615,311        | 12,963,409,160        | 13,557,815,260        |

The accompanying notes form an integral part of these financial statements.

F-3



## PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF PROFIT AND LOSS FOR

## THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

|  | Notes     | 2004                 | 2004                 | 2003                 | 2002                 |
|--|-----------|----------------------|----------------------|----------------------|----------------------|
|  |           | U.S. Dollar          | Euro                 | Euro                 | Euro                 |
| <b>Operating Revenues:</b>                                   |           |                      |                      |                      |                      |
| Services rendered  | 21        | 6,399,947,359        | 5,276,131,376        | 5,056,469,413        | 4,950,845,832        |
| Sales of merchandise and products                            | 21        | 748,367,897          | 616,956,222          | 583,532,339          | 492,030,480          |
| Telephone directories  | 21        | 157,406,610          | 129,766,373          | 136,109,823          | 139,156,808          |
| <b>Total operating revenues</b>                              |           | <b>7,305,721,867</b> | <b>6,022,853,971</b> | <b>5,776,111,575</b> | <b>5,582,033,120</b> |
| <b>Operating Costs and Expenses:</b>                         |           |                      |                      |                      |                      |
| Wages and salaries   | 22        | 905,100,148          | 746,166,651          | 705,902,478          | 694,775,367          |
| Post retirement benefits                                     | 30.4      | 168,015,018          | 138,511,969          | 222,942,179          | 183,213,062          |
| Costs of telecommunications                                  | 23        | 669,880,981          | 552,251,427          | 587,145,058          | 622,938,664          |
| Depreciation and amortization                                | 11 and 12 | 1,161,250,352        | 957,337,471          | 953,978,392          | 962,824,885          |
| Subsidies  |           | (18,337,039)         | (15,117,097)         | (20,627,776)         | (31,519,859)         |
| Maintenance and repairs                                      |           | 145,022,830          | 119,557,156          | 126,536,660          | 129,248,379          |
| Own work capitalized   |           | (108,577,498)        | (89,511,540)         | (74,499,765)         | (114,033,783)        |
| Raw materials and consumables                                |           | 82,989,547           | 68,416,774           | 73,999,927           | 97,182,987           |
| Costs of products sold                                       |           | 721,348,675          | 594,681,513          | 550,154,948          | 462,664,452          |
| Telephone directories  |           | 105,373,792          | 86,870,397           | 90,419,679           | 92,049,002           |
| Marketing and publicity                                      |           | 228,925,098          | 188,726,379          | 141,945,303          | 108,812,870          |
| Concession rent  | 1         |                      |                      |                      | 16,278,750           |
| Other general and administrative                             | 24        | 1,305,118,200        | 1,075,942,457        | 966,525,817          | 925,561,923          |
| Provision for doubtful receivables,<br>inventories and other | 28        | 208,310,103          | 171,731,330          | 130,806,217          | 132,763,318          |
| Other net operating income                                   |           | (81,626,954)         | (67,293,449)         | (89,988,262)         | (45,258,357)         |
| Taxes other than income taxes                                |           | 152,830,431          | 125,993,760          | 97,143,507           | 77,840,569           |
| <b>Total operating costs and expenses</b>                    |           | <b>5,645,623,684</b> | <b>4,654,265,198</b> | <b>4,462,384,362</b> | <b>4,315,342,229</b> |
| <b>Operating Income</b>                                      |           | <b>1,660,098,183</b> | <b>1,368,588,773</b> | <b>1,313,727,213</b> | <b>1,266,690,891</b> |
| <b>Other Expenses (Income):</b>                              |           |                      |                      |                      |                      |
| Net interest expenses  |           | 246,066,846          | 202,858,076          | 201,838,301          | 197,060,843          |
| Net foreign currency exchange losses/(gains)                 |           | 39,721,612           | 32,746,589           | 41,905,966           | (87,776,346)         |
| Other net financing costs/(income)                           | 25        | 15,155,351           | 12,494,106           | (95,372,242)         | 111,736,185          |
| Goodwill amortization  | 12        | 117,809,579          | 97,122,489           | 110,612,770          | 142,909,438          |
| Equity in (earnings)/losses of affiliated<br>companies, net  | 10        | (33,626,764)         | (27,721,982)         | 19,156,675           | 160,873,350          |
| Net losses/(gains) on sales and disposals of<br>fixed assets | 26        | 14,570,225           | 12,011,727           | (28,630,291)         | (3,966,594)          |
| Work force reduction program costs                           | 30.4      | 207,227,520          | 170,838,846          | 314,084,702          | 53,701,919           |
| Extraordinary Items  | 27        | 106,039,419          | 87,419,142           | 52,784,472           | 38,622,625           |
| <b>Income Before Income Taxes</b>                            |           | <b>947,134,393</b>   | <b>780,819,780</b>   | <b>697,346,860</b>   | <b>653,529,471</b>   |
| Provision for income taxes                                   | 29        | (217,279,014)        | (179,125,321)        | (377,886,629)        | (337,094,337)        |
| <b>Net Income Before Minority Interests</b>                  |           | <b>729,855,379</b>   | <b>601,694,459</b>   | <b>319,460,231</b>   | <b>316,435,134</b>   |
| Loss/(income) applicable to minority<br>interests            | 19        | (123,203,275)        | (101,569,064)        | (79,224,930)         | 74,620,664           |
| <b>Net Income</b>  |           | <b>606,652,104</b>   | <b>500,125,395</b>   | <b>240,235,301</b>   | <b>391,055,798</b>   |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|  | <u>Notes</u> | <u>2004</u> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|--------------|-------------|-------------|-------------|-------------|
| Earnings per Share and ADS (U.S.D/EUR) |              | 0.52        | 0.43        | 0.19        | 0.31        |

The accompanying notes form an integral part of these financial statements.

F-4

---

**PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY FOR**  
**THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004**

(Amounts stated in Euros)

|   | Share<br>Capital     | Capital<br>Issued<br>Premium | Treasury<br>Shares   | Legal<br>reserve   | Other<br>reserves    | Cumulative<br>foreign<br>currency<br>translation<br>adjustments | Retained<br>earnings |
|---|----------------------|------------------------------|----------------------|--------------------|----------------------|---|----------------------|
| <b>Balance as of December 31, 2001</b>                | <b>1,254,285,000</b> | <b>2,149,565,000</b>         |                      | <b>128,814,507</b> | <b>1,935,039,113</b> | <b>(944,948,774)</b>  | <b>144,028,261</b>   |
| Earnings allocated to reserves                        |                      |                              |                      | 15,369,780         |                      |   | (15,369,780)         |
| Foreign currency translation adjustments (Note 3.s)   |                      |                              |                      |                    |                      | (1,321,467,418)   |                      |
| Gains on the sale of own shares                       |                      |                              |                      |                    | (2,400,223)          |   |                      |
| Dividends paid  |                      |                              |                      |                    |                      |   | (125,428,500)        |
| Provision for impairment                              |                      |                              |                      |                    |                      |   | (500,000,000)        |
| Other adjustments                                     |                      |                              |                      |                    | 87,358,287           |   | (84,576,821)         |
| Net income 2002                                       |                      |                              |                      |                    |                      |   | 391,055,798          |
| <b>Balance as of December 31, 2002</b>                | <b>1,254,285,000</b> | <b>2,149,565,000</b>         |                      | <b>144,184,287</b> | <b>2,019,997,177</b> | <b>(2,266,416,192)</b>  | <b>(190,291,042)</b> |
| Acquisition and sales of treasury shares, net         |                      |                              | (210,040,062)        |                    |                      |   |                      |
| Distribution of PT shares to employees                |                      |                              |                      |                    | (4,794,502)          |   |                      |
| Capital issued premium allocated to retained earnings |                      | (2,057,860,109)              |                      |                    |                      |   | 2,057,860,109        |
| Foreign currency translation adjustments (Note 3.s)   |                      |                              |                      |                    |                      | 4,838,570   |                      |
| Gains on the sale of own shares                       |                      |                              |                      |                    | (276,767)            |   |                      |
| Dividends paid  |                      |                              |                      |                    | (200,685,600)        |   |                      |
| Other adjustments                                     |                      |                              |                      |                    | 39,628,924           |   | (39,403,169)         |
| Net income 2003                                       |                      |                              |                      |                    |                      |   | 240,235,301          |
| <b>Balance as of December 31, 2003</b>                | <b>1,254,285,000</b> | <b>91,704,891</b>            | <b>(210,040,062)</b> | <b>144,184,287</b> | <b>1,853,869,232</b> | <b>(2,261,577,622)</b>  | <b>2,068,401,199</b> |
| Acquisition of treasury shares                        |                      |                              | (480,912,955)        |                    |                      |   |                      |
| Cancellation of treasury shares                       | (87,799,950)         |                              | 690,953,017          |                    | (603,153,067)        |   |                      |
| Dividends paid  |                      |                              |                      |                    | (76,724,707)         |   | (190,774,979)        |
| Distribution of PT shares to employees                |                      |                              |                      |                    | (6,220,610)          |   |                      |
| Earnings allocated to the legal reserve               |                      |                              |                      | 10,040,788         |                      |   | (10,040,788)         |
| Foreign currency translation adjustments (Note 3.s)   |                      |                              |                      |                    |                      | 21,156,626  |                      |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|  | Share<br>Capital     | Capital<br>Issued<br>Premium | Treasury<br>Shares | Legal<br>reserve   | Other<br>reserves  | Cumulative<br>foreign<br>currency<br>translation<br>adjustments | Retained<br>earnings |
|--|----------------------|------------------------------|--------------------|--------------------|--------------------|---|----------------------|
| Other adjustments(1)                       |                      |                              |                    |                    | (688,003,474)      |   | 685,304,951          |
| Net income 2004                            |                      |                              |                    |                    |                    |   | 500,125,395          |
| <b>Balance as of December<br/>31, 2004</b> | <b>1,166,485,050</b> | <b>91,704,891</b>            |                    | <b>154,225,075</b> | <b>479,767,374</b> | <b>(2,240,420,996)</b>  | <b>3,053,015,778</b> |

(1) The adjustment made to other reserves and retained earnings, includes basically: (i) an amount of Euro 720,000,000 related to reserves distributed by PT Comunicações and TMN; and (ii) Euro 34,695,049 representing the difference between the 2003 results of the subsidiary and affiliated companies considered in the preparation of the Company's consolidated financial statements, and the dividends distributed by those entities during 2004.

The accompanying notes form an integral part of these financial statements.

## PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

|   | 2004                   | 2004                 | 2003                   | 2002                   |
|---|------------------------|----------------------|------------------------|------------------------|
|   | U.S. Dollar            | Euro                 | Euro                   | Euro                   |
| <b>OPERATING ACTIVITIES</b>                           |                        |                      |                        |                        |
| Collections from clients                              | 8,465,060,848          | 6,978,615,703        | 6,508,513,684          | 6,521,776,690          |
| Payments to suppliers                                 | (4,203,049,588)        | (3,465,003,782)      | (2,796,599,245)        | (2,940,476,605)        |
| Payments to employees                                 | (1,028,364,866)        | (847,786,369)        | (822,506,844)          | (763,798,144)          |
| <b>Cash flow from operations</b>                      | <b>3,233,646,395</b>   | <b>2,665,825,552</b> | <b>2,889,407,595</b>   | <b>2,817,501,941</b>   |
| Payments relating to income taxes                     | (80,022,042)           | (65,970,356)         | 144,366,627            | (289,131,732)          |
| Other payments relating to operating activities, net  | (574,235,111)          | (473,400,751)        | (566,274,305)          | (384,970,914)          |
| <b>Cash flow before non operating activities</b>      | <b>2,579,389,242</b>   | <b>2,126,454,445</b> | <b>2,467,499,917</b>   | <b>2,143,399,295</b>   |
| Receivables relating to non recurring items           | 1,063,785              | 876,987              | 7,157,682              | 43,098,416             |
| Payments relating to non recurring items              | (132,911,903)          | (109,572,880)        | (140,647,691)          | (94,174,202)           |
| <b>Cash flow from operating activities(1)</b>         | <b>2,447,541,124</b>   | <b>2,017,758,552</b> | <b>2,334,009,908</b>   | <b>2,092,323,509</b>   |
| <b>INVESTING ACTIVITIES</b>                           |                        |                      |                        |                        |
| Cash receipts resulting from:                         |                        |                      |                        |                        |
| Financial investments                                 | 25,768,049             | 21,243,239           | 3,625,011              | 1,311,634,564          |
| Tangible fixed assets                                 | 43,358,989             | 35,745,251           | 116,621,650            | 29,038,119             |
| Intangible assets                                     | 4,329                  | 3,569                | 32,686                 |                        |
| Subsidies for investments                             | 3,613,476              | 2,978,958            |                        | 196,288                |
| Interest and related income                           | 320,089,002            | 263,882,112          | 283,952,038            | 245,909,913            |
| Dividends   | 20,149,454             | 16,611,256           | 26,225,115             | 20,734,668             |
| Other   | 41,589,034             | 34,286,096           | 193,841,327            | 17,622,306             |
|   | <b>454,572,334</b>     | <b>374,750,481</b>   | <b>624,297,827</b>     | <b>1,625,135,858</b>   |
| Payments resulting from:                              |                        |                      |                        |                        |
| Financial investments                                 | (391,681,078)          | (322,902,785)        | (403,988,292)          | (321,342,491)          |
| Tangible fixed assets                                 | (757,094,690)          | (624,150,610)        | (560,712,772)          | (855,984,006)          |
| Intangible assets                                     | (19,035,637)           | (15,693,023)         | (55,036,318)           | (358,641,234)          |
| Advance for the acquisition of a financial investment | (60,650)               | (50,000)             | (42,648,612)           | (947,451,821)          |
| Other investments                                     | (44,227,234)           | (36,461,034)         | (21,429,108)           | (151,343,088)          |
|   | <b>(1,212,099,289)</b> | <b>(999,257,452)</b> | <b>(1,083,815,102)</b> | <b>(2,634,762,640)</b> |
| <b>Cash flow from investing activities(2)</b>         | <b>(757,526,956)</b>   | <b>(624,506,971)</b> | <b>(459,517,275)</b>   | <b>(1,009,626,782)</b> |

The accompanying notes form an integral part of these financial statements.

F-6

---

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|  | 2004                    | 2004                    | 2003                   | 2002                    |
|--|-------------------------|-------------------------|------------------------|-------------------------|
|  | U.S. Dollar             | Euro                    | Euro                   | Euro                    |
| <b>FINANCING ACTIVITIES</b>                            |                         |                         |                        |                         |
| Cash receipts resulting from:                          |                         |                         |                        |                         |
| Loans obtained   | 20,770,323,436          | 17,123,102,585          | 6,777,581,209          | 13,457,226,263          |
| Increases in share capital and paid-in surplus         | 112,045,613             | 92,370,662              |                        | 176,434,867             |
| Sale of treasury shares                                |                         |                         | 39,159,546             | 34,299,931              |
| Subsidies  | 446,744                 | 368,297                 | 526,023                | 699,631                 |
| Other  | 83,204,680              | 68,594,130              | 3,517,130              | 48,484                  |
|  | <b>20,966,020,473</b>   | <b>17,284,435,674</b>   | <b>6,820,783,908</b>   | <b>13,668,709,176</b>   |
| Payments resulting from:                               |                         |                         |                        |                         |
| Loans repaid   | (21,684,130,519)        | (17,876,447,254)        | (7,397,524,940)        | (13,472,717,994)        |
| Lease rentals (principal)                              | (32,967,430)            | (27,178,425)            | (9,037,369)            | (4,136,597)             |
| Interest and related expenses                          | (651,305,025)           | (536,937,366)           | (603,550,509)          | (506,569,415)           |
| Dividends  | (360,433,652)           | (297,142,335)           | (227,516,018)          | (129,035,959)           |
| Acquisition of treasury shares                         | (600,813,723)           | (495,312,220)           | (234,988,926)          | (42,197,733)            |
| Other  | (47,202,217)            | (38,913,617)            | (2,292,094)            | (126,683)               |
|  | <b>(23,376,852,566)</b> | <b>(19,271,931,217)</b> | <b>(8,474,909,856)</b> | <b>(14,154,784,381)</b> |
| Cash flow from financing activities(3)                 | <b>(2,410,832,094)</b>  | <b>(1,987,495,543)</b>  | <b>(1,654,125,948)</b> | <b>(486,075,205)</b>    |
| Variation of cash and equivalents (4)=(1)+(2)+(3)      | (720,817,926)           | (594,243,962)           | 220,366,685            | 596,621,522             |
| Effect of exchange differences                         | 4,418,453               | 3,642,583               | 10,378,990             | (45,211,595)            |
| Effect of Brasilcel consolidation                      |                         |                         |                        | 485,410,651             |
| Cash and equivalents at the beginning of the period(a) | 3,051,975,109           | 2,516,055,325           | 2,297,800,295          | 1,231,222,245           |
| <b>Cash and equivalents at the end of the period</b>   | <b>2,335,575,637</b>    | <b>1,925,453,946</b>    | <b>2,528,545,970</b>   | <b>2,268,042,823</b>    |

(a) The balance of cash and cash equivalents as of December 31, 2003 and 2002 differs from the balance of cash and equivalents at the beginning of 2004 and 2003, respectively, as a result of changes in the consolidation perimeter.

|   | 2004                 | 2004                 | 2003                 | 2002                 |
|---|----------------------|----------------------|----------------------|----------------------|
|   | Euro                 | Euro                 | Euro                 | Euro                 |
| <b>DETAIL OF CASH AND EQUIVALENTS</b>   |                      |                      |                      |                      |
| Cash  | 15,354,936           | 12,658,645           | 28,049,854           | 7,540,373            |
| Bank deposits   | 519,807,270          | 428,530,313          | 230,853,653          | 345,862,930          |
| Short-term investments  | 1,818,181,378        | 1,498,912,925        | 2,272,188,060        | 1,923,104,592        |
| <b>Cash, bank deposits and treasury applications as stated in the balance sheet</b> | <b>2,353,343,584</b> | <b>1,940,101,883</b> | <b>2,531,091,567</b> | <b>2,276,507,895</b> |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|                             | <u>2004</u>          | <u>2004</u>          | <u>2003</u>          | <u>2002</u>          |
|-----------------------------|----------------------|----------------------|----------------------|----------------------|
| Other treasury elements     |                      |                      |                      |                      |
| Bank overdrafts (Note 13)   | (17,767,948)         | (14,647,937)         | (2,545,597)          | (8,465,072)          |
| <b>Cash and equivalents</b> | <b>2,335,575,636</b> | <b>1,925,453,946</b> | <b>2,528,545,970</b> | <b>2,268,042,823</b> |

The accompanying notes form an integral part of these financial statements.

F-7



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following represents statements of cash flows prepared under IAS 7 reflecting: (i) the reclassification of cash acquired from purchased entities as a cash flow from investing activity, rather than as part of the beginning balance of cash and cash equivalents, as considered under Portuguese GAAP; and (ii) the reclassification of treasury debt from "Cash and cash equivalents" to debt liabilities.

|   | December, 31         |                      |                      |                      |
|---|----------------------|----------------------|----------------------|----------------------|
|   | 2004                 | 2004                 | 2003                 | 2002                 |
|   | US\$                 | €                    | €                    | €                    |
| <b>Statements of cash flows:</b>                      |                      |                      |                      |                      |
| Cash flows from operating activities                  | 2,447,541,124        | 2,017,758,552        | 2,334,009,908        | 2,092,323,509        |
| Cash flows from investing activities                  | (772,678,108)        | (636,997,616)        | (429,759,803)        | (1,003,454,768)      |
| Cash flows from financing activities                  | (2,410,832,094)      | (1,987,495,543)      | (1,654,125,948)      | (486,075,205)        |
| Effect of exchange differences                        | 4,418,453            | 3,642,583            | 10,378,990           | (45,211,595)         |
| Effect of Brasilcel consolidation                     |                      |                      |                      | 485,410,651          |
| <b>Total movements in "Cash and cash equivalents"</b> | <b>(731,550,625)</b> | <b>(603,092,024)</b> | <b>260,503,147</b>   | <b>1,042,992,592</b> |
| Beginning "Cash and cash equivalents"                 | 3,067,126,262        | 2,528,545,970        | 2,268,042,823        | 1,225,050,231        |
| <b>Ending "Cash and cash equivalents"</b>             | <b>2,335,575,636</b> | <b>1,925,453,946</b> | <b>2,528,545,970</b> | <b>2,268,042,823</b> |

The accompanying notes form an integral part of these financial statements.

**PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2004**

**(Amounts stated in Euro, Brazilian Real (BRL) and United States Dollar (US\$),  
except where otherwise stated)**

**1. Introduction**

**a) Parent Company**

Portugal Telecom, SGPS, S.A. (formerly Portugal Telecom, S.A., "Portugal Telecom") was incorporated on June 23, 1994 as a result of the merger, effective January 1, 1994, of Telecom Portugal, S.A. ("TP"), Telefones de Lisboa e Porto, S.A. ("TLP") and Teledifusora de Portugal, S.A. ("TDP").

The shares of Portugal Telecom are traded on the Euronext Lisbon Stock Exchange and on the New York Stock Exchange.

**b) Corporate purpose**

Portugal Telecom is engaged indirectly through its subsidiary and affiliated companies ("the Group" or "the Company") in rendering a comprehensive range of telecommunications and multimedia services in Portugal and other countries, including Brazil.

In Portugal the fixed telephone services were rendered directly by Portugal Telecom under the provisions of the Concession Agreement entered into with the Portuguese State on March 20, 1995 in accordance with Decree-Law 40/95, for an initial period of thirty years, subject to renewal for subsequent periods of 15 years. As a result of an internal reorganization of the Group and in accordance with the terms of Decree-Law 219/2000, the Concession Contract was transferred to PT Comunicações, S.A. ("PT Comunicações"), the Company's wholly owned subsidiary for fixed line telecommunications. In exchange for the concession, PT Comunicações paid, up to 2002, an annual rent to the Portuguese State corresponding to 1% of the gross operating revenues from services covered by the Concession, after deduction of losses incurred in meeting the universal service obligation and certain other items. On December 11, 2002, according to the terms of the Modifying Agreement to the Concession Contract, PT Comunicações acquired the property of the Basic Network of Telecommunications and Telex ("Basic Network").

Data transmission services are provided through PT Prime Soluções Empresariais de Telecomunicações e Sistemas, S.A. ("PT Prime"). This company is also an Internet Service Provider ("ISP") for large clients.

ISP services for residential clients are provided by PT.com Comunicações Interactivas, S.A. ("PT.com" former PT Multimédia.com Serviços de Acesso à Internet, SGPS, S.A.), which also provides services relating to the conception of publicity, publicity space and information on Internet portals.

Mobile services in Portugal are provided by TMN Telecomunicações Móveis Nacionais, S.A. ("TMN") under a GSM license granted by the Portuguese State in 1990 and under a UMTS license obtained in December 19, 2000.

PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. ("PT Multimédia") is the Group's sub-holding for multimedia operations. Through its subsidiary TV Cabo Portugal, S.A. ("TV Cabo Portugal"), PT Multimédia renders cable and satellite television services in mainland Portugal, Madeira and Azores.

PT Multimédia also provides other multimedia services in Portugal, namely editing and selling of DVDs and video games, through Lusomundo Audiovisuais, S.A. ("Lusomundo Audiovisuais"), the distribution and exhibition of movies, through Lusomundo Cinemas, S.A. ("Lusomundo Cinemas"), and the publishing of large circulation newspapers and the edition of radio programs, through Lusomundo Media, SGPS, S.A. ("Lusomundo Media").

On December 27, 2002 Portugal Telecom and Telefónica Móviles, S.A. ("Telefónica Móviles") completed their joint-venture for the Brazilian mobile telecommunications market by contributing 100% of the share holdings that each group owned in mobile telecommunications companies in Brazil to a new incorporated company Brasilcel N.V. ("Brasilcel" or "VIVO"). Currently, VIVO provides mobile services in the Brazilian States of São Paulo (through Telesp Celular S.A. "Telesp Celular"), Paraná and Santa Catarina (through Global Telecom S.A. "Global Telecom"), Rio de Janeiro (through Telerj Celular S.A.), Espírito Santo (through Teleste Celular S.A.), Bahia (through Telebahia Celular S.A.), Sergipe (through Telegirpe Celular S.A.), Rio Grande do Sul (through Celular CRT S.A.) and eleven states in the Midwestern and Northern regions of Brazil (through Tele Centro Oeste Celular Participações S.A. and its subsidiaries "TCO"). Telesp Celular, S.A., Global Telecom, S.A. and TCO are controlled by the sub-holding Telesp Celular Participações, S.A. ("TCP"), Telerj Celular, S.A. and Teleste Celular, S.A. are controlled by the sub-holding Tele Sudeste Celular Participações, S.A. ("Tele Sudeste), and Telebahia Celular, S.A. and Telergipe Celular, S.A. are controlled by the sub-holding Tele Leste Celular Participações, S.A. ("Tele Leste").

## **2. Basis of Presentation**

The consolidated financial statements are presented in Euros and have been prepared from the accounting records of Portugal Telecom and its subsidiary companies (listed in Exhibit I to these financial statements), which include adjustments and reclassifications in order to conform to the Company's accounting policies and with generally accepted accounting principles in Portugal ("Portuguese GAAP"), and for certain situations not specifically addressed by these standards, International Accounting Standards ("IAS") are considered. These financial statements also include certain reclassifications in order to conform more closely to the form and content of financial statements prepared in the United Kingdom and the United States of America.

The preparation of the financial statements in conformity with Portuguese GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

### **a) Consolidation Principles**

The Company has fully consolidated the financial statements of all material subsidiary companies in which effective control is exercised by virtue of ownership of a majority of the voting rights (Exhibit I.1) or management control. All significant inter-company account balances and transactions have been eliminated in the consolidated financial statements and the interests of the minority shareholders have been recognized in the consolidated financial statements. Any

gains generated on the sale of financial investments within the consolidation perimeter are reversed inside the consolidation perimeter.

Investments in associated companies (Exhibit I.3) and certain companies excluded from the consolidation (as indicated in Exhibit I.2) are recorded based on the equity method of accounting. Under this method, investments in associated companies are initially recorded at cost, which is subsequently adjusted to the proportional equity of the related associated company, at the date of acquisition. The difference is recorded as an intangible asset under goodwill, and then amortized during the estimated period to recover the investment. Subsequently, investments in associated companies are periodically adjusted by an amount corresponding to Portugal Telecom's share of the results and other changes in shareholders' equity of those affiliated companies. Dividends received from associated companies are recorded as a reduction of their corresponding book value. In relation to associated companies with a negative shareholders' equity position, the Company records a provision under "Provision for other risks and costs" in the balance sheet (Note 18). The loans granted to associated companies are recorded at nominal values less a provision for estimated losses, when applicable.

The investment in Brasilcel is accounted for using the proportional consolidation method, in which Portugal Telecom exercises joint control with Telefónica Móviles (Exhibit I.4).

Investments in other companies (participation of less than 20%) are recorded at cost and loans granted are recorded at nominal value less a provision for estimated losses, when applicable (Exhibit I.3).

**b) Changes in the Consolidated Group**

The main changes in the consolidated Group in the year ended December 31, 2004 are summarized in Exhibit II.

**3. Summary of Significant Accounting Policies**

The significant accounting policies used in the preparation of the consolidated financial statements are:

**a) Short-term investments**

Short-term investments consist of short-term treasury applications and marketable securities and are accounted for at the lower of cost or market value. Additionally, loans granted to affiliated companies represented by Floating Rate Notes negotiable in the financial markets are also accounted for as short-term investments.

**b) Provision for doubtful accounts**

The provision for doubtful accounts receivable is stated at the amount considered necessary to cover potential risks in the collection of overdue accounts receivable balances.

**c) Inventories**

Inventories are stated at the lower of cost or market value; cost is determined on the weighted average cost method. A provision is recorded to cover obsolete inventories and certain items whose net realizable value is lower than cost.

**d) Fixed assets**

Fixed assets acquired up to December 31, 1991 are carried at restated value (determined in accordance with the revaluation criteria established by the applicable Portuguese legislation). Fixed assets acquired after that date are stated at cost. Depreciation is provided on cost or restated value on a straight-line basis, over the estimated useful lives of the fixed assets, starting as from the month of its acquisition. A portion (40%) of the additional depreciation arising from the revaluation is not deductible for income tax purposes, originating a deferred tax liability of Euro 20,768,988 (Note 29).

The depreciation rates correspond to the following estimated average useful lives:

|                                     | <u>Years</u> |
|-------------------------------------|--------------|
| Buildings and other constructions   | 10 - 50      |
| Basic equipment:                    |              |
| Network installations and equipment | 5 - 25       |
| Switching equipment                 | 5 - 10       |
| Telephones, switchboards and other  | 5 - 10       |
| Submarine cables                    | 15 - 20      |
| Satellite stations                  | 15           |
| Other telecommunications equipments | 3 - 10       |
| Other basic equipment               | 4 - 20       |
| Transportation equipment            | 4 - 8        |
| Tools and dies                      | 4 - 10       |
| Administrative equipment            | 3 - 10       |
| Other tangible fixed assets         | 3 - 10       |

A provision is recorded to reduce the carrying amount of basic equipment, which is to be disposed before the end of its useful life, to net realizable value (Note 18).

The cost of recurring maintenance and repairs is charged to income as incurred. Significant renewals and betterments are capitalized.

**e) Intangible assets**

This caption consists primarily of goodwill, telecommunications licenses, software development costs and research and development costs. Except for goodwill, telecommunications licenses and the amount paid to the Portuguese State for the acquisition of the Basic Network (Note 12), intangible assets are amortized as from the month of its acquisition on a straight-line basis over periods ranging from three to six years.

Goodwill, arising from the difference between the cost of the investments in subsidiaries and the related fair value of the subsidiaries' net assets on the date of acquisition, is capitalized and amortized on a straight-line basis during the expected period to recover the investment, as indicated in Note 12.

The excess amount paid by the Company for the net assets of Brasilcel's subsidiaries includes a portion related with the licenses owned by those subsidiaries. This portion is presented separately from goodwill in the caption "Industrial property and other rights" and is amortized based upon the projected revenues of those subsidiaries, during the corresponding estimated useful lives of those assets.

The UMTS license obtained by TMN and other related intangibles (Note 12) are being amortized on a straight line basis over the remaining period of the license (until 2015), as from May 2004 following the start of operations of the UMTS system.

The amount paid to the Portuguese State for the acquisition of the Basic Network (Note 12) is being amortized on a straight-line basis over the remaining period of the concession (until 2025).

Additionally, this caption includes rental contracts of satellite capacity contracted by TV Cabo (Note 12) which are being amortized over the corresponding period of each contract. These contracts were considered as capital leases.

**f) Pension benefits**

(i) Under the provisions of articles 5, 6 and 7 of Decree-Law 122/94, which were the legal basis for the incorporation of Portugal Telecom in 1994, the employees in service and those retired from the merged companies maintain all the rights and obligations to which they were entitled. Decree Law 219/2000 established that these obligations of Portugal Telecom were transferred to PT Comunicações on its incorporation. Therefore, PT Comunicações has the obligation to grant:

|  | <b>Benefits</b>      |
|--|----------------------|
| To retirees and employees of PT Comunicações coming from and hired by CTT up to May 14, 1992 | Pension              |
| To retirees and employees of PT Comunicações coming from TLP and TDP                         | Supplemental pension |
| To retirees and employees of PT Comunicações coming from and hired by CTT after May 14, 1992 | Not covered          |
| To employees hired directly by Portugal Telecom or PT Comunicações                           | Not covered          |

There are three autonomous pension funds to cover these liabilities, one for each company merged into Portugal Telecom. These pension funds are managed autonomously by the pension fund management companies.

In addition, employees of PT Comunicações hired by Companhia Portuguesa Rádio Marconi, S.A. (a company fully incorporated in PT Comunicações in 2002 "Marconi") until February 1, 1998 have a special social security scheme through Caixa de Previdência do Pessoal da Companhia Portuguesa Rádio Marconi ("Caixa"), an independent entity reporting to the Ministry of Social Security. The employees hired after that date are covered by the Portuguese State Social Security system. PT

Comunicações' liabilities with these employees hired by Marconi are covered by three autonomous Pension Funds.

(ii) Lusomundo Media, through its subsidiary Global Notícias Publicações, S.A. ("Global Notícias" former Diário de Notícias, S.A. and Jornal de Notícias, S.A.) has the obligation to grant a supplemental pension to retirees and employees hired up to 1979 by Diário de Notícias and up to 1994 by Jornal de Notícias.

(iii) PT Sistemas de Informação, S.A. ("PT SI") has the obligation to grant supplemental pensions to employees who were transferred from PT Comunicações.

The amount of the Company's liabilities with respect to pensions and pension supplements of PT Comunicações, Lusomundo Media and PT SI is estimated based on actuarial valuations prepared annually by an independent actuary. The liabilities that are not covered by any existing pension fund are covered by the accrued post retirement liability. Actuarial gains and losses arising from differences between the actuarial assumptions and financial and demographic information collected in the period are recorded in the balance sheet net of the accrued post retirement benefits, and are recognized in the profit and loss statement from the following year, on a straight line basis during the remaining average working life of active employees, in accordance with IAS 19. The adoption of IAS 19 was made since the Company considered that this standard is more adequate than the Portuguese Accounting Directive 19 to reflect the post retirement liabilities.

(iv) Up to December 31, 1999 Telesp Celular, TCO and the companies controlled by Tele Leste and Tele Sudeste were jointly responsible, with the other companies resulting from the Telebrás split, for a pension fund managed by Fundação Sistel de Seguridade Social ("SISTEL"). On December 28, 1999 these companies negotiated conditions for the creation of autonomous pension funds applicable to all active employees of each company and to retired employees after January 31, 2000. This statutory change was approved by the Brazilian Federal Government on January 13, 2000.

As a result of this agreement, Telesp Celular, TCO and the companies controlled by Tele Leste and Tele Sudeste implemented on October 31, 2000 defined contribution plans ("TCP PREV", "TCO PREV" and "Plano de Benefícios Visão Celular", respectively), that provide a supplemental pension, managed by SISTEL, covering the majority of the employees of these companies which will operate through contributions from both the employees and companies. The contributions of the employers for this plan are equivalent to the contributions of the employees, which correspond from 1% up to 9% of the salary based on the percentage chosen by the employee. The costs related with these contribution plans are recorded by the companies on the dates the related contributions are due.

In relation to the active employees previously covered by the SISTEL pension fund, Telesp Celular, TCO and the companies controlled by Tele Leste and Tele Sudeste proposed the migration to their new defined contribution plans which was accepted by 99% of the employees of Telesp Celular and TCO and 94% and 83% of the employees of the companies controlled by Tele Leste and Tele Sudeste, respectively. In relation to the employees that have not accepted the migration and as a result of the split in the SISTEL pension fund described above, Telesp Celular, TCO and the companies controlled by Tele Leste and Tele Sudeste established defined benefit plans ("PBS Telesp Celular", "PBS TCO", "PBS Tele Leste Celular" and "PBS Tele Sudeste Celular", respectively). These companies contribute with amounts determined based on actuarial studies (in accordance with Brazilian actuarial rules) made

by an independent actuary. Presently, the contributions made by these companies correspond to 12% of the employees salaries.

(v) CRT Celular was responsible for a private retirement benefit plan. As this private retirement plan is a multi-employer plan, the related pension costs were recognized when contributions were due. In December 2003, CRT Celular obtained its release from this multi-sponsored plan and established a new defined contribution plan ("Plano de Benefícios Visão CRT"), which will operate through contributions from both the employees and companies. The costs related with this contribution plan are also recorded by the companies on the dates the related contributions are due.

(vi) The individuals employed by the Company's remaining subsidiaries are included in the social security system of each respective country and are not covered by the benefits mentioned above.

**g) Other employee benefits**

(i) In accordance with the terms of Article 8 of Decree-Law 122/94 relating to the harmonization of medical benefits applicable to the employees of PT Comunicações, a medical plan was designed applicable to its employees, active and retired (excluding the employees hired after July 31, 2003 and the employees hired by Marconi), and eligible relatives, which is managed by Portugal Telecom *Associação de Cuidados de Saúde* ("PT-ACS").

The plan referred to above became effective on January 1, 1996. As from that date the health care services previously provided by *Instituto das Obras Sociais* ("IOS") and *Caixa de Previdência do Pessoal dos TLP* ceased to be used.

The following parties contribute to fund this health care plan:

The principal beneficiaries (beneficiaries of one of the aforementioned health schemes) 1.5% of salaries;

Serviço Nacional de Saúde ("SNS") with Euro 281 per beneficiary of the plan; and

Portugal Telecom with the balance required to fully cover the costs.

The retired and active employees of PT Comunicações hired by Marconi up to February 1, 1998 and eligible relatives are also entitled to medical benefits, which are provided through PT-ACS.

Certain employees of PT SI who were transferred from PT Comunicações are also covered by the health care benefits described above.

The health care liabilities and costs are calculated in a similar manner to the pension liabilities and costs referred to above, in accordance with employees past services.



The actuarially determined costs of health care to be provided as from retirement age are recorded in the statement of profit and loss in the caption "Post retirement benefits" and the Company's obligations are recorded in the balance sheet in the caption "Accrued post retirement liability". Actuarial gains and losses arising from differences between the actuarial assumptions and financial and demographic information collected in the period, are recorded in the balance sheet, net of the accrued post retirement benefits, and are recognized in the profit and loss statement from the following year, on a straight line basis during the remaining average working life of active employees, in accordance with IAS 19.

The contributions from SNS and contributions of the employees of PT Comunicações (including the employees hired by Marconi) and PT SI are recorded as reductions in the cost for the year to which they relate.

(ii) The employees of Telesp Celular, TCO and the companies controlled by Tele Leste and Tele Sudeste, together with the employees of the other telecommunications operators in Brazil resulting from the Telebrás split, are entitled to medical benefits through "*Fundo de Assistência Médica Sistel*" ("Sistel Medical Fund"), which is a multi-employer fund. Accordingly, post retirement medical costs are recognized when contributions are due to the fund.

(iii) The individuals employed by the Company's remaining subsidiaries are included in the social security system of each applicable country and are not covered by the benefits mentioned above.

**h) Pre-retirements, early retirements and suspended contracts**

The Company records liabilities for the payment of salaries up to the date of retirement and for pensions, pension supplements and other employee benefits payable after that date, in relation to all employees that are under a suspended contract agreement, that have pre-retired or entered into the early retirement programs (Notes 30.1 and 30.2), at the time that the Company signs the suspended contract, pre-retirement or early retirement benefits to the affected employees.

**i) Vacation pay and bonuses**

The Company provides an accrual at the end of each period for bonuses and vacation earned but not yet paid.

**j) Current classification**

Assets to be realized and liabilities to be settled within one year from the date of the balance sheet are classified as current.

**k) Grants and subsidies for fixed assets**

Grants and subsidies received from the Portuguese Government and from European Union entities to finance the acquisition of fixed assets are accounted for as deferred income and recognized in profit and loss over the useful lives of the related assets.

**l) Own work capitalized (Self constructed assets)**

The value of works performed for own purposes and capitalized as part of fixed assets is included as a reduction in operating expenses. These works, which consist mainly of additions to telecommunications and other installations, are stated at the direct cost of labor, materials and services rendered by outside contractors, but do not include overhead allocations and financing costs.

**m) Leases**

Fixed assets acquired under long-term lease contracts are recorded as capital leases, if they meet the criteria to be classified as such. The leased assets are recorded at the lower of the present value of the lease payments or the fair value of the leased assets at the time the arrangement commences and the corresponding liability is recognized in the balance sheet. The leased assets are depreciated over their estimated useful lives and the interest component of the lease payment is expensed in the period to which it relates, using the effective interest method.

**n) Statements of cash flows**

The statements of cash flows are prepared in accordance with Portuguese GAAP, using the direct method. This methodology is also consistent with IAS 7, except for: (i) the classification related with the balance of "Cash and cash equivalents" from companies acquired or sold during the period; and (ii) the classification of treasury debt as a reduction of "Cash and cash equivalents". Under IAS 7, the balance of "Cash and cash equivalents" of such companies should be classified as "Cash from investing activities", while under Portuguese GAAP it appears as changes in consolidation.

The statements of cash flows present the annual cash flows of the Company and the cash and cash equivalents at period end. The Company classifies all highly liquid investments purchased with original maturity of three months or less as cash and cash equivalents. Cash flows are classified as to whether they relate to operating, investing or financing activities.

Cash flows from operating activities include collections from clients, payments to suppliers, payments to personnel and other collections and payments relating to operating activities.

Cash flows used in investing activities include the acquisitions and disposals of investments in associated companies and the purchase and sale of property, plant and equipment.

Cash flows from financing activities include the following: (i) borrowings and repayments of debt; (ii) acquisition and sale of treasury securities; and (iii) payments of dividends to shareholders.

**o) Provision for income taxes**

Portugal Telecom, PT Multimédia and Lusomundo Media adopted the tax consolidation regime in Portugal. The provision for income taxes is determined on the basis of the estimated taxable income for all the companies covered by this regime (all 90% or more owned Portuguese subsidiaries). The remaining group companies, not covered by the tax consolidation regimes of Portugal Telecom, PT Multimédia or Lusomundo Media, are taxed individually based on their respective taxable income, at the applicable tax rates.

The Company adopted in 2000 the Accounting Directive No. 28 related with the computation of the income tax provision and the recognition of deferred taxes. As a result, the Company recognized deferred tax assets and liabilities (Note 29) for differences between the financial reporting and the tax basis of assets and liabilities at each reporting date related to differences arising from Portuguese financial reporting and tax reporting methodologies. Deferred tax assets are recorded only when management believes that these deferred tax assets will be realized to offset future taxable income or deferred tax liabilities.

Income taxes, either current or deferred, arising from transactions or events recognized directly in shareholders' equity are recorded in the same caption.

**p) Financial instruments and risk management**

Financial instruments include basically interest rate and currency swap agreements to hedge the impact of changes in interest rates and currency rates on certain of the Company's long-term borrowings denominated in foreign currencies (Note 31).

Gains or losses from financial instruments which are hedging the above mentioned risks or certain assets or liabilities, are recorded symmetrically to the losses or gains arising from the related assets or liabilities. In the case that financial instruments are not hedging any risk, asset or liability, they are recorded based on their fair value at the balance sheet date; gains or losses arising from the change in the fair value of these financial instruments are recorded in the income statement of the period in which they occur.

Up-front premiums or expenses, received or paid, in connection with derivatives contracted by the Company are recognized in results on a straight line basis during the maturity period of those derivatives.

**q) Recognition of operating revenues and related expenses**

Revenues from telephone and other telecommunications services are recognized when earned. Billings for these services are made on a monthly basis throughout the month. Unbilled revenues from the billing cycle up to the end of each month are estimated based on the previous months' traffic and are accrued at the end of the month. Differences between estimated and actual unbilled revenues, which have not been significant, are recognized in the following period.

Operating revenues are reported on a gross basis, with the compensations paid to other telecommunications carriers being accounted for as operating expenses (Note 23) in the same period the revenue is earned.

Revenues from telephone line rentals are recognized in the period to which they apply. Unbilled revenues relating to these rentals are accrued at the end of the period.

Revenues from mobile telephony services result essentially from: (i) fee for use of wireless network; (ii) interconnection fees; (iii) roaming; and (iv) pre-paid phone cards. These service revenues are recognized on the month the service is provided. In relation to the pre-paid phone cards, income is recognized for the pre-paid minutes of traffic used.

Revenues from the sale of terminal telecommunications equipments and the corresponding cost are recognized at the moment of sale.

Revenues from cable and satellite television services result essentially from: (i) amounts invoiced relating to monthly subscriptions for use of the service; (ii) advertising placed in the cable television channels; and (iii) rental and sale of equipment. Revenues from monthly subscriptions and installation are recognized in the period the services are rendered to the clients. Revenues from advertising are recognized in the period the advertising is inserted. Revenues from the rental of equipment are recognized in the period it is rented and revenues from the sale of equipment are recognized at the moment of sale.

Revenues from ISP services result essentially from monthly subscriptions, the provision of access to the internet and telephone traffic generated by clients upon usage of the services. These revenues are recognized when invoiced.

PT Comunicações, S.A. has a contract with Páginas Amarelas, S.A. through which the latter is responsible for the production, publishing and distribution of its telephone directories, as well as selling advertising space in the directories. The total cost to be paid by PT Comunicações for such services is set to be a fixed 64% of its gross revenues from the sale of advertising space in telephone directories. This cost is initially recorded as a prepaid expense and then recorded in earnings on a straight-line basis during a one-year period corresponding to the life of each directory.

The revenues from the sale of advertising space in our telephone directories are invoiced directly by PT Comunicações to its corporate customers for a one-year advertising period, the life of each directory. These revenues are recorded in earnings on a straight line basis during the life period of the directory.

Advertising revenues from telephone directories and related costs are recognized in the period in which the directories are effective.

Advertising revenues from publications of newspapers and magazines are recognized in the period in which the advertising is inserted.

Revenues derived from the sale of newspapers and magazines are recognized at the moment of sale, except for subscriptions fees where revenues are deferred over the subscription period.

Revenues from the exhibition of films results from the sale of cinema tickets and revenues from the distribution of films results from the sale to other cinema operators of distribution rights acquired by Lusomundo Audiovisuais from film distributors or makers. These revenues are recognized in the period of the exhibition or in the period of the sale of the rights.

**r) International telecommunications services**

Fees from international telecommunications services are remitted to operators in the country in which calls are terminated based on the traffic records of the country of origin and rates established in agreements between the telecommunications operators. The operator of the country of origin of the traffic is responsible for crediting the operator of the destination country and, if applicable, the operators of the transit countries. In circumstances in which PT Comunicações is the originator of an

international telecommunications service, PT Comunicações recognizes the amounts remitted to international operators as a cost, and records revenues for the gross amounts billed. In instances in which PT Comunicações terminates an international call, the Company records only the net amount received from the originating carrier as revenues.

**s) Foreign currency transactions and balances**

Transactions denominated in foreign currencies are translated to Euros at the rates of exchange prevailing at the time the transactions are made. At the balance sheet date, assets and liabilities denominated in foreign currencies are adjusted to reflect the exchange rates published by "Banco de Portugal" (Central Bank) prevailing at such date. The resulting gains or losses on foreign exchange transactions are credited or charged to the profit and loss statement, except for unrealized exchange differences on long term intra-group balances, representing an extension of the related investments and where settlement is not expected in the foreseeable future, which are recorded in shareholders' equity in a specific caption in accordance with IAS 21.

The financial statements of subsidiaries operating in other countries are translated to Euros, using the following exchange rates:

Assets and liabilities: exchange rates prevailing at the balance sheet date;

Profit and loss statement: period average exchange rates;

Share capital, reserves and retained earnings: historical exchange rates; and

Cash flow statement: annual average exchange rates for cash flows where these rates are closer to the effective exchange rates; in the remaining cash flows the exchange rate of the day of operation is used.

The effect of translation differences is recorded in shareholders' equity under the specific caption "Cumulative foreign currency translation adjustments".

**4. Translation of Euro to United States Dollar Amounts**

The financial statements are stated in Euros. The translation of the Euro amounts to United States Dollars is included solely for the convenience of the readers, using the noon buying rate certified for customs purposes by the Federal Reserve Bank of New York as of June 22, 2005, which was Euro 1 to US\$ 1.2130. The convenience translations should not be assumed as representations that Euro amounts have been, could have been, or could in the future be, converted into United States Dollars at this or any other rate of exchange.

**5. Short term investments**

This caption consists of:

|   | <u>2004</u>                 | <u>2003</u>                 |
|---|-----------------------------|-----------------------------|
| Short-term treasury applications:                   |                             |                             |
| Denominated in local currency(i)                    | 1,393,099,961               | 2,089,377,517               |
| Other currencies(ii)                                | 105,812,964                 | 182,829,609                 |
|   | <u>1,498,912,925</u>        | <u>2,272,207,126</u>        |
| Less: Provision for marketable securities (Note 28) |                             | (19,066)                    |
|   | <u><b>1,498,912,925</b></u> | <u><b>2,272,188,060</b></u> |

- 
- (i) As of December 31, 2003 this caption included Euro 208,025,245 corresponding to 50% of a loan granted to TCP, denominated in local currency, which was not eliminated with the proportional consolidation of VIVO. This loan was repaid in November 2004.
- (ii) As of December 31, 2003 this caption included Euro 83,135,392 corresponding to 50% of the loans granted to TCP, denominated in U.S. Dollars, which was not eliminated with the proportional consolidation of VIVO. During 2004, an amount of Euro 33,559,504 was repaid and at year-end the loans outstanding amount to Euro 44,049,629.
- As of December 31, 2004 and 2003 this caption also included Euro 39,828,143 and Euro 72,986,139, respectively, related with financial instruments contracted by Brasilcel's subsidiaries, which currently are not covering any specific risk and, accordingly, are recorded at fair value. During 2004 some of these financial instruments were cancelled (approximately Euro 33 million).

**6. Trade Receivables**

This caption consists of:

|   | <b>2004</b>                 | <b>2003</b>                 |
|---|-----------------------------|-----------------------------|
|   | <u>                    </u> | <u>                    </u> |
| <b>Third parties</b>  |                             |                             |
| Accounts receivable from customers                            | 1,077,867,979               | 1,051,761,281               |
| Doubtful accounts receivable                                  | 260,755,168                 | 297,345,299                 |
| Notes receivable  | 154,292                     | 211,130                     |
| Unbilled revenues   | 192,230,090                 | 157,976,832                 |
|   | <u>                    </u> | <u>                    </u> |
|   | 1,531,007,530               | 1,507,294,542               |
| Less: Provision for doubtful accounts receivable<br>(Note 28) | (364,802,804)               | (389,281,397)               |
|   | <u>                    </u> | <u>                    </u> |
|   | <b>1,166,204,726</b>        | <b>1,118,013,145</b>        |
|   | <u>                    </u> | <u>                    </u> |

The Company grants credit, in the normal course of business, to governmental and individual customers and, in the case of outbound traffic, to international telecommunications companies. As of December 31, 2004 and 2003 there were no significant concentrations of credit risk.

The Company classifies as doubtful specific accounts receivable balances overdue from customers. As these balances, together with other balances classified as accounts receivable from customers, are not fully collectible, the provision for doubtful accounts receivable reasonably covers the estimated losses relating to those balances.

**7. Other Receivables and Other Non-Current Assets**

These captions consist of:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| <b>OTHER RECEIVABLES</b>                                   |                    |                    |
| Third parties  |                    |                    |
| Accounts receivable from public entities                   |                    |                    |
| Value added tax  | 21,827,386         | 17,427,292         |
| Income tax receivable (Note 16)                            | 2,671,827          | 3,232,311          |
| Other tax receivable                                       | 2,613,264          | 2,182,043          |
|  | <b>27,112,477</b>  | <b>22,841,646</b>  |
| Accounts receivable from foreign public entities(1)        | 153,671,149        | 98,392,064         |
| Discounts given to retired Portuguese citizens (Note 33.c) | 47,597,244         | 49,657,701         |
| Interest to be received                                    | 38,010,025         | 40,273,623         |
| Contribution from SNS(Note 3.g)                            | 20,786,447         | 19,051,992         |
| Advances to suppliers                                      | 22,016,616         | 19,141,681         |
| Other billing  | 6,760,692          | 8,696,276          |
| Funds from European Union                                  | 3,923,129          | 10,360,925         |
| Unbilled revenues  | 3,451,657          | 7,183,739          |
| Other  | 114,933,090        | 108,223,695        |
|  | <b>411,150,049</b> | <b>360,981,696</b> |
| Less: Provision for doubtful accounts receivable (Note 28) | (15,873,011)       | (18,448,447)       |
|  | <b>395,277,038</b> | <b>342,533,249</b> |
| Total third party receivables                              | <b>422,389,515</b> | <b>365,374,895</b> |
| Affiliated companies                                       |                    |                    |
| Subsidiaries of Brasilcel(2)                               | 17,821,820         | 24,973,763         |
| Médi Telecom   | 5,026,385          | 4,098,025          |
| Other  | 10,950,770         | 4,838,761          |
| Total receivables from affiliated companies                | <b>33,798,975</b>  | <b>33,910,549</b>  |
| <b>OTHER NON-CURRENT ASSETS</b>                            |                    |                    |
| Taxes receivable(3)  | 62,623,744         | 22,922,839         |
| Mobile clients retention plans(4)                          | 5,853,721          | 7,959,954          |
| Interest paid in advance(5)                                | 4,907,808          | 7,642,938          |
| Maintenance and repairs                                    | 1,521,993          | 2,433,275          |
| Other  | 24,744,145         | 29,566,858         |
|  | <b>99,651,411</b>  | <b>70,525,864</b>  |
| Less: Provision for doubtful accounts receivable (Note 28) | (3,598,842)        | (2,000,060)        |
|  | <b>96,052,569</b>  | <b>68,525,804</b>  |



- (1) As of December 31, 2004 this caption includes Euro 147,995,529 related with 50% of direct and indirect taxes to be recovered by Brasilcel's subsidiaries.

F-23

---

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- (2) This caption corresponds to 50% of the balances receivable from subsidiaries of Brasilcel, which are not eliminated in the proportional consolidation of these subsidiaries.
- (3) As of December 31, 2004 and 2003 this caption relates to 50% of direct and indirect taxes to be recovered by Brasilcel's subsidiaries in more than one year.
- (4) This caption corresponds to direct costs related to contracts entered into with mobile clients. These costs are expensed during the period of the respective contracts.
- (5) This caption corresponds to expenses incurred in connection with certain loans obtained by the Company, which will be expensed during the maturity period of the respective loans.

**8. Inventories**

This caption consists of:

|   | <u>2004</u>        | <u>2003</u>        |
|---|--------------------|--------------------|
| Merchandise   | 182,979,978        | 108,321,329        |
| Raw materials and consumables   | 19,514,308         | 15,700,420         |
| Work-in-process   | 6,263,690          | 5,951,195          |
| Advances for purchases  | 128,950            | 356,088            |
|   | <u>208,886,926</u> | <u>130,329,032</u> |
| Less: Provision for obsolete and slow moving inventories<br>(Note 28) | (31,789,805)       | (27,444,050)       |
|   | <u>177,097,121</u> | <u>102,884,982</u> |

**9. Prepaid Expenses and Other Current Assets**

This caption consists of:

|   | <u>2004</u>        | <u>2003</u>        |
|---|--------------------|--------------------|
| Telephone directories   | 47,208,585         | 50,674,110         |
| Mobile clients retention plans(1)   | 32,439,005         | 32,093,416         |
| Advances for the acquisition of distribution rights for the<br>exhibition of movies in Portugal | 14,435,959         | 12,756,002         |
| Rents   | 6,544,606          | 6,071,809          |
| ICMS(2)   | 6,469,692          | 6,025,514          |
| Interest paid in advance(3)   | 5,255,592          | 7,288,011          |
| Advances to employees   | 2,411,039          | 2,287,207          |
| Other   | 38,882,439         | 23,045,820         |
|   | <u>153,646,917</u> | <u>140,241,889</u> |

(1)

This caption includes certain expenses relating to client retention plans of TMN and Vivo which are expensed during the period of the respective contracts.

F-24

---

- (2) This caption corresponds to 50% of the deferred value added taxes by Brasilcel's subsidiaries.
- (3) This caption corresponds to expenses incurred in connection with certain loans obtained by the Company, which will be expensed during the maturity period of the respective loans.

**10. Investments, net**

This caption consists of:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| Loans granted to associated companies and other companies(i)   | 297,963,869        | 250,295,256        |
| Investments in associated companies(ii)  | 108,122,553        | 157,988,308        |
| Investments in other companies:  |                    |                    |
| Banco Espirito Santo, SA. ("BES")  | 55,300,000         | 55,300,000         |
| Intelsat   | 13,127,252         | 13,127,252         |
| Grupo Media Capital, SGPS, S.A. ("Media Capital")(1)   | 6,960,000          |                    |
| Cypress Entertainment, Inc.(2)   | 3,016,754          | 3,016,754          |
| INESC Instituto de Engenharia de Sistemas e Computadores ("INESC")   | 2,992,787          | 2,992,787          |
| Telefónica de España, S.A.   | 2,156,034          | 2,156,034          |
| Tagusparque-Sociedade de Promoção e Desenvolvimento do Parque de<br>Ciência e Tecnologia da Área de Lisboa, S.A. | 1,296,875          | 1,296,875          |
| New Skies Satellites, NV(3)  |                    | 4,674,500          |
| Eutelsat(3)  |                    | 3,055,710          |
| Other  | 4,255,141          | 3,531,217          |
| Real estate investments  | 54,248,363         | 30,194,199         |
| Advances for investments   | 2,185,233          | 1,688,320          |
| Other long-term investments  | 848,144            | 1,086,480          |
|  | <b>552,473,004</b> | <b>530,403,692</b> |
| Less: Amortization for investments   | (25,835,340)       | (12,195,806)       |
| Less: Provision for investments (Note 28)  | (94,024,988)       | (70,128,694)       |
|  | <b>432,612,676</b> | <b>448,079,192</b> |

- (1) During 2004, Portugal Telecom acquired a 1.93% interest in Media Capital, for an amount of Euro 6,960,000 (Exhibit II).
- (2) The investment in this company is fully provided for.
- (3) These companies were sold in 2004.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- (i) Loans granted to associated companies and other companies are basically to finance its operations and to develop new businesses, and consist of:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
|  | <b>_____</b>       | <b>_____</b>       |
| UOL, Inc ("UOL")(1)  | 77,989,260         | 84,108,607         |
| Sport TV Portugal, S.A. ("Sport TV")                             | 66,213,937         | 17,475,958         |
| Médi Telecom, S.A. ("Médi Telecom")                              | 64,442,408         | 64,699,898         |
| Sportinveste Multimédia, SGPS, S.A. ("Sportinvest")(2)           | 35,318,668         | 29,318,668         |
| Idealyze, S.A. ("Idealyze")(3)                                   | 29,420,510         | 31,728,959         |
| Web-Lab, SGPS, S.A. ("Web-Lab")                                  | 6,684,761          | 4,886,562          |
| Marconi Suisse Telecommunications, S.A.R.L. ("Marconi Suisse")   | 5,732,692          | 2,502,684          |
| INESC  | 3,292,066          | 3,292,066          |
| Sportstat Informação Desportiva Independente, Lda. ("Sportstat") | 1,610,068          | 1,610,068          |
| EJV Plataforma de Comércio Electrónico, S.A. ("EJV")(4)          |                    | 5,422,112          |
| Other  | 7,259,499          | 5,303,269          |
|  | <b>_____</b>       | <b>_____</b>       |
|  | <b>297,963,869</b> | <b>250,348,851</b> |
|  | <b>_____</b>       | <b>_____</b>       |

- (1) This loan corresponds to 6,017,141 convertible bonds issued by UOL, which were subscribed for by the Company during 2002. As of December 31, 2004 there is a provision of Euro 39,371,875 to cover risks related with the recoverability of these bonds. In addition, there is a provision of Euro 18,432,125 regarding the Company's share in the accumulated losses of UOL, as presented below in this Note. As a result, the company's exposure to the investment in UOL amounts to approximately Euro 20 million as of December 31, 2004.
- (2) This caption includes Euro 30,023,168 of additional paid-in capital contributions (Note 32.f) and Euro 5,295,500 of shareholders loans granted to this affiliated company.
- (3) This loan is fully provided for.
- (4) This company was merged into PT.com during 2004.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- (ii) Investments in associated companies (with a positive equity position), accounted for by the equity method except where otherwise stated, consist of:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| Unitel, S.A. ("Unitel")  | 28,461,383         | 14,160,640         |
| CTM Companhia de Telecomunicações de Macau, SARL ("CTM")                               | 27,965,749         | 31,509,064         |
| Warner Lusomundo Sogecable Cines de España, S.A.                                       | 7,603,000          | 8,054,333          |
| Idealyze(1)  | 7,417,741          | 7,417,741          |
| Banco Best, S.A.   | 7,362,700          | 10,420,519         |
| Lisboa TV Informação e Multimédia, S.A.  | 5,572,558          | 4,631,845          |
| Páginas Amarelas, S.A. ("Páginas Amarelas")  | 5,149,371          | 3,353,544          |
| Guiné Telecom Companhia de Telecomunicações da Guiné-Bissau, SARL ("Guiné Telecom")(1) | 3,716,555          | 3,716,555          |
| Vasp Sociedade de Transporte e Distribuição, Lda. ("Vasp")                             | 2,019,110          | 1,414,445          |
| Hungaro Digitel KFT (HDT)  | 1,990,635          | 1,677,245          |
| Simarc Promoções Imobiliárias, S.A. ("Simarc")(2)                                      |                    | 30,385,669         |
| Lusomundo Sociedade de Investimentos Imobiliários, SGPS, S.A.(2)                       |                    | 16,034,501         |
| Web-Lab(3)   |                    | 8,192,526          |
| BancoI.net, S.A. ("BancoI.net")(4)   |                    | 3,742,997          |
| Naveprinter, S.A.(2)   |                    | 3,111,239          |
| Previsão Sociedade Gestora de Fundos de Pensões, S.A. ("Previsão")(5)                  |                    | 1,531,864          |
| TPT-Telecomunicações Públicas de Timor, S.A.(2)  |                    | 1,316,726          |
| Other  | 10,863,751         | 7,316,855          |
|  | <b>108,122,553</b> | <b>157,988,308</b> |

- (1) As of December 31, 2004 the investments in these associated companies are not recorded by the equity method, as they are fully provided for.
- (2) These companies were fully consolidated as of December 31, 2004.
- (3) At the end of 2004, Portugal Telecom increased its interest in Web-Lab to 90% of its share capital (Exhibit II) and, as a result, the investment in this company in 2004 was recorded by the equity method of accounting. As of December 31, 2004 the investment in Web-Lab is recorded under "Provision for losses in affiliated companies", since it has a negative equity position. At December 31, 2003 this investment was fully provided for.
- (4) This company was sold during 2004 (Exhibit II).
- (5) During 2004, the Company increased its interest in Previsão to 78.12% of its share capital and, as a result, this company was fully consolidated as of December 31, 2004 (Exhibit II).

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

As described in Note 2.a), investments in associated companies with a negative equity position are recorded under "Provision for losses in affiliated companies". As of December 31, 2004 and 2003 this provision amounts to Euro 129,315,472 (Note 18) and is made up as follows:

|                              | <b>2004</b>        | <b>2003</b>       |
|------------------------------|--------------------|-------------------|
| Sport TV                     | 43,945,196         | 28,544,528        |
| Médi Telecom                 | 38,225,006         | 33,240,081        |
| UOL                          | 18,432,125         | 22,048,099        |
| Web-Lab(1)                   | 14,864,355         |                   |
| Marconi Suisse               | 4,763,659          | 2,564,064         |
| TV Cabo Macau, S.A.          | 2,551,594          | 1,205,689         |
| Tradecom International, N.V. | 1,968,387          | 1,259,761         |
| Sportstat                    | 1,439,496          | 1,405,945         |
| Other                        | 3,125,654          | 9,389,299         |
|                              | <b>129,315,472</b> | <b>99,657,466</b> |

(1)

As described above, the investment in Web-Lab was only recorded by the equity method of accounting starting January 1, 2004.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

During the years ended December 31, 2004, 2003 and 2002 equity accounting in earnings and losses of affiliated companies is made up as follows:

|   | <u>2004</u>                | <u>2003</u>              | <u>2002</u>               |
|---|----------------------------|--------------------------|---------------------------|
| <b>Losses:</b>                                    |                            |                          |                           |
| Médi Telecom                                      | 5,553,004                  | 24,923,719               | 55,508,346                |
| Banco Best  | 3,094,000                  | 3,502,000                | 3,630,865                 |
| TV Cabo Macau                                     | 1,538,934                  | 2,168,055                | 2,691,976                 |
| Sport TV  | 834,032                    | 5,053,730                | 7,163,244                 |
| Tradecom International, N.V.                      | 738,913                    | 1,554,947                | 4,295,880                 |
| Global Telecom(1)                                 |                            |                          | 88,641,563                |
| PrimeSys, S.A. (PrimeSys)(2)                      |                            |                          | 5,401,078                 |
| Other   | 5,047,735                  | 7,452,613                | 18,863,184                |
|   | <u>16,806,618</u>          | <u>44,655,064</u>        | <u>186,196,136</u>        |
| <b>Earnings:</b>                                  |                            |                          |                           |
| Unitel  | 16,820,236                 | 6,457,074                | 3,597,925                 |
| CTM   | 11,379,327                 | 13,080,811               | 14,468,022                |
| Mascom Wireless Proprietary Limited ("Mascom")(3) | 7,561,155                  |                          |                           |
| Páginas Amarelas                                  | 3,526,629                  | 3,037,003                | 4,165,056                 |
| UOL(4)  | 1,735,353                  |                          |                           |
| Other   | 3,505,900                  | 2,923,501                | 3,091,783                 |
|   | <u>44,528,600</u>          | <u>25,498,389</u>        | <u>25,322,786</u>         |
|   | <u><b>(27,721,982)</b></u> | <u><b>19,156,675</b></u> | <u><b>160,873,350</b></u> |

- (1) Pursuant to the acquisition by TCP on December 27, 2002 of a controlling position in Global Telecom and the contribution of Portugal Telecom's investments in Brazilian mobile telecommunications companies to Brasilcel, this company has been proportionally consolidated since January 1, 2003.
- (2) After July 1, 2002 this company has been fully consolidated.
- (3) During 2004, Mascom was excluded from full consolidation, as the investment in this subsidiary was in the process of being sold only pending regulatory approval from the Botswana authorities. This approval was granted in September 2004. During the first nine months of 2004, this company was consolidated by the equity method of accounting (Exhibit II).
- (4) During 2004, Portugal Telecom increased its interest in UOL and, as result, the investment in this associated company was recorded by the equity method of accounting.



**11. Fixed Assets**

This caption consists of:

December 31, 2004

|                                       | Cost or<br>restated<br>values | Accumulated<br>Depreciation | Net book<br>value    |
|---------------------------------------|-------------------------------|-----------------------------|----------------------|
| Land                                  | 98,665,850                    | 12,641,436                  | 86,024,414           |
| Buildings and other constructions     | 1,010,280,304                 | 557,984,837                 | 452,295,467          |
| Network installations and equipment   | 5,740,339,452                 | 3,868,504,823               | 1,871,834,629        |
| Switching equipment                   | 2,301,311,278                 | 1,848,025,931               | 453,285,347          |
| Telephones, switchboards and other    | 668,126,193                   | 355,603,465                 | 312,522,728          |
| Submarine cables                      | 261,013,291                   | 119,655,532                 | 141,357,759          |
| Satellite stations                    | 61,474,179                    | 60,681,377                  | 792,802              |
| Other telecommunications equipment    | 1,039,721,278                 | 752,222,391                 | 287,498,887          |
| Other basic equipment                 | 189,643,394                   | 106,283,438                 | 83,359,956           |
| Transportation equipment              | 62,619,195                    | 37,397,694                  | 25,221,501           |
| Tools and dies                        | 18,946,431                    | 16,764,528                  | 2,181,903            |
| Administrative equipment              | 850,003,596                   | 701,448,734                 | 148,554,862          |
| Other tangible fixed assets           | 69,103,113                    | 54,187,820                  | 14,915,293           |
| Construction in progress              | 182,754,242                   |                             | 182,754,242          |
| Advances to suppliers of fixed assets | 260,486                       |                             | 260,486              |
|                                       | <b>12,554,262,282</b>         | <b>8,491,402,006</b>        | <b>4,062,860,276</b> |

F-30

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

December 31, 2003

|                                       | Cost or<br>restated<br>values | Accumulated<br>Depreciation | Net book<br>value    |
|---------------------------------------|-------------------------------|-----------------------------|----------------------|
| Land                                  | 95,394,159                    | 13,203,045                  | 82,191,114           |
| Buildings and other constructions     | 892,553,549                   | 484,404,549                 | 408,149,000          |
| Network installations and equipment   | 5,212,181,367                 | 3,335,410,458               | 1,876,770,909        |
| Switching equipment                   | 2,283,107,233                 | 1,734,293,826               | 548,813,407          |
| Telephones, switchboards and other    | 847,422,769                   | 493,501,942                 | 353,920,827          |
| Submarine cables                      | 264,134,524                   | 106,673,232                 | 157,461,292          |
| Satellite stations                    | 61,686,679                    | 60,199,100                  | 1,487,579            |
| Other telecommunications equipment    | 1,079,846,086                 | 733,751,467                 | 346,094,619          |
| Other basic equipment                 | 126,230,474                   | 77,622,073                  | 48,608,401           |
| Transportation equipment              | 54,479,713                    | 36,602,246                  | 17,877,467           |
| Tools and dies                        | 18,563,005                    | 16,390,291                  | 2,172,714            |
| Administrative equipment              | 862,152,069                   | 661,311,307                 | 200,840,762          |
| Other tangible fixed assets           | 64,489,260                    | 51,464,199                  | 13,025,061           |
| Construction in progress              | 209,991,608                   |                             | 209,991,608          |
| Advances to suppliers of fixed assets | 553,278                       |                             | 553,278              |
|                                       | <b>12,072,785,773</b>         | <b>7,804,827,735</b>        | <b>4,267,958,038</b> |

Fixed assets, net by geographic area are as follows:

|                       | 2004                 | 2003                 |
|-----------------------|----------------------|----------------------|
| Domestic market       | 3,078,752,942        | 3,269,888,319        |
| International market: |                      |                      |
| Brazil                | 918,071,511          | 887,590,706          |
| Other                 | 66,035,823           | 110,479,013          |
|                       | <b>4,062,860,276</b> | <b>4,267,958,038</b> |

Submarine cables represent the Company's pro-rata share of the submarine cable circuits jointly constructed, operated, maintained and owned with other telecommunications operators located in other countries, based on the respective contracts and/or construction and maintenance agreements.

Depreciation charged to operations during the years ended December 31, 2004 and 2003 amounted Euro 818,888,679 and Euro 863,451,434, respectively.

As a result of technological enhancements and urban improvements, the Company retired some fixed assets in the years ended December 31, 2004 and 2003. The losses recorded as a result of those retirements amounted to Euro 3,631,366 and Euro 4,176,106, respectively (Note 26).

In previous years PT Comunicações, PT Prime, TV Cabo and TMN contracted cross border leases, which comprised the sale of certain telecommunications equipments to foreign entities for an amount of Euro 771,637,016. Simultaneously, those entities made leasing contracts of the equipment with special purpose entities, which made conditional sale agreements to sell the related equipments to PT

Comunicações, PT Prime, TV Cabo and TMN, by an amount equivalent to the value of the initial sale. Group companies maintained the legal ownership of the those equipments, continuing to be able to sell or substitute any equipment. These transactions correspond to an operation of sale and lease back and, in accordance with Portuguese GAAP, the sale of the equipment was not recorded and the equipment continued to be recorded in the Company's consolidated balance sheet.

## 12. Intangible Assets

This caption consists of:

### December 31, 2004

|                                      | Cost                 | Accumulated<br>Amortization | Net book<br>value    |
|--------------------------------------|----------------------|-----------------------------|----------------------|
| Goodwill                             | 1,690,967,518        | 280,581,279                 | 1,410,386,239        |
| Industrial property and other rights | 2,064,141,119        | 340,480,289                 | 1,723,660,830        |
| Research and development costs       | 82,461,046           | 55,359,084                  | 27,101,962           |
| Incorporation expenses               | 30,247,688           | 22,618,751                  | 7,628,937            |
| Other intangibles                    | 11,853,363           | 5,471,663                   | 6,381,700            |
| In-progress intangibles              | 37,695,235           |                             | 37,695,235           |
|                                      | <b>3,917,365,969</b> | <b>704,511,066</b>          | <b>3,212,854,903</b> |

### December 31, 2003

|                                      | Cost                 | Accumulated<br>Amortization | Net book<br>value    |
|--------------------------------------|----------------------|-----------------------------|----------------------|
| Goodwill                             | 1,466,990,764        | 182,831,526                 | 1,284,159,238        |
| Industrial property and other rights | 1,910,209,538        | 241,833,618                 | 1,668,375,920        |
| Incorporation expenses               | 86,048,875           | 76,341,814                  | 9,707,061            |
| Research and development costs       | 66,706,649           | 39,633,780                  | 27,072,869           |
| Other intangibles                    | 12,139,734           | 3,689,400                   | 8,450,334            |
| In-progress intangibles              | 152,356,963          |                             | 152,356,963          |
|                                      | <b>3,694,452,523</b> | <b>544,330,138</b>          | <b>3,150,122,385</b> |

As of December 31, 2004, the caption "Industrial property and other rights" includes certain intangible assets related with concessions or licenses held by subsidiaries which are being amortized as described in Note 3.e), as follows:

(a)

Euro 339,964,723 related to the acquisition of the ownership of the Basic Network from the Portuguese State. This amount corresponds to the difference between the amount paid in 2002 (Euro 365 million) and: (i) the concession rent of 2002 (Euro 16,604,413), which was still recorded in the income statement as a cost of the year 2002; and (ii) the gain obtained from a cross border lease operation (Euro 8,430,864) made in 2003 with equipment allocated to the basic network, as this gain was considered in the determination of the value attributable to the basic network.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- (b) Euro 992,058,080 related with 50% of the value allocated to the band A licenses owned by VIVO's subsidiaries (Note 3.e)), and Euro 135,070,208 related to 50% of the cost of mobile telecommunications licenses obtained by Global Telecom and TCO to operate in certain Brazilian states.
- (c) Euro 99,759,579 related with a UMTS license obtained by TMN and an amount of Euro 33,333,333 paid to Oniway in connection with an agreement signed in 2002 between that company and the others three mobile operators in Portugal (including TMN). These intangibles were included in the caption "In-progress intangibles" as of December 31, 2003, but with the beginning of the UMTS operations in May 2004 they were transferred to the caption "Industrial property and other rights".
- (d) Euro 106,769,032 related with rental contracts of satellite capacity signed by TV Cabo in the second half of 2004, which have a maturity of 12 years and were considered as capital leases.

Intangible assets, net by geographic area are as follows:

|                       | <u>2004</u>          | <u>2003</u>          |
|-----------------------|----------------------|----------------------|
| Domestic market       | 1,376,701,844        | 1,319,887,830        |
| International market: |                      |                      |
| Brazil                | 1,832,838,693        | 1,827,700,956        |
| Other                 | 3,314,366            | 2,533,599            |
|                       | <u>3,212,854,903</u> | <u>3,150,122,385</u> |

Amortization charged to operations, excluding amortization of goodwill, in the years ended December 31, 2004 and 2003 amounted to Euro 138,448,792 and Euro 90,526,958, respectively.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Goodwill, net of accumulated amortization, is related with the acquisition of the following investments:

|  | 2004                 | 2003                 |
|--|----------------------|----------------------|
| VIVO(1)  | 610,920,846          | 463,143,545          |
| Wireline business:   |                      |                      |
| PT.com (ISP and Portals businesses)                          | 153,950,736          | 162,624,017          |
| PT Comunicações (international carrier business)             | 68,758,535           | 75,634,389           |
| PT Prime (Data & Corporate business)                         | 30,435,654           | 32,126,523           |
| Other  | 293,341              | 1,003,014            |
|  | 253,438,266          | 271,387,943          |
| PT Multimédia:   |                      |                      |
| Pay TV and Cable Internet(2)                                 | 187,965,579          | 176,647,950          |
| Audiovisuals:  |                      |                      |
| Lusomundo Audiovisuais, S.A. ("Lusomundo Audiovisuais")      | 62,717,816           | 66,577,374           |
| Lusomundo Cinemas, S.A. ("Lusomundo Cinemas")                | 36,606,543           | 38,751,006           |
| Media:   |                      |                      |
| Lusomundo Serviços, SGPS, S.A. ("Lusomundo Serviços")        | 85,293,080           | 90,541,885           |
| Global Notícias Publicações, S.A. ("Global Notícias")        | 13,064,974           | 14,694,252           |
| Lusomundo Media, SGPS, S.A. ("Lusomundo Media")              | 7,618,540            | 8,041,793            |
| Ocasião Edições Periódicas, S.A.                             | 4,946,105            |                      |
| Rádio Press Comunicação e Radiodifusão, S.A. ("Rádio Press") | 1,729,289            | 1,930,245            |
| Vasp Sociedade de Transporte e Distribuição, S.A. ("Vasp")   | 1,226,475            | 1,717,064            |
| Other  | 2,035,915            | 1,054,055            |
|  | 403,204,316          | 399,955,624          |
| Other businesses:  |                      |                      |
| Páginas Amarelas, S.A. ("Páginas Amarelas")                  | 79,287,531           | 83,754,434           |
| Unitel, S.A. ("Unitel")                                      | 21,567,869           | 26,217,691           |
| PrimeSys   | 20,302,243           | 23,363,425           |
| PT Sistemas de Informação, S.A. ("PT SI")                    | 6,473,516            | 8,931,685            |
| Cabo Verde Telecom, S.A. ("Cabo Verde Telecom")              | 7,012,058            | 7,404,891            |
| Web-Lab, SGPS, S.A.  | 8,179,594            |                      |
|  | 142,822,811          | 149,672,126          |
|  | <b>1,410,386,239</b> | <b>1,284,159,238</b> |

(1) The increase in this caption is primarily related with the goodwill generated in the acquisitions of further investments in Brasilcel's subsidiaries (Exhibit II).

(2) This caption also includes the goodwill generated in the acquisition of a further investment of 16.67% in the share capital of Sport TV made during 2004, amounting to Euro 22,126,657 (Exhibit II).

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Goodwill is amortized on a straight line basis during the following periods (Note 3.e)):

| Company  | Period   |
|--|--|
| Brasilcel's subsidiaries                         | Period expected to recover the investment (20 years).  |
| PT.com   | Period expected to recover the investment (20 years).  |
| PT Comunicações (international carrier business) | Period expected to recover the investment (20 years).  |
| PT Prime   | Period expected to recover the investment (20 years).  |
| PT Multimédia and subsidiaries                   | Period expected to recover the investment (20 years).  |
| Páginas Amarelas                                 | Period expected to recover the investment (20 years).  |
| Unitel   | Period remaining to the end of the license on the date of acquisition of the investment (9 years).     |
| PrimeSys   | Period expected to recover the investment (10 years).  |
| Cabo Verde Telecom                               | Period remaining to the end of the concession on the date of acquisition of the investment (19 years). |
| Other  | Period expected to recover the investment (maximum 20 years).  |

F-35

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Amortization of goodwill in the years ended December 31, 2004, 2003 and 2002 was as follows:

|  | <b>2004</b>       | <b>2003</b>        | <b>2002</b>        |
|--|-------------------|--------------------|--------------------|
| <b>VIVO</b>                                      | 38,634,938        | 53,076,620         | 48,731,785         |
| <b>Wireline business:</b>                        |                   |                    |                    |
| PT.com   | 8,673,281         | 8,673,281          | 8,974,176          |
| PT Comunicações (international carrier business) | 6,875,854         | 6,875,854          | 6,875,854          |
| PT Prime   | 1,690,870         | 1,690,870          |                    |
| Other  | 276,863           | 796,233            | 941,404            |
|  | <b>17,516,868</b> | <b>18,036,238</b>  | <b>16,791,434</b>  |
| <b>PT Multimédia:</b>                            |                   |                    |                    |
| Pay TV and Cable Internet                        | 10,809,028        | 9,979,276          | 8,381,315          |
| <b>Audiovisuals:</b>                             |                   |                    |                    |
| Lusomundo Audiovisuais                           | 3,859,558         | 2,894,668          |                    |
| Lusomundo Cinemas                                | 2,144,463         | 1,305,066          |                    |
| <b>Media:</b>                                    |                   |                    |                    |
| Lusomundo Serviços                               | 5,248,805         | 3,936,604          |                    |
| Global Notícias                                  | 1,629,279         | 1,625,420          | 1,625,420          |
| Vasp   | 490,590           | 490,590            |                    |
| Lusomundo Media                                  | 423,252           | 423,252            |                    |
| Rádio Press                                      | 200,957           | 200,957            | 201,037            |
| Lusomundo SGPS(1)                                |                   | 2,668,172          | 29,394,937         |
| Other  | 400,066           | 500,591            | 704,661            |
|  | <b>25,205,998</b> | <b>24,024,596</b>  | <b>40,307,370</b>  |
| <b>Other businesses:</b>                         |                   |                    |                    |
| Páginas Amarelas                                 | 4,466,903         | 4,466,903          | 413,942            |
| Unitel   | 4,369,670         | 4,369,670          | 4,369,670          |
| PrimeSys   | 3,363,978         | 3,509,738          | 15,661,906         |
| PT SI  | 1,616,252         | 1,616,252          |                    |
| Other  | 1,947,882         | 1,512,753          | 16,633,331         |
|  | <b>15,764,685</b> | <b>15,475,316</b>  | <b>37,078,849</b>  |
|  | <b>97,122,489</b> | <b>110,612,770</b> | <b>142,909,438</b> |

(1)

As a result of the corporate restructuring of Lusomundo, made in the second quarter of 2003, the goodwill related with this investment was transferred to Lusomundo Audiovisuais, Lusomundo Cinemas and Lusomundo Serviços.

The Company, supported on the business plans of the subsidiary and associated companies mentioned above, believes that the carrying value of the financial investments on the above mentioned

companies (including goodwill, net of accumulated amortization and provisions for impairments), is lower than its fair value.

### 13. Loans

This caption consists of:

|                          | December 31, 2004    |                      | December 31, 2003    |                      |
|--------------------------|----------------------|----------------------|----------------------|----------------------|
|                          | Short-term           | Long-term            | Short-term           | Long-term            |
| Exchangeable bonds(a)    |                      | 390,335,000          | 450,485,000          | 440,335,000          |
| Bonds(b)                 | 584,950,000          | 1,848,162,033        | 124,699,474          | 2,669,141,209        |
| Bank loans(c):           |                      |                      |                      |                      |
| External market loans    | 452,179,951          | 1,329,321,190        | 284,700,985          | 1,356,219,875        |
| Domestic market loans    | 7,100,357            | 7,712,975            | 6,583,720            | 7,373,996            |
| Overdrafts               | 14,647,937           |                      | 2,545,597            |                      |
| Other loans              |                      |                      |                      |                      |
| Commercial Paper(d)      | 318,808,486          | 8,950,000            | 285,487,967          | 10,900,000           |
| External market loans(e) | 19,156,806           | 81,737,245           | 36,575,981           | 71,643,923           |
|                          | <b>1,396,843,537</b> | <b>3,666,218,443</b> | <b>1,191,078,724</b> | <b>4,555,614,003</b> |

As of December 31, 2004 the medium and long-term portion of the loans is repayable as follows:

|                          |                      |
|--------------------------|----------------------|
| 2006                     | 1,524,528,265        |
| 2007                     | 458,444,296          |
| 2008                     | 507,138,776          |
| 2009                     | 959,027,456          |
| 2010 and following years | 217,079,650          |
|                          | <b>3,666,218,443</b> |

(a) Exchangeable bonds

On June 7, 1999 PT Finance issued exchangeable bonds totaling Euro 509,435,000, convertible into Portugal Telecom shares, as follows:

Number of exchangeable bonds: 101,887;

Exchange price: Euro 10,515 per share (as a result of the stock split and the share capital increases that occurred up to December 31, 2001);

Nominal value: Euro 5,000;

Maturity: June 7, 2004; and



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Fixed interest rate: 1.5% per annum, paid quarterly at the end of each period.

Up to December 31, 2003 the Company had converted 76 of these exchangeable bonds into 35,431 shares of Portugal Telecom and unwound 11,710 of these exchangeable bonds, with a notional

F-37

---

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

value of Euro 58,950,000. As of June 7, 2004 the remaining exchangeable bonds amounting to Euro 450,485,000 were repaid.

On December 6, 2001 PT Finance issued exchangeable bonds totaling Euro 550,000,000, convertible into Portugal Telecom shares, as follows:

Number of exchangeable bonds: 110,000;

Exchange price: Euro 12.3985 per share;

Nominal value: Euro 5,000;

Maturity: December 6, 2006; and

Fixed interest rate: 2% per annum, paid quarterly at the end of each period.

On December 2003 and October 2004 the Company unwound, respectively, 21,933 of these exchangeable bonds, with a notional value of Euro 109,665,000, and 10,000 of these exchangeable bonds with a notional value of Euro 50,000,000. As of December 31, 2004 the notional value of these exchangeable bonds outstanding amounted to Euro 390,335,000.

(b)

### Bonds

On April 7, 1999, PT Finance issued notes totaling Euro 1,000,000,000, under a Global Medium Term Note ("GMTN") program, with an annual fixed interest rate of 4.625%. These notes mature in 10 years. In November 2004, the Company cancelled the bonds from this program held as marketable securities with a notional value of Euro 120,500,000.

On February 21, 2001 PT Finance issued notes totaling Euro 1,000,000,000, under a second GMTN program, with an annual fixed interest rate of 5.75%. These notes mature in five years. In the second half of 2004, the Company cancelled the bonds from this program held as marketable securities with a notional value of Euro 100,500,000.

On November 16, 2001 PT Finance issued notes totaling Euro 600,000,000, under a Floating Rate Note program, at a floating interest rate corresponding to the three months Euribor plus a 0.75% spread. These notes mature in three years and three months. In November 2004, the Company cancelled the bonds from this program held as marketable securities with a notional value of Euro 15,050,000.

On August 1, 2003, TCP obtained a bond amounting to BRL 500 million, with a maturity of five years and bearing an annual interest rate corresponding to 104.4% of the CDI.

On November 17, 2004 Portugal Telecom repaid the PT/97 bond amounting to Euro 124,699,474.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

(c)

Bank loans

As of December 31, 2004 and 2003 bank loans are denominated in the following currencies:

|                 | 2004                        |                      | 2003                        |                      |
|-----------------|-----------------------------|----------------------|-----------------------------|----------------------|
|                 | In the currency of the loan | Euro                 | In the currency of the loan | Euro                 |
| Euro            | 1,240,722,309               | 1,240,722,309        | 1,219,645,650               | 1,219,645,650        |
| U.S. Dollars    | 55,817,405                  | 40,978,933           | 41,858,799                  | 33,142,358           |
| Brazilian Reais | 1,907,815,568               | 527,793,612          | 1,367,019,988               | 373,033,888          |
| Other           |                             | 1,467,556            |                             | 31,602,277           |
|                 |                             | <b>1,810,962,410</b> |                             | <b>1,657,424,173</b> |

As of December 31, 2004 and 2003, the guarantees given by third parties on behalf of the Company, in connection with these loans, were as follows:

|   | 2004        | 2003        |
|---|-------------|-------------|
| European Investment Bank loans guaranteed from Portuguese banks       | 257,406,112 | 301,402,179 |
| Guarantee from the Portuguese State to Kreditanstalt Für Wiederaufbau | 9,127,071   | 10,585,276  |

During 2003, the Company obtained a Multicurrency Revolving Credit Facility amounting to Euro 500,000,000, with a maturity of two years. On February 17, 2004, the maturity of this Facility was renegotiated, being 50% of the loan payable in 2007 and the remaining in 2008.

In 2004, Portugal Telecom and PT Finance obtained three other Multicurrency Revolving Credit Facilities totaling Euro 400,000,000, in the following dates and with the following maturities and amounts:

In June 24, 2004, with an amount of Euro 150,000,000 and a maturity of four years;

In October 18, 2004, with an amount of Euro 100,000,000 and a maturity of three years;

In October 22, 2004, with an amount of Euro 150,000,000 and a maturity of three years and six months.

As of December 31, 2004, the Group has used an amount of Euro 75,000,000 in connection with these facilities.

On December 10, 2004 the Company signed a contract for a new loan with the European Investment Bank ("EIB") amounting to Euro 150 million with a maturity as of December 15, 2014. This contract allows an additional financing of Euro 100 million. As of December 31, 2004, the Company had not yet used any funding from this contract.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

As of December 31, 2004 and 2003, bank loans bear interest at annual interest rates, equivalent to loans denominated in Euros, that vary between:

|         | 2004  | 2003  |
|---------|-------|-------|
| Maximum | 4.9%  | 4.9%  |
| Minimum | 2.02% | 2.08% |

(d) Commercial paper

As of December 31, 2004 this caption relates basically to commercial paper programs issued by the following Group companies:

|                     |             |
|---------------------|-------------|
| Portugal Telecom(i) | 312,858,486 |
| Lusomundo           | 14,900,000  |
|                     | 327,758,486 |

- (i) Short term commercial paper program issued in 2002, amounting to a total of Euro 875,000,000. As of December 31, 2004, the Company was using an amount of Euro 312,858,486, which matured in January 2005 and bears interest at an annual rate of 2.34%.

(e) Other loans external market

As of December 31, 2004 other loans comprise basically 50% of the loans obtained by VIVO from BNDES (the Brazilian Development Bank) amounting to Euro 82,150,010 at the Euro/Real exchange rate prevailing at year-end. These loans will be repaid from 2005 until 2011.

(f) Covenants

As of December 31, 2004, the Company had several covenants related with its indebtedness, which have been fully complied with. As of that date, the main covenants are as follows:

Credit rating

If at any time the long term credit rating assigned by the rating agencies to Portugal Telecom is reduced to BBB+/Baa1, then Portugal Telecom must present a guarantee acceptable to the EIB. This covenant is applied to certain EIB loans totaling Euro 300 million, of which Euro 150 million were being used as of December 31, 2004.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The Facility obtained in October 18, 2004, amounting to Euro 100,000,000, establishes that Portugal Telecom must have a minimum rating of at least BBB-/Baa3.

### Control/disposal of subsidiaries

Portugal Telecom must, directly or indirectly, maintain majority ownership and control of each material subsidiary. Material subsidiaries are those companies whose total assets equal or exceed 10% of total consolidated assets or whose total revenues also equal or exceed

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

10% of total consolidated revenues. This covenant is applied to the Facility of Euro 500 million and to certain EIB loans totaling Euro 762 million, of which Euro 612 million were used as of December 31, 2004.

### Financial ratios

The legal documentation regarding the Facility of Euro 500 million states that the consolidated ratio Net Debt/EBITDA, should not be higher than 4.5. The two Facilities obtained in October 2004, totaling Euro 250 million, state that the consolidated ratio Net Debt/EBITDA, should not be higher than 3.5, although in one of these Facilities this is only applicable if the rating from Portugal Telecom is reduced. In addition, the conditions (spread and maturity) applicable to the Facility of Euro 500 million and to the Facility of Euro 150 million obtained in June 2004 may be changed if the consolidated ratio Net Debt/EBITDA is higher than, respectively, 2.5 and 2.25. As of December 31, 2004 this ratio stood at 1.34.

In addition, the Global Medium Term Notes, the Exchangeable Bonds, the Facility of Euro 500 million and the Facilities totaling Euro 400 million include certain restrictions to pledge the Company's consolidated assets, in order to secure any loan or obligation to third parties.

### 14. Accounts Payable Other Third Parties

This caption consists of:

|  | <u>2004</u>        | <u>2003</u>        |
|--|--------------------|--------------------|
| Accounts payable to fixed assets suppliers   | 336,486,029        | 237,393,030        |
| Taxes payable in foreign countries(1)  | 93,907,101         | 75,635,262         |
| Advances received for the sale of certain<br>accounts receivable from the Portuguese State<br>(Note 33.c)) | 26,392,172         | 27,399,604         |
| accounts payable to employees  | 16,477,092         | 15,226,927         |
| Advances received from customers   | 5,651,760          | 4,412,361          |
| Contributions to PT-ACS (Note 3.g))  | 3,444,945          | 12,270,401         |
| Contributions payable to the pension funds(2)  |                    | 2,342,959          |
| Other(3)   | 83,720,238         | 160,326,723        |
|  | <u>566,079,337</u> | <u>535,007,267</u> |

(1) This caption includes primarily 50% of the taxes payable by VIVO, including income taxes and indirect taxes. As of December 31, 2004 the taxes payable by VIVO amount to Euro 78,783,194.

(2) As of December 31, 2003 this amount includes: Euro 4,672,376 (Note 30.1) related to contributions payable by PT Comunicações to the pensions funds, net of Euro 2,329,417 related with payments on account made throughout the year on behalf of Caixa Marconi.

- (3) As of December 31, 2004 this caption included: (i) Euro 13,390,533 related to 50% of the management fees due to Telefónica Móviles by certain Brasilcel's subsidiaries; (ii) Euro 8,391,439 related with commissions payable to agents; and (iii) Euro 7,547,000 related with 50% of the amount due by TCP in relation with the acquisition of TCO.

**15. Accrued Expenses**

This caption consists of:

|                                       | <b>2004</b>        | <b>2003</b>        |
|---------------------------------------|--------------------|--------------------|
| General and administrative expenses   | 233,682,857        | 163,585,775        |
| Interest expense                      | 155,511,043        | 176,139,490        |
| Vacation pay and bonuses              | 120,849,761        | 109,396,438        |
| Discounts to clients(1)               | 36,987,839         | 58,818,100         |
| Commissions                           | 18,609,545         | 18,770,926         |
| Contribution to PT-ACS                | 4,908,757          | 6,841,810          |
| Interest on unpaid taxes (Note 32.a)) | 1,116,083          | 1,157,276          |
| Other(2)                              | 66,844,507         | 54,684,798         |
|                                       | <b>638,510,392</b> | <b>589,394,613</b> |

- (1) This caption comprises discounts to clients related to sole volume discount, granted to the major fixed live clients. These discounts are accounted as a reduction of the related revenues.
- (2) As of December 31, 2004 this caption includes an accrual of approximately Euro 41 million corresponding to the fair value of certain cross-currency swaps which are not hedging any specific risk, asset or liability (Note 3.p)).



**16. Taxes Payable**

This caption consists of:

|   | <b>2004</b>       | <b>2003</b>        |
|---|-------------------|--------------------|
| Value added tax                             | 60,996,378        | 78,545,853         |
| Social Security contributions               | 10,863,432        | 11,830,966         |
| Personnel income tax withholdings           | 10,594,555        | 9,590,122          |
| City tax                                    | 62,909            | 1,069,902          |
| Income taxes, net of payments on account(i) |                   | 1,621,852          |
| Other                                       | 295,168           | 266,906            |
|   | <b>82,812,442</b> | <b>102,925,601</b> |

(i)

As of December 31, 2004 and 2003, net income taxes receivable is made up as follows:

|                                  | <b>2004</b>      | <b>2003</b>      |
|----------------------------------|------------------|------------------|
| Income taxes receivable (Note 7) | 2,671,827        | 3,232,311        |
| Income taxes payable             |                  | (1,621,852)      |
| <b>Net income tax receivable</b> | <b>2,671,827</b> | <b>1,610,459</b> |

  

|                                  | <b>2004</b>      | <b>2003</b>      |
|----------------------------------|------------------|------------------|
| Payments on account              | 5,086,990        | 2,966,267        |
| Withholding income taxes         | 4,106,310        | 533,438          |
| Current income taxes             | (8,882,069)      | (4,853,827)      |
| Other                            | 2,360,596        | 2,964,581        |
| <b>Net income tax receivable</b> | <b>2,671,827</b> | <b>1,610,459</b> |

Reconciliation between current income taxes in the Company's balance sheet as of December 31, 2004 and 2003 and the current income tax expense for the years then ended is as follows:

|   | <b>2004</b> | <b>2003</b> |
|---|-------------|-------------|
| Current income taxes in the balance sheet                       | 8,882,069   | 4,853,827   |
| Taxes losses carryforward used in the year (Note 29)            | 237,178,778 | 250,752,473 |
| Foreign income taxes payable by subsidiaries                    | 38,305,380  | 39,551,056  |
| Provision for legal actions related with income taxes (Note 28) | 4,717,540   |             |
| Other   | 1,538,014   | (344,004)   |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   | <u>2004</u>        | <u>2003</u>        |
|---|--------------------|--------------------|
| <b>Total Income tax expense current</b> | <b>290,621,781</b> | <b>294,813,352</b> |

F-43

---

The current income tax expense was recorded in the following captions:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| Income statement (Note 29)   | 289,300,465        | 287,122,537        |
| Shareholders' equity:  |                    |                    |
| Cumulative foreign currency translation adjustments<br>(Note 3.o)) | 1,812,409          | 6,108,630          |
| Other reserves (Note 3.o))   | (491,093)          | 1,582,185          |
|  | <b>290,621,781</b> | <b>294,813,352</b> |

### 17. Deferred Income

This caption consists of:

|                                  | <b>2004</b>        | <b>2003</b>        |
|----------------------------------|--------------------|--------------------|
| Advance billing (1)              | 141,944,699        | 113,190,687        |
| Investment subsidies (Note 3.k)) | 9,953,460          | 14,537,473         |
| Financial instruments (2)        | 8,328,285          | 22,006,110         |
| Telephone directories            | 2,151,118          | 2,118,787          |
| Other                            | 75,107,083         | 60,560,438         |
|                                  | <b>237,484,645</b> | <b>212,413,495</b> |

- (1) As of December 31, 2004 this caption included Euro 110,390,994 related mainly with pre-paid minutes of traffic in mobile networks, not used by customers from TMN and VIVO (Note 3.q)).
- (2) As of December 31, 2004 this caption relates to 50% of the net premium obtained in connection with the equity derivatives over PT Multimédia shares contracted with Banco Espírito Santo Group (Note 31). As of December 31, 2003 this caption included upfront fees received in connection with the restructuring of interest rate swap contracts, that are recognized in income during the maturity period of those contracts.

**18. Other Non-Current Liabilities****1. Provision For Other Risks and Costs**

This caption consists of (Note 28):

|   | <b>2004</b>        | <b>2003</b>        |
|---|--------------------|--------------------|
| Provision for legal actions(a)          | 67,825,144         | 14,927,504         |
| Provision for taxes(b)                  | 51,138,186         | 43,451,561         |
| Provision for fixed assets (Note 3.d)   | 50,403,228         | 43,278,576         |
| Other provisions for risks and costs(c) | 291,509,751        | 259,722,025        |
|   | <b>460,876,309</b> | <b>361,379,666</b> |

(a)

The provision for legal actions is to cover potential liabilities arising from legal actions against the Company for which the final outcome as of December 31, 2004 was not yet settled. The amount of the provision is based on information obtained from the Company's legal counsel. During 2004, this provision was increased by approximately Euro 47 million as a result of new judicial and arbitrage processes presented against the Company.

(b)

The provision for taxes is to cover potential tax liabilities and was estimated based on information obtained from the Company's legal counsel and tax consultants. As of December 31, 2004 its detail by subsidiary, is the following:

|                              |                   |
|------------------------------|-------------------|
| VIVO                         | 27,982,100        |
| Portugal Telecom (Note 32.a) | 13,975,284        |
| PT Comunicações (Note 32.a)  | 1,963,893         |
| Other                        | 7,216,909         |
|                              | <b>51,138,186</b> |

The provisions recorded by VIVO are basically related to indirect taxes in Brazil (ICMS), which legality under Brazilian Constitution is being challenged by Brasilcel's subsidiaries.

(c)

As of December 31, 2004, the detail of this caption is as follows:

|  |                    |
|--|--------------------|
| Provision for losses in affiliated companies (Note 10) | 129,315,472        |
| Provision for restructuring of TV Cabo(i)              | 68,350,766         |
| Other provisions(ii)                                   | 93,843,513         |
|  | <b>291,509,751</b> |

(i)

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

This provision is to cover costs with the retirement of the analogue network. During 2004, the provision was increased by Euro 26,250,000 (Note 27).

(ii)

This caption includes a provision for impairments in the audiovisuals business amounting to Euro 40,000,000 (Note 27).

F-45

---

**2. Other Non-Current Liabilities**

This caption consists of:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| Accounts payable to fixed assets suppliers       | 121,489,388        | 19,154,800         |
| Deferred income investment subsidies (Note 3.k)) | 31,208,019         | 38,744,052         |
| Taxes payable in foreign countries(1)            | 25,634,200         | 24,943,234         |
| Other  | 30,437,227         | 61,929,247         |
|  | <b>208,768,834</b> | <b>144,771,333</b> |

(1)

This caption relates to 50% of the ICMS payable by Global Telecom to the Brazilian state of Paraná, which resulted from a tax benefit obtained.

**19. Minority Interests**

During the year ended December 31, 2004 the movement in minority interests was as follows:

|  | <b>Opening<br/>balance</b> | <b>Acquisitions<br/>and<br/>disposals</b> | <b>Income/(loss)</b> | <b>Changes<br/>in the<br/>consolidation<br/>perimeter</b> | <b>Dividends</b>    | <b>Currency<br/>translation<br/>adjustments</b> | <b>Other</b>   | <b>Closing<br/>balance</b> |
|--|----------------------------|---|----------------------|---|---------------------|---|----------------|----------------------------|
| Brasilcel(1)   | 419,201,233                | (115,229,615)                             | 43,014,109           |   | (30,156,059)        | 7,260,395                                       | 408,831        | 324,498,894                |
| PT Multimédia(2)   | 166,169,910                |   | 46,723,131           |   | (5,327,366)         | (72,523)  | (53,251)       | 207,439,901                |
| Cabo Verde Telecom                                       | 28,772,842                 |   | 7,165,483            |   | (5,273,610)         |   | 167,335        | 30,832,050                 |
| Mascom(3)  | 16,682,849                 | (16,682,849)                              |                      |   |                     |   |                |                            |
| Cabo TV Madeirense, S.A.                                 | 5,155,415                  |   | 1,445,421            |   | (539,400)           |   |                | 6,061,436                  |
| Timor Telecom, S.A.                                      |                            |   | 828,850              | 1,716,566   |                     | (262,851)                                       |                | 2,282,565                  |
| Cabo TV Açoreana, S.A.                                   | 1,872,300                  |   | 502,535              |   | (349,197)           |   |                | 2,025,638                  |
| CST Companhia<br>Santomense de<br>Telecomunicações, SARL | 1,438,850                  |   | 355,784              |   | (33,385)            | (232,066)                                       | (57,367)       | 1,471,816                  |
| Kenya Postel Directories,<br>Ltd.                        | 1,127,747                  |   | 234,808              |   | (369,088)           | (96,281)  | (11,182)       | 886,004                    |
| LTM Listas Telefónicas de<br>Moçambique, Lda.            | 1,299,359                  |   | 544,595              |   | (527,288)           | 161,588   | 19,314         | 1,497,568                  |
| Empresa Gráfica<br>Funchalense, S.A.                     | 1,080,177                  |   |                      | (1,080,177)   |                     |   |                |                            |
| Previsão   |                            |   | 27,821               | 1,029,851   |                     |   |                | 1,057,672                  |
| Lusomundo Media  | 494,440                    |   | 114,872              |   |                     |   | 296,207        | 905,519                    |
| Naveprinter  |                            | 713,787                                   | 3,842                |   |                     |   |                | 717,629                    |
| Grafilme Sociedade<br>Impressora de Legendas,<br>S.A.    | 577,237                    |   | 173,987              |   | (88,880)            |   |                | 662,344                    |
| Telecomunicações Públicas<br>de Timor, S.A.              |                            |   | 193,450              | 424,942   |                     | (62,970)  |                | 555,422                    |
| Other  | 95,609                     |   | 240,376              | 41,440  | (225,368)           | (22,225)  | 341            | 130,173                    |
|  | <b>643,967,968</b>         | <b>(131,198,677)</b>                      | <b>101,569,064</b>   | <b>2,132,622</b>  | <b>(42,889,641)</b> | <b>6,673,067</b>                                | <b>770,228</b> | <b>581,024,631</b>         |

F-46

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Income applicable to minority interests in the periods ended December 31, 2004, 2003 and 2002 were as follows:

|                    | 2004               | 2003              | 2002                |
|--------------------|--------------------|-------------------|---------------------|
| PT Multimédia(2)   | 46,723,131         | 13,036,880        | (61,406,838)        |
| Brasilcel(1)       | 43,014,109         | 51,527,882        |                     |
| Cabo Verde Telecom | 7,165,483          | 7,405,816         | 7,055,199           |
| Cabo TV Madeirense | 1,445,421          | 1,072,541         | 890,458             |
| Mascom(3)          |                    | 6,484,585         | 4,532,724           |
| TCP(4)             |                    |                   | (23,313,734)        |
| Other              | 3,220,920          | (302,774)         | (2,378,473)         |
|                    | <b>101,569,064</b> | <b>79,224,930</b> | <b>(74,620,664)</b> |

- (1) The minority interests in Brasilcel correspond to 50% of the interests of minority shareholders of Brasilcel's subsidiaries in their corresponding amounts of shareholders' equity and net income.
- (2) The minority interests in PT Multimédia correspond to the interests of minority shareholders in their equity and net income, considering the application of the equity method of accounting to their subsidiaries.
- (3) During 2004, Mascom was excluded from the consolidation as the financial investment in this subsidiary was in the process of being sold, only pending regulatory approval from the Botswana authorities (Note 10).
- (4) As mentioned in Note 1, this subsidiary was incorporated in Brasilcel as of December 27, 2002.

### 20. Share Capital and Reserves

On December 28, 2004 Portugal Telecom cancelled 87,799,950 treasury shares, with a nominal value of one Euro each, that were held, following a decision taken in the Annual General Meeting of April 2, 2004 regarding an announced share buyback. As a result, the Company's share capital was reduced from Euro 1,254,285,000 to Euro 1,166,485,050.

As of December 31, 2004 Portugal Telecom's fully subscribed and paid share capital amounted to Euro 1,166,485,050 and is represented by 1,166,485,050 shares, with a nominal value of one Euro each, and with the following distribution:

1,166,484,550 ordinary shares;

500 Class A shares.

All the Class A shares are held by the Portuguese State.

In accordance with Portugal Telecom's Articles of Associates, the Class A shares have special voting rights as follows:

Election of one third of the Directors, including the Chairman of the Board of Directors;

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Authorization to require distributions to all shareholders of dividends in excess of 40% of Portugal Telecom's net income;

Capital increases and other changes in Portugal Telecom's Articles of Association;

Issuance of bonds and other securities;

Authorization for a shareholder operating in an area which is in competition with Portugal Telecom to hold more than 10% of the ordinary shares;

Amending the general objectives, the strategy or the policies of Portugal Telecom; and

Defining investment policies of Portugal Telecom, including authorizing acquisitions and disposals.

As a result of the privatization of Portugal Telecom, initiated in June 1, 1995 and concluded on December 4, 2000, the interest of the Portuguese Government in the Company's share capital as of December 31, 2004 was 6.79%, including the 500 Class A shares indicated above.

### Capital issued premium

This caption results from premiums generated in capital increases made by Portugal Telecom. According to Portuguese law, applicable to companies listed in stock exchanges under the supervision of *Comissão do Mercado de Valores Mobiliários* (the Portuguese stock exchange regulator), these amounts can only be used to increase share capital or to cover for accumulated losses (even before the use of other reserves). This amount can not be used to pay dividends or to acquire treasury shares.

### Legal reserve

Portuguese law provides that at least 5% of each year's profits must be appropriated to a legal reserve until this reserve equals the minimum requirement of 20% of share capital. This reserve is not available for distribution to shareholders but may be capitalized or used to absorb losses, once all other reserves and retained earnings have been exhausted.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

### Equity Available for Distribution

Pursuant to Portuguese legislation, the amount of shareholders' equity available for distribution is determined based on the standalone financial statements of the Company. During 2004, the movements in the Company's shareholders' equity, on a standalone basis, were as follows:

|   | Opening<br>Balance   | Application of<br>Net Income and<br>Other Reserves | Equity<br>adjustments | Aquisition<br>of treasury<br>shares | Cancellation of<br>share capital | Other              | Closing<br>Balance   |
|---|----------------------|--|-----------------------|-------------------------------------|----------------------------------|--------------------|----------------------|
| Share capital                                 | 1,254,285,000        |  |                       |                                     | (87,799,950)                     |                    | 1,166,485,050        |
| Capital issued premium                        | 91,704,891           |  |                       |                                     |                                  |                    | 91,704,891           |
| Treasury shares                               | (210,040,062)        |  |                       | (480,912,955)                       | 690,953,017                      |                    |                      |
| Equity adjustments in<br>affiliated companies | 995,031,540          |  | (666,892,260)         |                                     |                                  |                    | 328,139,280          |
| Non-distributable reserves:                   |                      |  |                       |                                     |                                  |                    |                      |
| Legal   | 144,184,287          | 10,040,788   |                       |                                     |                                  |                    | 154,225,075          |
| Treasury shares                               | 210,040,062          |  |                       | 480,912,955                         | (690,953,017)                    |                    |                      |
| Cancellation of treasury<br>shares            |                      |  |                       |                                     | 87,799,950                       |                    | 87,799,950           |
| Distributable reserves:                       |                      |  |                       |                                     |                                  |                    |                      |
| Free reserves                                 | 254,853,267          | (76,724,707)                                       |                       | (172,284,916)                       |                                  |                    | 5,843,644            |
| Retained earnings                             | (39,403,169)         | 39,403,169   | 685,304,951           | (308,628,039)                       |                                  | (6,220,610)        | 370,456,302          |
| Net income                                    | 240,218,936          | (240,218,936)                                      |                       |                                     |                                  | 500,085,704        | 500,085,704          |
|   | <b>2,940,874,752</b> | <b>(267,499,686)</b>                               | <b>18,412,691</b>     | <b>(480,912,955)</b>                |                                  | <b>493,865,094</b> | <b>2,704,739,896</b> |

Pursuant to the Annual General Meeting of April 2, 2004, net income for 2003, amounting to Euro 240,218,936, was applied as follows:

|                   |                    |
|-------------------|--------------------|
| Dividends         | 190,774,979        |
| Retained earnings | 39,403,169         |
| Legal reserve     | 10,040,788         |
|                   | <b>240,218,936</b> |

The Annual General Meeting of April 2, 2004 also approved an additional distribution to shareholders, in the form of dividends, of free reserves amounting to Euro 76,724,707 and a distribution of PT shares to employees amounting to Euro 6,220,610.

The net increase in the caption "Equity adjustments in affiliated companies" includes an amount of approximately Euro 22 million related with currency translations adjustments generated during 2004.

According to Portuguese legislation, a non-distributable reserve should be set-up to cover for any treasury shares acquired by an amount equivalent to the acquisition value of such shares. This reserve will be freed up upon the sale or cancellation of such treasury shares. However, Portuguese law also establishes that upon cancellation of such treasury shares a non-distributable reserve should be set-up corresponding to the nominal value of such shares.

Portuguese legislation establishes that the amount of equity available for distribution to shareholders is determined by the lower of the following amounts:

- a) Distributable reserves (95% of Net Income + Retained Earnings + Free Reserves);

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

b)

Total shareholders' equity less the sum of share capital, capital issued premium, treasury shares and non-distributable reserves.

As of December 31, 2004 the amount of equity available for distribution to shareholders amounts to Euro 851 million.

**21. Operating Revenues**

This caption consists of:

|                                      | <b>2004</b>          | <b>2003</b>          | <b>2002</b>          |
|--------------------------------------|----------------------|----------------------|----------------------|
| Wireline business (Note 34.2)(1)     | 2,123,830,033        | 2,138,054,627        | 2,273,636,769        |
| Services rendered                    | 1,957,089,460        | 1,965,212,406        | 2,099,712,574        |
| Directories                          | 129,735,137          | 136,089,291          | 139,139,288          |
| Sales                                | 37,005,436           | 36,752,930           | 34,784,907           |
| Domestic Mobile TMN (Note 34.3)      | 1,444,293,249        | 1,346,740,297        | 1,266,647,997        |
| Services rendered                    | 1,300,371,237        | 1,213,221,073        | 1,132,761,033        |
| Sales                                | 143,922,012          | 133,519,224          | 133,886,964          |
| Brazilian Mobile VIVO (Note 34.4)(2) | 1,502,984,689        | 1,361,513,763        | 1,217,622,274        |
| Services rendered                    | 1,183,397,482        | 1,093,778,637        | 1,048,632,419        |
| Sales                                | 319,587,207          | 267,735,126          | 168,989,855          |
| PT Multimédia (Note 34.5)(1)         | 728,973,662          | 683,478,362          | 621,901,893          |
| Services rendered                    | 616,240,929          | 544,080,630          | 475,777,581          |
| Sales                                | 112,732,733          | 139,397,732          | 146,124,312          |
| Other businesses                     | 222,772,338          | 246,324,526          | 202,224,187          |
| Services rendered                    | 219,032,268          | 240,176,667          | 193,962,225          |
| Directories                          | 31,236               | 20,532               | 17,520               |
| Sales                                | 3,708,834            | 6,127,327            | 8,244,442            |
|                                      | <b>6,022,853,971</b> | <b>5,776,111,575</b> | <b>5,582,033,120</b> |

(1)

As a result of changes that occurred in the composition of these business segments (Note 34.1), the amounts related to year 2002 were adjusted accordingly. PT.com's results were included in the wireline business segment and excluded from the PT Multimédia business segment.

(2)

Since the contribution to Brasilcel of Portugal Telecom's investment in TCP occurred on December 27, 2002 the amounts for the year ended December 31, 2002 include 100% of TCP's operating revenues and the amounts for the years 2003 and 2004 include 50% of the consolidated operating revenues of VIVO.

**22. Wages and Salaries**

This caption consists of:

|                   | <b>2004</b>        | <b>2003</b>        | <b>2002</b>        |
|-------------------|--------------------|--------------------|--------------------|
| Salaries          | 620,674,846        | 585,494,416        | 581,537,670        |
| Employee Benefits | 97,381,015         | 86,188,097         | 74,672,734         |
| Social Charges    | 17,461,279         | 20,367,531         | 19,331,095         |
| Insurance         | 2,835,384          | 3,327,329          | 3,164,379          |
| Other             | 7,814,127          | 10,525,105         | 16,069,489         |
|                   | <b>746,166,651</b> | <b>705,902,478</b> | <b>694,775,367</b> |

**23. Costs of Telecommunications**

This caption consists of:

|  | <b>2004</b>        | <b>2003</b>        | <b>2002</b>        |
|--|--------------------|--------------------|--------------------|
| Interconnection charges mobile/mobile      | 142,473,045        | 167,587,697        | 176,195,727        |
| Interconnection charges fixed/mobile       | 110,512,681        | 127,385,114        | 151,446,742        |
| International telecommunications operators | 86,074,482         | 72,051,122         | 83,384,871         |
| Rental of telecommunications circuits      | 63,415,789         | 68,328,380         | 54,278,630         |
| Roaming                                    | 34,982,988         | 31,623,077         | 33,585,706         |
| Interconnection charges mobile/fixed       | 33,335,774         | 44,348,594         | 42,525,551         |
| Satellite charges                          | 5,382,288          | 9,384,808          | 9,390,213          |
| Other costs of telecommunications services | 76,074,380         | 66,436,266         | 72,131,224         |
|  | <b>552,251,427</b> | <b>587,145,058</b> | <b>622,938,664</b> |

**24. General and Administrative Expenses**

This caption consists of:

|   | <b>2004</b>          | <b>2003</b>        | <b>2002</b>        |
|---|----------------------|--------------------|--------------------|
| Specialized work and subcontracts         | 562,464,040          | 493,846,049        | 495,187,549        |
| Commissions                               | 162,934,980          | 138,692,906        | 104,505,101        |
| Rents                                     | 95,440,593           | 92,947,784         | 103,471,276        |
| Electricity                               | 50,251,740           | 44,879,402         | 46,832,747         |
| Communication expenses                    | 30,346,276           | 32,615,448         | 38,601,976         |
| Travel and entertainment                  | 22,773,144           | 20,071,589         | 16,534,541         |
| Security expenses                         | 11,734,179           | 10,510,399         | 9,350,331          |
| Insurance                                 | 10,347,046           | 10,249,331         | 10,297,929         |
| Fuel and gas                              | 8,248,030            | 7,466,295          | 7,154,280          |
| Other general and administrative expenses | 121,402,429          | 115,246,614        | 93,626,193         |
|   | <b>1,075,942,457</b> | <b>966,525,817</b> | <b>925,561,923</b> |

**25. Other net financing expenses/(income)**

This caption consists of:

|  | <b>2004</b>       | <b>2003</b>         | <b>2002</b>        |
|--|-------------------|---------------------|--------------------|
| Bank commissions and expenses                                  | 19,328,565        | 27,868,829          | 68,877,740         |
| Increases in provisions for other risks and costs (Note 28)(1) | 10,422,355        | 7,664,225           | 47,206,380         |
| Financial discounts, net                                       | 5,704,466         | 2,463,886           | 4,866,436          |
| Gains on investments   | (1,521,043)       | (1,292,259)         | (1,143,322)        |
| Decreases in provisions for other risks and costs (Note 28)(2) | (13,024,673)      | (156,770,873)       | (15,746,172)       |
| Other net financial expenses/(income)(3)                       | (8,415,564)       | 24,693,950          | 7,675,123          |
|  | <b>12,494,106</b> | <b>(95,372,242)</b> | <b>111,736,185</b> |

(1) In 2004 this caption included primarily Euro 7,929,153 related with the increase in the provision for investments.

(2) In 2004 this caption included primarily Euro 11,305,603 related with the decrease in the provision for risks related with financial instruments, as a result of the cancellation of the corresponding instruments (equity swaps on own shares). In 2003 this caption included: (i) Euro 82,498,690 related with equity swaps; and (ii) Euro 74,272,183 related with financial instruments contracted by VIVO, which as of December 31, 2002 were recorded as investments net of provisions and as of December 31, 2003 were recorded at fair value in the caption "Short term investments".

(3) In 2004 this caption included primarily: (i) a gain amounting to Euro 33,416,640 related to a cancellation of an equity swap over PT Multimédia shares; and (ii) 50% of the taxes paid by Brasilcel's subsidiaries amounting to Euro 13,264,646 related with financial revenues.

**26. Net losses/(gains) on sales and disposals of fixed assets, net**

This caption consists of:

|  | <b>2004</b>       | <b>2003</b>         | <b>2002</b>        |
|--|-------------------|---------------------|--------------------|
| Losses on sales and disposals of fixed assets      | 15,394,469        | 9,890,091           | 9,033,216          |
| Losses on the retirement of fixed assets (Note 11) | 3,631,366         | 4,176,106           | 4,274,208          |
| Gains on sales and disposals of fixed assets(1)    | (6,888,934)       | (45,746,591)        | (17,565,682)       |
| Other  | (125,174)         | 3,050,103           | 291,664            |
|  | <b>12,011,727</b> | <b>(28,630,291)</b> | <b>(3,966,594)</b> |

(1) In 2003, this caption included basically a gain obtained by PT Comunicações on the sale of a building to the Pension Funds.

**27. Extraordinary Items**

This caption consists of:

|  | <u>2004</u>       | <u>2003</u>       | <u>2002</u>       |
|--|-------------------|-------------------|-------------------|
| Increases in provisions for other risks and costs (Note 28)(1) | 34,348,329        | 62,710,282        |                   |
| Losses/(Gains) on disposals of investments, net:               |                   |                   |                   |
| Disposals of investment in Mascom(2)                           | (24,764,670)      |                   |                   |
| Disposals of Telefónica shares                                 |                   |                   | (30,519,163)      |
| Disposals of investment in Deltapress                          |                   |                   | (5,098,510)       |
| Donations  | 9,766,443         | 15,613,110        | 2,518,643         |
| Provision to adjust assets and liabilities in TMN              |                   |                   | 50,915,335        |
| Other(3)   | 68,069,040        | (25,538,920)      | 20,806,320        |
|  | <u>87,419,142</u> | <u>52,784,472</u> | <u>38,622,625</u> |

- (1) In 2004 this caption included Euro 26,250,000 related to a provision recorded by TV Cabo in connection with the obligation to dismantle the analogue premium service and the implementation of a digital offer (Note 18). In 2003 this caption includes Euro 57,130,000 related to a provision to cover estimated losses resulting from the restructuring of certain activities of TV Cabo, including unrealizable assets and unrecorded liabilities.
- (2) In September 2004 the sale of the investment in Mascom was completed following regulatory approval. As a result, a gain of Euro 24,764,670 was recorded related with this transaction (Exhibit II).
- (3) In 2004 this caption includes: (i) Euro 40,000,000 related with a provision for potential impairments in the audiovisuals business (Note 18); and (ii) Euro 10 million related with the cost of several initiatives implemented by PT Comunicações during 2004 related with an agreement entered into with a consumer protection association (Note 32.c).

**28. Movement in the Provisions**

During 2004 the movement in the provision accounts was as follows:

|   | <b>Opening<br/>balance</b> | <b>Increases</b>   | <b>Reductions</b>   | <b>Other<br/>movements</b> | <b>Closing<br/>balance</b> |
|---|----------------------------|--------------------|---------------------|----------------------------|----------------------------|
| Provision for marketable securities                           | 19,066                     |                    | (19,066)            |                            |                            |
| Provision for doubtful accounts receivable<br>(Notes 6 and 7) | 409,729,904                | 71,374,970         | (13,980,389)        | (82,849,828)               | 384,274,657                |
| Provision for inventories (Note 8)                            | 27,444,050                 | 7,976,558          | (2,481,476)         | (1,149,327)                | 31,789,805                 |
| Provision for investments (Note 10)                           | 70,128,694                 | 7,929,153          | (1,700,005)         | 17,667,146                 | 94,024,988                 |
| Provision for other risks and costs<br>(Note 18):             |                            |                    |                     |                            |                            |
| Legal actions   | 14,927,504                 | 47,097,555         | (552,668)           | 6,352,753                  | 67,825,144                 |
| Taxes   | 43,451,561                 | 7,600,865          | (3,339,521)         | 3,425,281                  | 51,138,186                 |
| Fixed assets  | 43,278,576                 | 16,481,519         | (8,349,130)         | (1,007,737)                | 50,403,228                 |
| Other   | 259,722,025                | 107,832,021        | (37,696,823)        | (38,347,472)               | 291,509,751                |
|   | <b>868,701,380</b>         | <b>266,292,641</b> | <b>(68,119,078)</b> | <b>(95,909,184)</b>        | <b>970,965,759</b>         |

(i)

The increases occurred during 2004 in these provision accounts were recorded as follows:

|  |                    |
|--|--------------------|
| Provisions for doubtful receivables, inventories and other | 146,340,064        |
| Depreciation and amortization                              | 56,481,519         |
| Extraordinary Items (Note 27)                              | 34,348,329         |
| Other net financing expenses (Note 25)                     | 10,422,355         |
| Equity in losses of affiliated companies                   | 10,181,917         |
| Provision for income taxes (Note 16)                       | 4,717,540          |
| Taxes and other than income taxes                          | 1,300,917          |
| Other non-operating expenses/(revenues), net               | 2,500,000          |
|  | <b>266,292,641</b> |

(ii)

The reductions occurred during 2004 in these provision accounts were recorded in the following profit and loss captions:

|  |                   |
|--|-------------------|
| Depreciation and amortization                              | 22,050,581        |
| Provisions for doubtful receivables, inventories and other | 17,445,464        |
| Other net financing expenses (Note 25)                     | 13,024,673        |
| Extraordinary Items  | 7,136,680         |
| Taxes and other than income taxes                          | 3,339,522         |
| Subsidies  | 2,905,293         |
| Equity in earnings of affiliated companies                 | 1,735,353         |
| Wages and salaries   | 481,512           |
|  | <b>68,119,078</b> |



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In the profit and loss statement for the year ended December 31, 2004, the caption "Provisions for doubtful receivables, inventories and other" includes the following items:

|   |                    |
|---|--------------------|
| Increases in these provisions   | 146,340,064        |
| Direct write-off of accounts receivables                                | 46,273,015         |
| Decreases in these provisions   | (17,445,464)       |
| Collections from accounts receivables which were previously written-off | (3,436,285)        |
|   | <hr/>              |
|   | <b>171,731,330</b> |
|   | <hr/>              |

Other movements in provisions account balances include basically the direct use of provisions, the inclusion and exclusion of companies from the consolidation perimeter and currency translation adjustments relating to provisions recorded by foreign subsidiaries.

### 29. Taxes

Portugal Telecom and its subsidiaries located in Portugal are subject to Corporate Income Tax ("IRC") at a rate of 25% which can be increased up to 10% through a municipal tax. Portugal Telecom, PT Multimédia and Lusomundo Media adopted the tax consolidation regime. The provision for income taxes is determined on the basis of the estimated taxable income for all companies covered by this regime (all 90% or more owned Portuguese subsidiaries). The remaining group companies, not covered by the tax consolidation regimes of Portugal Telecom, PT Multimédia and Lusomundo Media, are taxed individually based on their respective taxable income, at the applicable tax rates.

In accordance with Portuguese tax legislation, corporate tax returns are subject to review and adjustment by the tax authorities during four years following their filing (five years for social security, and ten years for the contributions made up to the year ended December 31, 2001). Management believes that any adjustment, which may result from such reviews or inspections, would not have a material impact on the consolidated financial statements as of December 31, 2004, except for the situations described in Note 32.a) where provisions or accruals have been recorded. Under prevailing Portuguese tax regulations, tax losses may be carried forward for up to six years.



**Deferred Taxes**

The movement in deferred taxes (Note 3.o)) during 2004 is as follows:

| Deferred tax assets   | Opening Balance      | Increase/(Decrease) |                         |  |                   | Closing Balance      |
|---|----------------------|---------------------|-------------------------|--|-------------------|----------------------|
|   |                      | Net income          | Taxes Payable (Note 16) | Foreign currency translation adjustments | Other adjustments |                      |
| Provisions  | 415,955,871          | 24,892,065          |                         | 279,975                                  | (17,883)          | 441,110,028          |
| Tax losses carryforward (i)                                 | 651,863,830          | 116,577,636         | (237,178,778)           | 626,645                                  | 4,573,115         | 536,462,448          |
| Financial instruments                                       | 10,815,788           | 4,570,582           |                         |  |                   | 15,386,370           |
| Additional contribution to pension funds                    | 36,436,390           | (700,972)           |                         |  |                   | 35,735,418           |
| Other(ii)   | 216,540,935          | (52,085,288)        |                         | 2,556,532                                | 70,083,156        | 237,095,335          |
|   | <b>1,331,612,814</b> | <b>93,254,023</b>   | <b>(237,178,778)</b>    | <b>3,463,152</b>                         | <b>74,638,388</b> | <b>1,265,789,599</b> |
| <b>Deferred tax liabilities</b>                             |                      |                     |                         |  |                   |                      |
| Revaluation of fixed assets (Note 3.d))                     | 24,567,396           | (3,864,335)         |                         |  | 65,927            | 20,768,988           |
| Gains on disposals of investments                           | 286,457,914          | (13,597,146)        |                         |  |                   | 272,860,768          |
| Distributable reserves of subsidiaries in foreign countries | 13,353,094           | 540,360             |                         |  |                   | 13,893,454           |
| Other   | 9,147,176            |                     |                         |  |                   | 9,147,176            |
|   | <b>333,525,580</b>   | <b>(16,921,121)</b> |                         |  | <b>65,927</b>     | <b>316,670,386</b>   |
|   |                      | <b>110,175,144</b>  | <b>(237,178,778)</b>    | <b>3,463,152</b>                         | <b>74,572,461</b> |                      |

(i) Other adjustments in this caption basically include deductions to income taxes obtained by certain group companies included in the tax consolidation regime of Portugal Telecom, since those amounts can only be recovered after the total use of the existing tax losses carryforward.

(ii) As of December 31, 2004 this caption included Euro 197,809,182 related with tax benefits obtained from a corporate restructuring in Brazil made by certain subsidiaries of Brasilcel. During 2004, TCO also completed its corporate restructuring, resulting in an increase of "Deferred tax assets" by Euro 69 million and a decrease of the same amount in the goodwill generated with this acquisition.

Deferred taxes recorded in the balance sheets as of December 31, 2004 and 2003 were classified as follows:

|         | 2004        |             | 2003        |             |
|---------|-------------|-------------|-------------|-------------|
|         | Assets      | Liabilities | Assets      | Liabilities |
| Current | 773,811,063 | 27,944,032  | 748,141,425 | 32,793,924  |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|             | 2004                 |                    | 2003                 |                    |
|-------------|----------------------|--------------------|----------------------|--------------------|
| Non-current | 491,978,536          | 288,726,354        | 583,471,389          | 300,731,656        |
|             | <b>1,265,789,599</b> | <b>316,670,386</b> | <b>1,331,612,814</b> | <b>333,525,580</b> |

F-56

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The reconciliation of the income tax provision for the year ended December 31, 2004 calculated at the statutory Portuguese income tax rate and the effective income tax rate, is as follows:

|  |  |
|--|--|
| Income before income taxes   | 780,819,780                                |
| Statutory tax rate (including municipal taxes at a 10% standard)   | 27.50%                                     |
|  | <hr style="border-top: 1px solid black;"/> |
|  | 214,725,440                                |
| Permanent differences(a)   | 42,845,103                                 |
| Differences in tax rates(b)  | 2,944,924                                  |
| Initial recognition of deferred tax assets related with tax losses carryforward from previous years(c)         | (104,487,722)                              |
| Valuation allowance for certain tax losses carryforward  | 34,957,108                                 |
| Reduction of deferred tax liabilities related with deferred taxation on the disposal of certain investments(d) | (12,610,960)                               |
| Other  | 751,428                                    |
|  | <hr style="border-top: 1px solid black;"/> |
| Income taxes in the profit and loss statement  | <b>179,125,321</b>                         |
|  | <hr style="border-top: 1px solid black;"/> |
| Effective tax rate   | 22.94%                                     |
| The income tax for the year, is as follows:  |  |
| Income tax-current (Note 16)   | 289,300,465                                |
| Deferred taxes   | (110,175,144)                              |
|  | <hr style="border-top: 1px solid black;"/> |
|  | <b>179,125,321</b>                         |
|  | <hr style="border-top: 1px solid black;"/> |

(a) This amount relates to the following:

|   |  |
|---|--|
| Goodwill amortization (Note 12)                                   | 97,122,489                                 |
| Provisions(i)   | 54,830,468                                 |
| Amortization of Band A licenses(ii)                               | 33,309,382                                 |
| Equity accounting in gains of affiliated companies, net (Note 10) | (27,721,982)                               |
| Other   | (1,739,982)                                |
|   | <hr style="border-top: 1px solid black;"/> |
| Tax effect  | 155,800,375                                |
|   | 27.50%                                     |
|   | <hr style="border-top: 1px solid black;"/> |
|   | <b>42,845,103</b>                          |
|   | <hr style="border-top: 1px solid black;"/> |

(i) This caption includes basically a provision recorded in 2004 amounting to Euro 40,000,000 to cover estimated losses in the audiovisuals business, which is not deductible for tax purposes (Note 18).

(ii) The amortization of Band A licenses held by Brasilcel's subsidiaries is not tax deductible because these intangibles result from the allocation of goodwill generated in the acquisition of those companies.

- (b) This amount relates to the impact of the different municipal tax rates applicable to the different group companies in Portugal and with the differences between the statutory tax rate in Portugal and the income tax rates applicable to foreign subsidiaries.
- (c) This amount refers to the initial recognition of deferred tax assets related with tax losses from previous years in PT Multimédia, since only in 2004 was evidence obtained that these losses can be realized.
- (d) This amount relates to the adoption by the Company of the voluntary taxation regime for certain gains on the disposal of investments obtained in previous years, which taxation was deferred due to the adoption at the time of the reinvestment regime.

### 30. Post Retirement Benefits

#### 1.

##### Pension Benefits

As referred to in Note 3.f), PT Comunicações, PT SI and Global Notícias (former Jornal de Notícias and Diário de Notícias) are liable for the payment of pensions, supplemental pension benefits to suspended employees and other gratuities to retired and active employees. These liabilities, which are estimated based on actuarial valuations prepared by an independent actuary, are as follows:

- a) Former Telecom Portugal employees Former employees of Telecom Portugal hired by CTT prior to May 14, 1992, or who were retired on that date, are entitled to a Company provided pension benefit. Employees hired after that date are covered by the general Portuguese State social security system. Suspended employees are also entitled to receive a benefit payment equal to 100% of salary prior to leaving service (increased in some cases).
- b) Former TLP employees The retired and active employees who were formerly employees of TLP and who were hired prior to June 23, 1994 are entitled to a pension supplement, which complements the pension paid by the Portuguese State social security system. Pre-retired employees are also entitled to receive benefit payments (equal to 25% to 100% of their present salaries) until they reach the Portuguese State social security retirement age. After this date these former employees become entitled to the pension supplement. Suspended employees are also entitled to receive a benefit payment equal to 100% of salary prior to leaving service (increased in some cases).
- c) Former TDP employees Former employees of TDP hired prior to June 23, 1994 are entitled to a pension supplement, which complements the pension paid by the Portuguese State social security system. Pre-retired employees are also entitled to receive benefit payments (equal to 25% to 100% of their present salaries) until they reach the Portuguese State social security retirement age. Suspended employees are also entitled to receive a benefit payment equal to 100% of salary prior to leaving service (increased in some cases).
- d) Former Employees of Marconi The former employees of Marconi hired prior to February 1, 1998 are entitled to a pension benefit from Caixa and two different supplemental pension benefits (Marconi Fundo de Melhoria and Marconi Complementary Fund). Employees hired after that date are not entitled to these benefits, as they are covered by the general Portuguese State social security system.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- e) On retirement PT Comunicações pays a lump sum gratuity of a fixed amount which depends on the length of service completed by the employee.
- f) Former Employees of Jornal de Notícias and Diário de Notícias Employees of Jornal de Notícias, hired prior to November 16, 1994 and of Diário de Notícias, hired prior to December 29, 1979, are entitled to a pension supplement, which complements the pension paid by the Portuguese State social security system.
- g) Employees of PT SI who were transferred from PT Comunicações and Marconi and were covered by pension plans of those companies are entitled to a pension supplement.

The actuarial valuations for these plans as of December 31, 2004, prepared by an independent actuary, used the projected unit credit method and considered the following actuarial assumptions and rates:

|   | <u>2004</u>  | <u>2003</u>  |
|---|--|--|
| Rate of return on pension fund assets                     | 6.00%  | 6.00%  |
| Pension liabilities' discount rate                        | 5.75%  | 6.00%  |
| Salaries liabilities' discount rate                       | 4.00%  | 4.00%  |
| Salary growth rate  | 3.00%  | 3.00%  |
| Pension growth rate(*)                                    | 2.00%  | 2.00%  |
| Inflation rate  | 2.00%  | 2.00%  |
| Mortality table:  |  |  |
| Employees (whilst in active service):                     | AM 92 males<br>AF 92 females   | AM 92 males<br>AF 92 females   |
| Pensioners and employees who have taken early retirement: | PA (90) m less<br>3 years males<br>PA (90) f less<br>3 years females | PA (90) m less<br>3 years males<br>PA (90) f less<br>2 years females |

Disability table: Swiss Reinsurance Company

Turnover of employees: Nil

(\*) Except for Diário de Notícias and Marconi Fundo de Melhoria, where there is no pension growth rate.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following table sets out the funded status of the PT Comunicações, PT SI and Global Notícias plans as of December 31, 2004 and 2003:

|  | <b>2004</b>                 | <b>2003</b>                 |
|--|-----------------------------|-----------------------------|
|  | <u>                    </u> | <u>                    </u> |
| Projected benefit obligation ("PBO"):                          |                             |                             |
| Retired, pre-retired and suspended employees                   | 1,905,319,000               | 1,846,468,000               |
| Salaries and gratuities to pre-retired and suspended employees | 986,385,800                 | 841,232,000                 |
| Active employees   | 700,674,000                 | 670,020,000                 |
|  | <u>                    </u> | <u>                    </u> |
|  | 3,592,378,800               | 3,357,720,000               |
| Plan assets at fair value                                      | (1,972,620,000)             | (1,828,066,000)             |
|  | <u>                    </u> | <u>                    </u> |
| Projected benefit obligation, in excess of plan assets         | <b>1,619,758,800</b>        | <b>1,529,654,000</b>        |
|  | <u>                    </u> | <u>                    </u> |

As of December 31, 2004 and 2003 the plan assets are as follows:

|  | <b>2004</b>                 | <b>2003</b>                 |
|--|-----------------------------|-----------------------------|
|  | <u>                    </u> | <u>                    </u> |
| Equities   | 681,516,951                 | 615,829,914                 |
| Bonds  | 671,112,135                 | 649,868,442                 |
| Property   | 259,565,035                 | 259,371,373                 |
| Real estate investment funds                                   | 54,654,566                  | 75,160,719                  |
| Cash, treasury bills, short-term stocks and net current assets | 305,771,313                 | 227,835,552                 |
|  | <u>                    </u> | <u>                    </u> |
|  | <b>1,972,620,000</b>        | <b>1,828,066,000</b>        |
|  | <u>                    </u> | <u>                    </u> |

F-60

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

As of December 31, 2004 and 2003 the reconciliation between the projected benefit obligation in excess of plan assets and the liability recorded in the consolidated balance sheet as of those dates is presented below:

|  | <b>2004</b>        | <b>2003</b>        |
|--|--------------------|--------------------|
| Projected benefit obligation, in excess of plan assets | 1,619,758,800      | 1,529,654,000      |
| Actuarial losses, net(i)                               | (884,263,944)      | (769,090,982)      |
| Transition obligation(ii)                              | (24,737,000)       | (26,519,596)       |
| Prior service cost                                     | 1,772,000          | 1,466,730          |
|  | <b>712,529,856</b> | <b>735,510,152</b> |
| <b>Pension Liabilities</b>                             | <b>712,529,856</b> | <b>735,510,152</b> |

(i)

Actuarial losses, net result basically from: (a) the lower actual return on fund assets as compared with the expected return on fund assets; (b) the change in some actuarial assumptions; and (c) the higher salary growth rates and higher increase in pensions and pre-retired salaries, than the long term assumptions considered in the actuarial studies. These actuarial gains and losses will be amortized over an average period of 14 years which corresponds to the estimated average working life of active employees. During 2004 and 2003, the movements in actuarial gains and losses were as follows:

|   | <b>2004</b>          | <b>2003</b>          |
|---|----------------------|----------------------|
| Beginning balance                                   | (769,090,982)        | (726,002,450)        |
| Actuarial gains and (losses) arising in the period: |                      |                      |
| PBO related   | (222,949,962)        | (144,596,532)        |
| Plan assets related                                 | 36,355,000           | 38,635,000           |
| Amortization of the period                          |                      |                      |
| Regular   | 68,587,000           | 58,114,000           |
| Curtailment related                                 | 2,835,000            | 4,759,000            |
|   | <b>(884,263,944)</b> | <b>(769,090,982)</b> |
| Ending balance                                      | <b>(884,263,944)</b> | <b>(769,090,982)</b> |

Actuarial losses from 2004 are basically related with the change in the discount rate of pension liabilities from 6% to 5.75% and the increase in mortality tables.

(ii)

The transition obligation results from the first time recognition of post retirement benefits, in 1993. This amount will be amortized over the estimated average working life of active employees at that date, which was estimated to be 18 years. In 2004, the amortization of the transition obligation amounts to Euro 1,785,000.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The pension liabilities of PT Comunicações, PT SI and Global Notícias were recorded in the consolidated balance sheet as of December 31, 2004 and 2003, in the following captions:

|   | 2004               | 2003               |
|---|--------------------|--------------------|
| Accrued post retirement liability (Note 30.3)           | 712,529,856        | 730,837,776        |
| Accounts payable other Third parties (Note 14 and 30.3) |                    | 4,672,376          |
|   | <b>712,529,856</b> | <b>735,510,152</b> |

A summary of the components of the net periodic pension cost for the years ended December 31, 2004 and 2003 is presented below:

|  | 2004               | 2003               |
|--|--------------------|--------------------|
| Service cost   | 18,617,000         | 20,618,000         |
| Interest cost  | 176,485,000        | 182,188,000        |
| Expected return on plan assets   | (111,127,000)      | (98,369,000)       |
| Net amortization of deferrals  | 5,205,969          | 60,516,000         |
|  | 89,180,969         | 164,953,000        |
| Sub-total (Note 30.4)  | 89,180,969         | 164,953,000        |
| Curtailment costs related to early retirements,<br>pre-retirements and suspended contracts (Note 30.4) | 153,315,800        | 268,032,000        |
|  | 242,496,769        | 432,985,000        |
| Net periodic pension cost  | <b>242,496,769</b> | <b>432,985,000</b> |

Curtailment costs were recorded in the caption "Work Force Reduction Program Costs".

The contributions made to the pension funds and payments of salaries to pre-retired and suspended employees in the years ended December 31, 2004 and 2003 were as follows:

|  | 2004               | 2003               |
|--|--------------------|--------------------|
| Contributions to pension funds:  |                    |                    |
| Employers' contributions   | 125,737,000        | 153,461,330        |
| Plan participants' contributions   | 10,991,000         | 11,032,603         |
|  | 136,728,000        | 164,493,933        |
| Payments of salaries to pre-retired and suspended employees<br>(Note 30.3) | <b>143,056,984</b> | <b>146,747,706</b> |

Employers' contributions include Euro 121.2 million (Note 30.3), which was recorded as a decrease in the accrued post retirement liability, and Euro 4.5 million which corresponds to the payment of an amount due to the pension funds at the end of 2003. Payments to pre-retired and suspended employees were recorded as a decrease in the accrued post retirement liability (Note 30.3).

As of December 31, 2004 the accrued post retirement liabilities relating to the defined benefit plans of the subsidiaries of Brasilcel amounted to Euro 1,265,772 (Note 30.3).



## 2. Other Employee Benefits

As referred to in Note 3.g), PT Comunicações and PT SI are liable for the payment of post retirement health care benefits to employees and their eligible relatives.

The actuarial valuations for these plans prepared by an independent actuary, as of December 31, 2004, used the projected unit credit method and considered the following assumptions and rates:

|   | <u>2004</u>  | <u>2003</u>  |
|---|--|--|
| <b>Health care cost trend rate:</b>                       |  |  |
| Next 6 years  | 3.50%  | 3.50%  |
| Years thereafter  | 3.00%  | 3.00%  |
| Discount rate   | 5.75%  | 6.00%  |
| Inflation rate  | 2.00%  | 2.00%  |
| Salary growth rate  | 3.00%  | 3.00%  |
| <b>Mortality table:</b>                                   |  |  |
| Employees (whilst in active service):                     | AM 92 males<br>AF 92 females   | AM 92 males<br>AF 92 females   |
| Pensioners and employees who have taken early retirement: | PA (90) m<br>less 3 years males<br>PA (90) f<br>less 3 years females | PA (90) m<br>less 2 years males<br>PA (90) f<br>less 2 years females |

Disability table: Swiss Reinsurance Company

Turnover of employees: Nil

Based on this study, the accumulated post retirement health care benefit obligation of PT Comunicações and PT SI as of December 31, 2004 and 2003 was Euro 701,797,100 and Euro 688,763,000, respectively. The reconciliation between the post retirement health care obligations and the liability recorded in the balance sheet at December 31, 2004 and 2003 is presented below:

|  | <u>2004</u>        | <u>2003</u>        |
|--|--------------------|--------------------|
| Accumulated health care benefit obligation   | 701,797,100        | 688,763,000        |
| Actuarial losses, net(i)                     | (108,483,572)      | (120,927,369)      |
| Transition obligation(ii)                    | (40,669,000)       | (46,273,802)       |
| Prior year service gain                      | 3,333,000          | 3,540,000          |
| <b>Post retirement health care liability</b> | <b>555,977,528</b> | <b>525,101,829</b> |

- (i) Actuarial losses, net result basically from the difference between the actual and expected healthcare costs and higher inflation rates than the long-term assumptions considered in the actuarial studies. These actuarial gains and losses will be amortized over 14 years, which

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

corresponds to the estimated average working life of active employees. During 2004 and 2003 the movements in the caption "Actuarial losses, net" were as follows:

|  | 2004                 | 2003                 |
|--|----------------------|----------------------|
| Beginning balance                                    | (120,927,369)        | (112,772,283)        |
| Actuarial gains/(losses), net arising in the period: |                      |                      |
| PBO related  | 8,772,797            | (14,707,086)         |
| Amortization of the period                           |                      |                      |
| Regular  | 3,302,000            | 6,036,000            |
| Curtailment related                                  | 369,000              | 516,000              |
| Ending balance                                       | <b>(108,483,572)</b> | <b>(120,927,369)</b> |

(ii)

The transition obligation results from the first time recognition of other employee benefits, in 1997. This amount will be amortized over the estimated average working life of active employees at that date, which was estimated to be 18 years. The costs related with the amortization of the transition obligation were recorded in the caption "Post retirement benefits" (Euro 4,207,000) and in the caption "Work force reduction program costs" (Euro 1,399,000).

A summary of the components of the net periodic post retirement health care cost for the years ended December 31, 2004 and 2003, is presented below:

|   | 2004              | 2003              |
|---|-------------------|-------------------|
| Service cost  | 5,061,000         | 5,628,000         |
| Interest cost   | 36,935,000        | 38,131,000        |
| Net amortization of deferrals   | 7,335,000         | 10,649,000        |
| Sub-total (Note 30.4)   | 49,331,000        | 54,408,000        |
| Curtailment costs related to early retirements, pre-retirements and suspended contracts (Note 30.4) | 11,120,100        | 27,363,000        |
| Net periodic post retirement health care costs  | <b>60,451,100</b> | <b>81,771,000</b> |

Curtailment costs were recorded in the caption "Work Force Reduction Program Costs".

During 2004, the contribution made to PT-ACS, net of the contributions from the SNS (Note 3.g)), amounted to Euro 29,777,489 and were recorded as a reduction to the accrued post retirement liability (Note 30.3).

As of December 31, 2004, the accrued post retirement health care liabilities include Euro 95,088 relating to healthcare liabilities of Brasilcel's subsidiaries (Note 30.3).

**3. Balance sheet captions**

Accrued Post Retirement Liability

This caption consists of:

|   | <b>2004</b>          | <b>2003</b>          |
|---|----------------------|----------------------|
| <b>Accrued Post Retirement Liability:</b> |                      |                      |
| Pension benefits (Note 30.1)              | 713,795,628          | 730,872,244          |
| Other employee benefits (Note 30.2)       | 556,072,616          | 525,166,751          |
|   | <b>1,269,868,244</b> | <b>1,256,038,995</b> |
| <b>Accounts Payable</b> (Note 30.1)       |                      | 4,672,376            |
|   | <b>1,269,868,244</b> | <b>1,260,711,371</b> |

The net increase in the accrued post retirement liabilities during the year of 2004 amounted to Euro 13,829,249, as follows:

|   | <b>Pension<br/>benefits</b> | <b>Other employee<br/>benefits</b> | <b>Total</b>      |
|---|-----------------------------|------------------------------------|-------------------|
| Post retirement benefits (Note 30.4)                        | 89,180,969                  | 49,331,000                         | 138,511,969       |
| Work force reduction program costs (Note 30.4)              | 156,719,526                 | 11,120,100                         | 167,839,626       |
| Payments to pre-retired and suspended employees (Note 30.1) | (143,056,984)               |                                    | (143,056,984)     |
| Contributions to pension funds and PT ACS (Note 30.1)       | (121,242,343)               | (29,777,489)                       | (151,019,832)     |
| Changes in consolidation                                    | 288,000                     |                                    | 288,000           |
| Currency translation adjustments                            | 130                         | 245                                | 375               |
| Other adjustments   | 1,034,086                   | 232,009                            | 1,266,095         |
|   | <b>(17,076,616)</b>         | <b>30,905,865</b>                  | <b>13,829,249</b> |

F-65

**4. Profit and loss captions**

|   | <b>2004</b>        | <b>2003</b>        |
|---|--------------------|--------------------|
| <b>Net Periodic Pension Cost:</b>                       |                    |                    |
| Post retirement benefits:                               |                    |                    |
| Pension benefits (Notes 30.1 and 30.3)                  | 89,180,969         | 168,493,045        |
| Other employee benefits (Notes 30.2 and 30.3)           | 49,331,000         | 54,449,134         |
|   | <b>138,511,969</b> | <b>222,942,179</b> |
| <b>Work force reduction program costs:</b>              |                    |                    |
| Extraordinary post retirement benefits (curtailment):   |                    |                    |
| Pension benefits (Note 30.1)                            | 153,315,800        | 268,032,000        |
| Other employee benefits (Note 30.2)                     | 11,120,100         | 27,363,000         |
|   | 164,435,900        | 295,395,000        |
| Additional cost related to 2004 curtailment (Note 30.3) | 3,403,726          |                    |
| Termination payments                                    | 2,999,220          | 13,678,485         |
| Additional cost related to 2002 curtailment             |                    | 7,077,591          |
| Decrease in provisions to restructuring                 |                    | (2,066,374)        |
|   | <b>170,838,846</b> | <b>314,084,702</b> |

**31. Financial instruments and risk management**

Derivative financial instruments are basically used by the Company to manage interest rate and exchange rate exposure.

The contracting of financial instruments is made after careful analysis of the risks and rewards of these instruments based on information obtained from different financial institutions. These operations are subject to authorization from Portugal Telecom's Executive Committee and are permanently monitored through an analysis of the financial markets and the positions held by the Company. The fair-value of these derivatives is assessed several times during the year to determine the economic and financial implications of their cancellation.

**Interest rate exposure**

Interest rate swaps were contracted by Portugal Telecom in order to diversify interest rate exposure or to take advantage of the possibility of converting from variable rates to fixed rates. During 2004, certain financial instruments reached maturity which, together with the anticipated cancellation of others, resulted in a reduction of the notional of interest rate swaps. As of December 31, 2004 the notional of these interest rate swaps amounted to approximately Euro 472 million with an average maturity of 6.8 years.

During 2004, VIVO contracted interest rate swaps in Brazilian Reais, which as of December 31, 2004 amounted to BRL1,601 million with an average maturity of 3 days.

### Exchange rate and interest rate exposure

Cross currency swaps were contracted primarily to reduce exposure to exchange rate and interest rate risks. As of December 31, 2004 the Company had a cross currency swaps from U.S. Dollars to Euros, with a notional of approximately Euro 74 million and an average maturity of 6.8 years.

Pursuant the cancellation of the interest rate component of certain cross currency swaps, as of December 31, 2004 Portugal Telecom had contracted foreign exchange options and forwards of Euros to U.S. Dollars, with a notional of Euro 200 million and an average maturity of 4.3 years.

Additionally, Portugal Telecom had contracted forwards of Euros to U.S. Dollars in order to cover the risk associated to future cash flow payments. As of December 31, 2004, those contracts had a notional of Euro 12 million and had an average maturity of 6 months.

As of December 31, 2004 VIVO had cross currency swaps to cover accounts payable denominated in U.S. Dollars and Japanese Yens (JPY) with a notional of USD 878 million and JPY 6,827 million and an average maturity of 1.2 years and 8 months, respectively.

As of December 31, 2004 VIVO had also contracted: (i) other cross currency swaps (U.S. Dollars/Brazilian Reais) with a notional of USD 418 million and an average maturity of 1.4 years; and (ii) cross currency swaps (Euros/Brazilian Reais) with a notional of Euro 25 million and an average maturity of 2 months.

### Equity derivatives

As of 31 December 2004 Portugal Telecom had contracted the following equity derivatives:

(a)

Own shares

In order to facilitate the completion of the share buyback program, Portugal Telecom contracted to ABN Amro and Citibank equity swaps over 21,551,006 own shares, representing 1.72% of the share capital prior to the cancellation in December 2004 of the 7% treasury shares held. Considering the difference between the exercise price of those derivatives (ranging from Euro 7.14 to Euro 8.99 per share) and PT's stock price at 31 December 2004, Portugal Telecom did not record any provision to cover estimated losses with these equity swaps. These contracts had maturities ranging from 2 to 12 months.

(b)

PT Multimédia shares

In order to increase its exposure to PT Multimédia, Portugal Telecom contracted with Santander Group equity swaps over 15,287,545 PT Multimédia shares, representing 9.7% of its share capital, as follows:

(i)

9,187,545 shares, with an exercise price of Euro 17.74 and a maturity of 17 months; and

(ii)

6,100,000 shares, with an exercise price of Euro 14.10 and a maturity of 5 months.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Additionally, during 2004 Portugal Telecom contracted with Banco Espírito Santo Group (Note 33) equity derivatives which consist of options to acquire shares of PT Multimédia, representing 5% of its share capital. These options are as follows:

- (i) Portugal Telecom acquired from Banco Espírito Santo de Investimento, S.A. ("BESI") a call option over 6.063 million shares of PT Multimédia shares with a strike price of Euro 26.513 at maturity (31 December 2005). Portugal Telecom can exercise this option at any time and BESI can choose between physical or financial settlement (the latter has a 15% discount over the strike price). At the same time, BESI acquired from Portugal Telecom a call option over the same number of shares of PT Multimédia with a strike price of Euro 16, which only offers the possibility of financial settlement. This call option can only be exercised if the stock price of PT Multimédia is above the strike of the call option acquired by Portugal Telecom, making the exercise of the option automatic in the case that Portugal Telecom exercises its call option.
- (ii) Portugal Telecom receives from Banco Espírito Santo a call option over 1.5 million PT Multimédia shares with a strike of Euro 23 at maturity (31 December 2005). Portugal Telecom can exercise this option at any time and Banco Espírito Santo can choose between physical or financial settlement (the latter has a 20% discount on the strike price).

As a result of these contracts, Portugal Telecom will receive from BESI an aggregate premium of Euro 16.657 million, corresponding to the difference between the acquisition prices of the options referred above, with 50% of this amount payable in December 31, 2004 and the remaining 50% on the exercise date of the option acquired by BESI or, if that option is not exercised, in December 31, 2005. This premium can only be claimed if BESI receives a premium in connection to any options contracted with these third parties to hedge BESI's position regarding the call options acquired and sold to PT over 6.063 million shares of PT Multimédia as referred above. In addition, BESI must clearly demonstrate to Portugal Telecom that these hedging options were contracted with third parties and that there was a default event on the payment of the corresponding premium. Given that BESI will celebrate with third parties an option contract that would permit it to obtain the hedging of the position assumed on the contract referred above, Portugal Telecom and BESI agreed that the latter has the right to reduce the options included in the contract to 3.469 million shares, with the proportional decreases in prices and fees, if those entities do not comply with their contractual obligations. However, BESI committed to develop all efforts to guarantee that those entities will assume their obligations. The amount payable at the end of 2004, amounting to Euro 8,328,285 was recorded under the caption "Deferred income" (Note 17).

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Fair value of financial instruments

As of December 31, 2004 and 2003 the carrying value and fair value of financial instruments are as follows (amounts in millions of Euros):

|  | 2004           |               | 2003           |             | 2002           |                |
|--|----------------|---------------|----------------|-------------|----------------|----------------|
|  | Carrying Value | Fair Value    | Carrying Value | Fair Value  | Carrying Value | Fair Value     |
| <b>Financial instruments to manage the risks of:</b> |                |               |                |             |                |                |
| Interest rate (Note 3.p)                             | 1.3            | (22.0)        | (8.5)          | (61.9)      | 1.1            | (66.2)         |
| Interest rate and exchange rate (Note 3.p)           | (67.7)         | (63.5)        | 80.5           | 99.5        | 162.0          | 75.5           |
| <b>Total</b>   | <b>(66.4)</b>  | <b>(85.5)</b> | <b>72.0</b>    | <b>37.6</b> | <b>163.1</b>   | <b>9.3</b>     |
| <b>Equity Swaps:</b>                                 |                |               |                |             |                |                |
| Own shares   | (0.6)          | 6.0           | (24.4)         | 3.4         | (42.6)         | (40.2)         |
| PT Multimédia shares                                 | (1.4)          | 43.8          | (3.9)          | 15.5        | (68.5)         | (69.1)         |
| <b>Total</b>   | <b>(2.0)</b>   | <b>49.8</b>   | <b>(28.3)</b>  | <b>18.9</b> | <b>(111.1)</b> | <b>(109.3)</b> |

32. Contingencies and Commitments

a) Tax contingencies

As of December 31, 2004 the Company is subject to certain tax contingencies. The Company's management, based on information obtained from the Company's legal counsel, does not expect that the resolution of these matters will have a material adverse effect on the Company's financial position or results of operations. These contingencies, which have not been provided for as of December 31, 2004 are as follows:

The tax returns of the former TLP for the years 1990 to 1993, the former TP for the year 1993 and the former Marconi and PT for the years 1997 to 1999, were reviewed by the tax authorities, resulting in additional income tax assessments amounting to Euro 28,008,616. Portugal Telecom decided to contest these assessments, based upon the opinion of its lawyers whose consensus is that the outcome will be in Portugal Telecom's favour.

Portugal Telecom is challenging the assessments made by the Municipal Councils of Porto and Lisbon relating to the usage of public rights-of-way for its telecommunications infrastructure, which as of December 31, 2004 were as follows:

|                             |                  |
|-----------------------------|------------------|
| Municipal Council of Oporto | 1,235,533        |
| Municipal Council of Lisbon | 102,553          |
|                             | <b>1,338,086</b> |

Pursuant to the New Basic Law (Law 91/97) operators of basic telecommunications networks, such as Portugal Telecom, are exempt from municipal taxes and rights-of-way and other fees with respect to access to and installation and usage of their telecommunications networks in connection with their obligations under their concession from the Portuguese Government, such as the Concession. The

Portuguese Government has stated that the New Basic Law confirms the exemption under Article 29 of the Concession, which was established by the decree law authorizing the Concession.

Additionally, there are the following situations which are fully provided for:

1. Due to additional assessments related with the 1999 and 2000 income tax returns of Portugal Telecom, SGPS, S.A., an accrual amounting to Euro 13,975,284 has been recorded and included in the provision for other risks and costs (Note 18).
2. Due to additional assessments related with the 1999 and 2000 income tax returns of PT Comunicações and related with the benefit from the tax credit from the investment, an accrual amounting to Euro 1,963,893 has been recorded and included in the provision for other risks and costs (Note 18).
3. In relation to the 1997, 1998 and 1999 tax returns, in the case that the positions taken by Portugal Telecom are considered to be inadequate, taxes have been paid or accruals have been recorded, which as of December 31, 2004 amounted to Euro 1,116,083 (Note 15).

**b) Other actions**

The activity of Portugal Telecom is regularly subject to investigations by ANACOM, the European Commission and the Competitor Authority, in connection with the review of the application of the related laws and regulations in its business practices. As of 31 December 2004 the Competition Authority is conducting an investigation related with the alleged use of predatory prices between PT Comunicações and PT Prime, price discrimination in the wireline business (wholesale and retail) and reductions in margins. Portugal Telecom might have to pay fines and penalties if, as a result of the investigations, it is considered guilty. Portugal Telecom considers that, based on information obtained from its lawyers, the final outcome of these legal actions do not have a material impact in the Company's financial position as of December 31, 2004.

**c) Claims by a consumer protection association**

The introduction by Portugal Telecom of new prices for fixed telephone services as from February 1998, which were subsequently approved by ICP Instituto de Comunicações de Portugal (currently ANACOM Autoridade Nacional de Comunicações "ANACOM") and by Direcção Geral de Concorrência e Preços has caused several legal actions from DECO Associação de Defesa do Consumidor ("DECO"). From a financial standpoint, the most relevant is the inhibiting action submitted in September 1999, in which it is demanded that ANACOM abstain from approving the prices for 1999 and that Portugal Telecom be forbidden from applying them. In the first instance the Court decided that the new prices were illegal and condemned Portugal Telecom to refund the amounts charged in 1999 as activation fees and publish the decision. Portugal Telecom did not accept the decision, considering it illegal, and through PT Comunicações submitted several appeals against this decision to superior courts, which maintained the decision of the first instance Court. In October 2003 PT Comunicações was notified by the Supreme Court that its appeal was denied and that it should refund the amounts charged in 1999 as activation fees. However, in March 2004 PT Comunicações and DECO signed an agreement facilitating an alternative solution to the refund of the amounts charged in 1999 as activation fees. This agreement comprises several initiatives implemented by PT Comunicações



during 2004, which had a cost of Euro 10 million (Note 27) that was recorded as an other non-operating expense. As a result of this agreement, DECO removed all legal actions against PT Comunicações on this subject matter.

#### d) Guarantees

As of December 31, 2004 the Company has given guarantees and comfort letters to third parties, as follows:

|   |             |
|---|-------------|
| Bank guarantees given to Portuguese courts for outstanding litigation | 9,036,548   |
| <hr/>   |             |
| Bank guarantees given to other entities:                              |             |
| By PT Comunicações(1)   | 18,287,518  |
| By PT Multimédia and subsidiaries(2)                                  | 9,332,897   |
| By TMN to ANACOM  | 3,162,539   |
| Other bank guarantees   | 1,540,519   |
| <hr/>   |             |
|   | 32,323,473  |
| <hr/>   |             |
| Comfort letters and other bank guarantees(3):                         |             |
| Sport TV  | 89,518,512  |
| Warner Lusomundo Espanha  | 13,333,333  |
| TV Cabo Macau   | 7,341,605   |
| Vasp  | 5,588,875   |
| Other   | 911,378     |
| <hr/>   |             |
|   | 116,693,703 |
| <hr/>   |             |

- (1) These guarantees were given by PT Comunicações to the Portuguese Tax Authorities, in respect of the tax contingencies discussed in Note 32.a).
- (2) These guarantees were given by PT Multimédia, to Alta Autoridade para a Comunicação Social (the Portuguese media regulator), in connection with the broadcasting of television shows.
- (3) These comfort letters were issued by the Group in order to guarantee loans obtained by associated companies. On September 1, 2004 PT Multimédia and PPTV Publicidade de Portugal e Televisão, S.A. (the other shareholder of Sport TV, together with PT Conteúdos) granted to Sport TV, a guarantee amounting to Euro 70 million, to cover a loan obtained by this company to acquire the rights to broadcast the games of the Portuguese football league for the seasons from 2004-2005 to 2007-2008.

#### e) Purchase commitments

As of December 31, 2004, the Company had assumed commitments for the purchase of basic equipment amounting to approximately Euro 79.2 million.

**f) Financial commitments**

In October 2000, Médi Telecom entered into medium and long term loan contracts totaling Euro 1,000,000,000 with a consortium led by International Finance Corporation and the banks ABN Amro and Société Générale. The loans have an average term of 8 years and serve to refinance the short term loan obtained to finance the acquisition of the mobile telecommunications license for Morocco in August 1999 and to cover the investment relating to the installation and development of the GSM network.

Under the provisions of the contracts, Médi Telecom is required to attain certain financial performance levels. In accordance with the financing operation, the major shareholders of Médi Telecom, Portugal Telecom, through PT Móveis (32.18%), Telefónica Intercontinental, S.A. (32.18%) and Banque Marocaine du Commerce Extérieur (18.06%), signed a Shareholders Support Deed, under which they are committed to make future capital contributions to Médi Telecom (in the form of capital or shareholders' loans), if this is necessary to cover possible shortfalls in the agreed financial targets. As a result of loans already granted to Médi Telecom by PT Móveis and Telefónica Intercontinental, the maximum amount of this liability, as of December 31, 2004, is limited to an additional maximum of Euro 84,000,000 and ends as soon as Médi Telecom reaches a Net Debt/EBITDA ratio of less than 3.0 during four consecutive quarters.

Portugal Telecom signed a Shareholders' Agreement with the other shareholders of Sportinveste, in which Portugal Telecom committed to give additional paid in capital contributions up to a maximum of Euro 40,000,000. As of December 31, 2004 Portugal Telecom had already granted additional paid in capital contributions to Sportinveste amounting to Euro 30,023,168 (Note 10).

**33. Transactions with Related Entities**

**Transactions with Portuguese State**

**a) Concession Agreement**

On February 15, 1995, through Decree Law 40/95, the Portuguese Government granted Portugal Telecom the exclusive right to provide infrastructure and leased circuit services as well as fixed telephone, telex and telegraphy services in Portugal. These rights were granted for an initial period of 30 years and can be renewed for successive minimum periods of 15 years. The above referred exclusive rights remained in force up to the date that the Portuguese Government liberalized the telecommunications industry. This Decree Law and the subsequent Concession Contract dated March 20, 1995 (the "Concessions Contract") establish the administrative and operational obligations of Portugal Telecom, the basic service prices framework, and the rent payable to the Portuguese State.

On September 9, 2000, through Decree Law 219/2000, the Portuguese Government approved the transfer of Portugal Telecom's position in the Concession Agreement to PT Comunicações and established the conditions for the related transfer of assets, liabilities, rights and obligations from Portugal Telecom to PT Comunicações.

On December 11, 2002, according to the terms of the Modifying Agreement to the Concession Contract, PT Comunicações acquired the ownership of the Basic Network and, as a result, the concession rent was terminated together with the reversibility principle that was previously applicable to concession assets.

**b) Discounts to retired Portuguese citizens**

In accordance with Decree Law 20-C/86, certain eligible retired Portuguese citizens are entitled to a discount on the telephone tariff, which is reimbursed to PT Comunicações by the Portuguese State. Up to December 31, 2001 this receivable balance was to be offset against the concession rent payable to the Portuguese State. As a result of the acquisition of the Basic Network at the end of 2002 and the related Modifying Agreement to the Concession Contract, this receivable balance should now be paid directly by the Portuguese State, which committed to include the corresponding expense in the Annual State Budget of incoming years, as stated by Decree Law 18/2003. As of December 31, 2004 the account receivable balance from the Portuguese State regarding discounts to retired Portuguese citizens amounts to Euro 47,597,244 (Note 7) and is made up as follows:

|                                   |                   |
|-----------------------------------|-------------------|
| Discounts given in 2003 (Note 14) | 26,392,172        |
| Discounts given in 2004           | 21,205,072        |
|                                   | <hr/>             |
|                                   | <b>47,597,244</b> |
|                                   | <hr/>             |

During 2004, PT Comunicações had signed agreements with a financial institution relating to the sale of the accounts receivable balances regarding the discounts given in 2002 and 2003. PT Comunicações received cash advances of those amounts, less the related expenses inherent in these transactions, and recorded accounts payable to this financial institution totaling Euro 53,791,776. In August 2004, the Portuguese State paid Euro 27,399,604, related with the discounts given in 2002. All expenses related with these transactions were recorded in the profit and loss statement.

**Other transactions**

Three of our major shareholders are financial institutions. We have entered into related party transactions with those entities within our ordinary course of business, and always on arm's length terms. During 2004, the executed transactions were usually corporate finance transactions and financial advisory services provided to us by these financial institutions and agreements for us to provide telecommunications and broadband services to such institutions. Additionally, during 2004, Portugal Telecom contracted with one of our major shareholder (Banco Espírito Santo Group) equity derivatives over PT Multimédia shares. The specific terms of this transaction, have been disclosed in Note 31.

During 2004 and as of the date of this Annual Report in 2005, none of Portugal Telecom Directors and no member of the management team has been involved in any related party transactions with Portugal Telecom.

**34. Disclosures about Segments of the Company and Related Information**

**34.1 General**

The basis used by management to identify the reportable segments was a combination of the following factors:

- (i) Differences in products and services;
- (ii) Differences in regulatory environments; and
- (iii) Geographic areas.

These segments are consistent with the way management currently analyses its businesses.

The Company identified the following reportable primary segments:

|  |  |
|--|--|
| <b>Wireline Business(1)</b>                  | Retail<br>Wholesale<br>Data and Corporate<br>Other   |
| <b>Domestic Mobile</b>                       | TMN(2)   |
| <b>Brazilian Mobile</b>                      | VIVO(3)  |
| <b>Multimedia Businesses (PT Multimédia)</b> | <b>Pay TV and Cable Internet</b> TV Cabo, PT Conteúdos and Primum TV<br><b>Audiovisuals</b> Lusomundo Audiovisuais and Lusomundo Cinemas<br><b>Media</b> Lusomundo Serviços and Lusomundo Media<br><b>Other Multimedia Operations</b> PT Multimédia and other sub-holdings |

- 
- (1) The wireline business includes several services which are provided mainly by PT Comunicações, PT Prime and PT.com.
  - (2) This business segment derives its revenues from mobile telecommunication services in Portugal.
  - (3) This business segment derives its revenues from mobile telecommunication services in Brazil, provided by Brasilcel's subsidiaries in several States of Brazil (Note 1).

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Transactions between segments are accounted for in the same manner as transactions with external parties.

The summarized results for each reportable segment do not include some extraordinary items as capital gains or losses from the sale/exchange of financial assets and are presented before consideration of the minority interests at Group level. The minority interests considered in each reportable segment are only related to the direct interests of minority shareholders of subsidiaries of the sub-holdings for each reportable segment.

Portugal Telecom has also identified its reportable secondary segments based on the geographical area in which businesses are located. Therefore, Portugal Telecom's reportable secondary segments are the (i) domestic market, (ii) the international market in Brazil and (iii) other international markets. In Notes 11 and 12 there is information related with the fixed and intangible assets for each of these segments.

The primary measure of profit and loss used by Portugal Telecom's management in assessing segment performance is operating profit before amortization and depreciation.

F-75

---

**34.2. Wireline Business**

Summarized profit and loss statements for this reportable segment, for the years ended December 31, 2004, 2003 and 2002 are presented below:

|  | 2004                   | 2003                   | 2002                   |
|--|------------------------|------------------------|------------------------|
| Services rendered external customers (Note 21)                 | 2,086,824,597          | 2,101,301,697          | 2,238,851,862          |
| Services rendered intersegment revenues                        | 141,873,589            | 149,583,769            | 167,112,101            |
| Sales of merchandise and products external customers (Note 21) | 37,005,436             | 36,752,930             | 34,784,907             |
| Sales of merchandise and products inter segment sales          | 605,158                | 225,361                | 329,109                |
| <b>Operating revenues</b>                                      | <b>2,266,308,780</b>   | <b>2,287,863,757</b>   | <b>2,441,077,979</b>   |
| Wages and salaries   | (294,984,700)          | (314,596,639)          | (350,923,455)          |
| Post-Retirement benefits                                       | (137,777,495)          | (219,938,209)          | (180,873,048)          |
| Costs of telecommunications                                    | (383,783,838)          | (428,914,406)          | (496,813,900)          |
| Depreciation and amortization                                  | (381,249,683)          | (404,339,250)          | (431,653,191)          |
| Own work capitalized   | 28,012,029             | 36,141,884             | 64,817,575             |
| Costs of products sold   | (37,873,306)           | (45,842,620)           | (32,206,438)           |
| Marketing and publicity  | (44,554,892)           | (26,598,019)           | (29,238,089)           |
| Concession rent  |                        |                        | 16,604,413             |
| General and administrative expenses                            | (270,062,380)          | (211,729,896)          | (225,969,200)          |
| Other net operating income                                     | (222,867,253)          | (169,128,124)          | (221,047,435)          |
| <b>Operating costs and expenses</b>                            | <b>(1,745,141,518)</b> | <b>(1,784,945,279)</b> | <b>(1,887,302,768)</b> |
| <b>Operating income</b>  | <b>521,167,262</b>     | <b>502,918,478</b>     | <b>553,775,211</b>     |
| Interest and related expenses                                  | (34,495,972)           | (47,651,404)           | (42,676,538)           |
| Goodwill amortization  | (7,152,717)            | (7,152,717)            | (7,679,221)            |
| Interest and related income                                    | 16,094,994             | 11,890,237             | 21,969,307             |
| Gains/(losses) on sales and disposals of fixed assets          | (158,372)              | 41,067,614             | 10,759,611             |
| Equity in losses of affiliated companies                       | (970,469)              | (1,077,261)            | (2,374,945)            |
| Work force reduction program costs                             | (169,558,740)          | (311,263,761)          | (49,313,318)           |
| Other net non-operating income/(expenses)                      | (6,630,168)            | (5,127,044)            | 694,630                |
| Extraordinary items  | 2,534,729              | (16,698,573)           | (487,818)              |
| <b>Income before income tax</b>                                | <b>320,830,547</b>     | <b>166,905,569</b>     | <b>484,666,919</b>     |
| Provision for income taxes                                     | (88,829,879)           | (137,646,453)          | (162,826,053)          |
| Income applicable to minority interests                        |                        | (63,774)               | (23,055)               |
| <b>Net income</b>  | <b>232,000,668</b>     | <b>29,195,342</b>      | <b>321,817,811</b>     |

Net income of this segment for years ended December 31, 2004, 2003 and 2002 was affected by curtailment costs of Euro 169,558,740, Euro 311,263,761 and Euro 49,313,318, respectively.

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Capital expenditures for this reportable segment for the years ended December 31, 2004, 2003 and 2002 were approximately Euro 206.4 million, Euro 165.3 million and Euro 604.6 million (including Euro 348.4 million related with the acquisition of the Basic Network), respectively. Total assets as of December 31, 2004 and 2003 were approximately Euro 3,976.8 million and Euro 3,969.0 million, respectively.

**34.3. Domestic Mobile TMN**

Summarized profit and loss statements for this reportable segment, for the years ended December 31, 2004, 2003 and 2002 are presented below:

|  | <b>2004</b>            | <b>2003</b>            | <b>2002</b>            |
|--|------------------------|------------------------|------------------------|
| Services rendered external customers (Note 21)                 | 1,300,371,237          | 1,213,221,073          | 1,132,761,033          |
| Services rendered intersegment revenues                        | 139,782,376            | 170,853,927            | 199,947,958            |
| Sales of merchandise and products external customers (Note 21) | 143,922,012            | 133,519,224            | 133,886,964            |
| Sales of merchandise and products inter segment sales          | 4,190,499              | 5,001,030              | 8,155,430              |
| <b>Operating revenues</b>                                      | <b>1,588,266,124</b>   | <b>1,522,595,254</b>   | <b>1,474,751,385</b>   |
| Wages and salaries   | (56,269,494)           | (59,188,048)           | (48,503,874)           |
| Costs of telecommunications                                    | (296,614,686)          | (295,485,140)          | (325,280,447)          |
| Depreciation and amortization                                  | (200,874,938)          | (189,900,617)          | (174,935,873)          |
| Own work capitalized   | 1,583,645              | 4,448,129              | 5,239,064              |
| Costs of products sold   | (170,866,479)          | (154,749,178)          | (167,983,520)          |
| Marketing and publicity  | (28,492,459)           | (26,260,516)           | (20,058,815)           |
| General and administrative expenses                            | (198,612,849)          | (210,773,711)          | (194,412,360)          |
| Other net operating income                                     | (92,295,823)           | (90,723,844)           | (100,537,618)          |
| <b>Operating costs and expenses</b>                            | <b>(1,042,443,083)</b> | <b>(1,022,632,925)</b> | <b>(1,026,473,443)</b> |
| <b>Operating income</b>  | <b>545,823,041</b>     | <b>499,962,329</b>     | <b>448,277,942</b>     |
| Interest and related expenses                                  | (9,855,549)            | (19,938,321)           | (13,672,071)           |
| Interest and related income                                    | 2,728,721              | 4,377,768              | 4,102,884              |
| Gains/(losses) on sales and disposals of fixed assets          | (8,246,778)            | (3,924,613)            | (9,474,681)            |
| Other net non-operating income/(expenses)                      | (996,684)              | (2,567,885)            | 9,578,881              |
| Extraordinary items  |                        |                        | (50,915,335)           |
| <b>Income before income tax</b>                                | <b>529,452,751</b>     | <b>477,909,278</b>     | <b>387,897,620</b>     |
| Provision for income taxes                                     | (143,305,228)          | (159,643,314)          | (128,132,791)          |
| <b>Net income</b>  | <b>386,147,523</b>     | <b>318,265,964</b>     | <b>259,764,829</b>     |

Capital expenditures for this reportable segment for the years ended December 31, 2004, 2003 and 2002 were approximately Euro 158.8 million, Euro 168.5 million and Euro 282.7 million, respectively, and total assets as of December 31, 2004 and 2003 were approximately Euro 1,464.2 million and Euro 1,335.6 million, respectively.

**34.4. Brazilian Mobile**

Summarized profit and loss statements for this reportable segment, for the years ended December 31, 2004, 2003 and 2002 are presented below:

|  | <b>2004</b>            | <b>2003</b>            | <b>2002</b>          |
|--|------------------------|------------------------|----------------------|
| Services rendered external customers (Note 21)                 | 1,183,397,482          | 1,093,778,637          | 1,048,632,419        |
| Services rendered intersegment revenues                        | (7,750)                | 24,134                 | 438,283              |
| Sales of merchandise and products external customers (Note 21) | 319,587,207            | 267,735,126            | 168,989,855          |
| <b>Operating revenues</b>                                      | <b>1,502,976,939</b>   | <b>1,361,537,897</b>   | <b>1,218,060,557</b> |
| Wages and salaries   | (93,145,897)           | (75,242,602)           | (60,175,996)         |
| Costs of telecommunications                                    | (87,746,166)           | (114,184,193)          | (109,159,918)        |
| Depreciation and amortization                                  | (267,833,258)          | (254,003,543)          | (236,719,658)        |
| Costs of products sold   | (371,185,077)          | (293,220,874)          | (197,576,814)        |
| Marketing and publicity  | (68,269,102)           | (50,479,600)           | (28,810,396)         |
| General and administrative expenses                            | (292,406,297)          | (252,152,645)          | (224,044,955)        |
| Other net operating income                                     | (93,879,883)           | (67,555,012)           | (85,607,551)         |
| <b>Operating costs and expenses</b>                            | <b>(1,274,465,680)</b> | <b>(1,106,838,469)</b> | <b>(942,095,288)</b> |
| <b>Operating income</b>  | <b>228,511,259</b>     | <b>254,699,428</b>     | <b>275,965,269</b>   |
| Interest and related expenses                                  | (214,182,985)          | (219,227,392)          | (212,600,748)        |
| Goodwill amortization  | (38,634,938)           | (53,076,620)           | (9,254,776)          |
| Interest and related income                                    | 79,941,276             | 152,176,165            | 45,334,794           |
| Gains/(losses) on sales and disposals of fixed assets          | (1,842,721)            | (4,743,592)            | 3,660,724            |
| Equity in losses of affiliated companies                       |                        |                        | (88,641,563)         |
| Other net non-operating income/(expenses)                      | (4,615,832)            | (2,808,208)            | 125,011              |
| <b>Income before income tax</b>                                | <b>49,176,059</b>      | <b>127,019,781</b>     | <b>14,588,711</b>    |
| Provision for income taxes                                     | (65,352,452)           | (85,374,043)           | (48,856,903)         |
| Income applicable to minority interests                        | (43,014,109)           | (51,527,882)           |                      |
| <b>Net income/(loss)</b>                                       | <b>(59,190,502)</b>    | <b>(9,882,144)</b>     | <b>(34,268,192)</b>  |

Net income of this reportable segment for the years ended December 31, 2004 and 2003 corresponds to 50% of the net income of Brasilcel, and for the year ended December 31, 2002, net income corresponds to Telesp Celular Participações results.

Capital expenditures for 50% of VIVO for the years ended December 31, 2004 and 2003 were approximately Euro 264.5 million and Euro 164.6 million, respectively and 50% of the total assets of Brasilcel as of December 31, 2004 and 2003 amounted to Euro 4,044.6 million and Euro 3,742.4 million, respectively. In the year ended December 31, 2002 TCP's capital expenditures were approximately Euro 88.2 million.



**34.5. PT Multimédia**

Summarized profit and loss statements for this reportable segment, for the years ended December 31, 2004, 2003 and 2002 are presented below:

|  | <b>2004</b>          | <b>2003</b>          | <b>2002</b>          |
|--|----------------------|----------------------|----------------------|
| Services rendered external customers (Note 21)                 | 616,240,929          | 544,080,630          | 475,777,581          |
| Services rendered intersegment revenues                        | 817,860              | 786,529              | 856,400              |
| Sales of merchandise and products external customers (Note 21) | 112,732,733          | 139,397,732          | 146,124,312          |
| Sales of merchandise and products inter segment sales          | 2,524                | 57,584               |                      |
| <b>Operating revenues</b>                                      | <b>729,794,046</b>   | <b>684,322,475</b>   | <b>622,758,293</b>   |
| Wages and salaries   | (86,726,376)         | (83,786,203)         | (86,009,282)         |
| Post-Retirement benefits                                       | (558,863)            | (1,139,803)          | (1,277,171)          |
| Costs of telecommunications                                    | (26,783,807)         | (25,165,051)         | (25,189,171)         |
| Depreciation and amortization                                  | (58,610,282)         | (62,989,542)         | (73,090,945)         |
| Own work capitalized   | 997,851              | 982,100              | 2,068,135            |
| Costs of products sold   | (25,657,733)         | (59,060,297)         | (66,624,370)         |
| Marketing and publicity  | (39,567,851)         | (30,217,909)         | (27,764,974)         |
| General and administrative expenses                            | (312,025,311)        | (306,572,517)        | (296,912,833)        |
| Other net operating income                                     | (47,897,598)         | (44,682,459)         | (41,874,813)         |
| <b>Operating costs and expenses</b>                            | <b>(596,829,970)</b> | <b>(612,631,681)</b> | <b>(616,675,424)</b> |
| <b>Operating income</b>  | <b>132,964,076</b>   | <b>71,690,794</b>    | <b>6,082,869</b>     |
| Interest and related expenses                                  | (7,936,890)          | (11,493,537)         | (4,055,399)          |
| Goodwill amortization  | (14,803,469)         | (13,622,067)         | (38,766,281)         |
| Interest and related income                                    | 1,249,283            | 6,529,136            | 3,176,197            |
| Gains/(losses) on sales and disposals of fixed assets          | (994,830)            | (3,883,337)          | (934,853)            |
| Equity in earnings/(losses) of affiliated companies            | 988,135              | (6,287,657)          | (12,166,472)         |
| Work force reduction program costs                             | (565,893)            |                      | (5,721,601)          |
| Other net non-operating income/(expenses)                      | (3,278,264)          | (6,869,410)          | (9,965,493)          |
| Extraordinary items  | (77,563,309)         | (61,667,538)         | 3,610,051            |
| <b>Income before income tax</b>                                | <b>30,058,839</b>    | <b>(25,603,616)</b>  | <b>(58,740,982)</b>  |
| Income taxes   | 82,615,694           | 55,758,667           | 4,284,446            |
| Income applicable to minority interests                        | (2,304,550)          | 948,063              | 2,388,427            |
| <b>Net income/(loss)</b>                                       | <b>110,369,983</b>   | <b>31,103,114</b>    | <b>(52,068,109)</b>  |

The net income for this reportable segment for the year ended December 31, 2004 was affected by: (i) a provision recorded by TV Cabo amounting to Euro 26,250,000 in connection with the dismantling of the analogue premium service and the implementation of a digital offer (Note 18); (ii) extraordinary costs amounting to Euro 40,000,000 related with provisions to cover estimated losses in the audiovisuals business (Note 18); and (iii) the initial recognition of deferred tax assets related with tax losses from previous years, since only in 2004 was obtained evidence that these tax losses can be realized.

Capital expenditures for this reportable segment for the years ended December 31, 2004, 2003 and 2002 were approximately Euro 80.5 million, Euro 57.4 million and Euro 78.9 million, respectively, and total assets as of December 31, 2004 and 2003 amounted to Euro 1,145.7 million and Euro 900.7 million, respectively.

### 34.6. Reconciliation of Operating Revenues and Net Income

#### a) Operating revenues

|                                       | 2004                        | 2003                        | 2002                        |
|---------------------------------------|-----------------------------|-----------------------------|-----------------------------|
|                                       | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total relating to reportable segments | 6,087,345,889               | 5,856,319,383               | 5,756,648,214               |
| Total relating to other segments      | 440,823,444                 | 404,819,337                 | 346,042,109                 |
| Elimination of intragroup revenues    | (505,315,362)               | (485,027,145)               | (520,657,203)               |
|                                       | <u>6,022,853,971</u>        | <u>5,776,111,575</u>        | <u>5,582,033,120</u>        |

#### b) Net income

|   | 2004                        | 2003                        | 2002                        |
|---|-----------------------------|-----------------------------|-----------------------------|
|   | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total relating to reportable segments                         | 669,327,672                 | 368,682,276                 | 495,246,339                 |
| Total relating to other segments                              | 16,677,009                  | 29,476,170                  | 33,530,955                  |
| Other items:  |                             |                             |                             |
| Financial expenses related with loans obtained at group level | (178,784,093)               | (165,325,475)               | (178,756,687)               |
| Exchange (Losses)/Gains with derivative instruments           | (12,334,906)                | (17,303,832)                | 147,846,301                 |
| Goodwill amortization at group level                          | (36,531,365)                | (36,761,366)                | (94,651,546)                |
| Equity accounting in losses of affiliated companies, net      | 27,704,179                  | (11,791,756)                | (57,690,370)                |
| Provisions for financial instruments                          | 11,305,603                  | 82,498,690                  | (26,830,171)                |
| Effect of change in tax rate                                  |                             | (56,118,907)                |                             |
| Adjustment of income tax                                      | 49,448,684                  | 60,267,671                  | 14,467,910                  |
| Minority interests not included on reportable segments        | (46,687,388)                | (13,388,170)                | 57,893,067                  |
|   | <u>500,125,395</u>          | <u>240,235,301</u>          | <u>391,055,798</u>          |

#### c) Total assets

|  | 2004                        | 2003                        |
|--|-----------------------------|-----------------------------|
|  | <u>                    </u> | <u>                    </u> |
| Total assets relating to reportable segments | 10,631,070,000              | 9,947,546,169               |
| Total assets relating to other segments      | 1,522,226,513               | 2,694,094,182               |
| Goodwill                                     | 501,764,481                 | 529,986,996                 |
| Investments in associated companies          | 308,348,166                 | 386,187,913                 |
|  | <u>12,963,409,160</u>       | <u>13,557,815,260</u>       |

### 35. Subsequent Events

The following significant events occurred after 31 December 2004:

On 5 January 2005 TCP successfully completed the capital increase of approximately BRL 2,054 million, which comprised the rights issue of BRL 2,000 million and the subscription in kind equivalent to the tax credits related to year 2003 in the amount of BRL 53.89 million. The proceeds of the rights issue were used to repay a bridge loan related to the TCO tender offer and to repay other short-term debt. With this capital increase the controlling shareholders increased the economic interest in TCP from 65.12% to 65.70%, through the ownership of 524,712 million common shares (94.90% of TCP's total common shares) and of 515,084 million preferred shares (50.02% of TCP's total preferred shares).

On 28 February 2005 Portugal Telecom announced the sale by its subsidiary PT Multimédia of its financial investment in Lusomundo Serviços, including its 80.91% shareholding in Lusomundo Media, through the execution of a promissory sale and purchase agreement with Controlinveste for a total consideration of Euro 173.8 million. With a view to simplifying the acquisition, prior to closing, PT will sell its 5.94% direct stake in Lusomundo Media to PT Multimédia, for a total consideration of Euro 10.1 million.

On 10 May 2005 Portugal Telecom has completed the acquisition of 37,628,550 treasury shares at an average price of Euro 8.57, in connection with the share buyback program announced in 2003. After these transactions Portugal Telecom holds 37,628,550 of its own shares, equivalent to 3.23% of its share capital.

On March 24, 2005, we issued Euro 1,000 million in notes under our global medium term notes program at a fixed interest rate of 3.75% per annum, maturing in 2012. On the same day, we issued Euro 500 million in notes under the program at a fixed interest rate of 4.375% per annum, maturing in 2017. In June 2005, we issued a Euro 500 million in notes under the program at a fixed interest rate of 4.5% per annum, maturing in 2025.

### 36. Summary of Significant Differences between Accounting Principles followed by the Company and U.S. Generally Accepted Accounting Principles

The Consolidated Financial Statements of Portugal Telecom have been prepared in accordance with Portuguese accounting principles ("Portuguese GAAP") that differ in certain significant respects from generally accepted accounting principles in the United States of America ("U.S. GAAP"). These differences are discussed below.

#### a) Employee benefits

PT Comunicações, PT-SI and Lusomundo (through its subsidiaries Jornal de Notícias and Diário de Notícias) have defined benefit pension plans covering certain current and former employees. The liability for payment of these benefits has been transferred to three autonomous pension funds. For Portuguese GAAP purposes the Company accounts for these plans in substance in accordance with IAS 19 since it considers that it is more adequate than Portuguese Directive 19 to reflect the post retirement benefits (Note 3 f)). Under U.S. GAAP, the Company accounted for these benefits on a

basis consistent with Statement of Financial Accounting Standards No. 87, "Employer's Accounting for Pensions" ("SFAS 87") effective January 1, 1993. The differences between the calculation of pension cost and funded status under Portuguese GAAP and U.S. GAAP are as follows:

- (i) The transition dates and amounts of transition assets (or obligation) and unrecognized actuarial net gains (or losses), which leads that the unrecognized obligations are higher under U.S. GAAP;
- (ii) Timing and calculation of effects of curtailment costs related with Marconi employees;
- (iii) In the amortization of net gains and losses, the 10% corridor is not used for Portuguese GAAP;
- (iv) U.S. GAAP allows the amortization of prior service cost, while Portuguese GAAP requires these costs to be recognized immediately;
- (v) The use of the market related value of assets for U.S. GAAP, but not for Portuguese GAAP, which leads to differences in the expected return on assets.
- (vi) Portuguese GAAP does not include a requirement to set up a Minimum Liability Adjustment.

The net effects of these differences leads to: (i) the recognition of a higher liability in Portugal Telecom's consolidated balance sheet as of December 31, 2004 under Portuguese GAAP, (ii) recognition of a lower periodic pension cost under Portuguese GAAP, and (iii) the recognition of a Minimum Liability Adjustment as a component of U.S. GAAP other comprehensive income, reflecting the unfunded portion of the accumulated benefit obligation.

Additionally, PT Comunicações maintains health care plans that provide benefits to employees, retirees and eligible relatives. For Portuguese GAAP purposes the Company accounts for these plans in substance in accordance with IAS 19 (Note 3 g)). For U.S. GAAP purposes, the Company has adopted Statement of Financial Accounting Standards No. 106, "Employer's Accounting for Post Retirement Benefits Other Than Pensions" ("SFAS 106") effective January 1, 1995. The differences between the calculation of health care cost under Portuguese GAAP and U.S. GAAP are:

- (i) The transition dates and amounts of transition assets (or obligation) and unrecognized actuarial net gains (or losses), which leads that the unrecognized obligations are higher under U.S. GAAP;
- (ii) Timing and calculation of effects of curtailment costs related with Marconi employees; and
- (iii) In the amortization of net gains and losses, the 10% corridor is not used for Portuguese GAAP.

**b) Revaluation of fixed assets**

In previous years, to reflect the impact of inflation, Portuguese legislation allowed companies to revalue their fixed assets in accordance with applicable official inflation rates. Depreciation of fixed assets is computed on the revalued amounts. In addition, original acquisition cost plus 60% of the

additional revaluation effect are deductible for corporate income tax purposes. Under U.S. GAAP, fixed assets may not be stated at more than their historical acquisition cost.

**c) Intangible assets and deferred costs**

Under Portuguese GAAP, costs relating to start-up expenses and research and development may be capitalized as intangible assets and amortized, or deferred to future periods and amortized over the period of time the related benefits are anticipated to be received. Under U.S. GAAP, these costs generally should be expensed in the period in which they are incurred.

**d) Capitalization of interest**

Under Portuguese GAAP, the Company does not capitalize interest costs incurred in connection with the construction of major capital projects. Under U.S. GAAP, the estimated amount of interest incurred in connection with the construction of these projects is calculated by applying the interest rates applicable to borrowings outstanding during each applicable period. Upon completion of the asset, this amount is considered part of the deemed cost of fixed assets and is depreciated over the life of the related assets.

**e) Accounting for certain investments in debt and equity securities**

Under Portuguese GAAP, investments in debt and equity securities are carried at the lower of cost or market value, less a provision for estimated losses, where applicable. Under U.S. GAAP companies are required to adopt Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"), which requires that investments in marketable securities be divided into three categories: trading (securities that are bought and held principally for the purpose of selling them in the near term), held to maturity (debt securities that the Company has a positive intent and ability to hold to maturity), and securities available for sale (all other securities). In accordance with SFAS 115, the Company has classified its investments in BES, Telefónica and Media Capital as available for sale with unrealized gains and losses excluded from earnings and reported as a component of shareholders' equity (other comprehensive income). Unrealized losses that are other than temporary are charged to income.

**f) Legal proceedings with employees**

The Portuguese government committed to assume the costs for resolving current and any future claims relating to legal proceedings with employees related to the period prior to the formation of Portugal Telecom, which would offset in income any related charge for Portuguese GAAP purposes. For U.S. GAAP purposes, amounts paid by the government would be recorded as a direct increase to shareholders' equity. In the years ended December 31, 2004 and 2003 no amounts were paid by the government.

**g) Provision for re-equipment**

Portugal Telecom recorded an additional depreciation to reflect the economic lives of some basic equipment (analogical switching equipments), which we believe are lower than the ones established pursuant to specific Portuguese legislation.

Under Portuguese GAAP this additional depreciation has been classified in the caption "Other non-current liabilities", while under U.S. GAAP it is recorded as accumulated depreciation of the related fixed assets. This reclassification has been included in the balance sheet under U.S. GAAP.

**h) Distribution of profits to employees**

Under Portuguese GAAP, it is acceptable under defined circumstances, to charge equity for distribution of profits to employees. Under U.S. GAAP such payments are considered a component of payroll expenses, and classified in the income statement.

**i) Regulation**

The Company provides telephone service in Portugal and therefore is subject to the regulatory control of ANACOM. Rates for telephone services are tariff determined by such agency. Although changes in rates for services are authorized and computed based on a rate agreement, there is no fixed rate of return over communications assets. Accordingly, the requirements of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" ("SFAS 71") related to a business whose rates are regulated on the basis of its actual costs is not applicable to these financial statements, and no regulatory asset has been recorded.

**j) Provisions for restructuring costs**

The Company has recorded in previous years provisions for special termination benefits related to estimated costs of voluntary severance programs in accordance with Portuguese GAAP. In general, U.S. GAAP requires, that such special termination benefits be recorded when the employees accept the offer and the amount can be reasonably estimated. As such, the timing of the recognition of these costs differs between Portuguese GAAP and U.S. GAAP.

**k) Comprehensive income**

Under U.S. GAAP, companies are required to adopt Statement of Financial Accounting Standards No. 130, "Reporting on Comprehensive Income" ("SFAS 130"). Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources; it includes all changes in equity during a period except those resulting from investments by owners. Under Portuguese GAAP, companies are not required to report on comprehensive income.

**l) Proportional consolidation**

As stated in Note 1, on December 27, 2002 Portugal Telecom and Telefónica Móviles completed their joint-venture for the Brazilian mobile telecommunications market by contributing 100% of the shareholdings that each entity owned in mobile telecommunications companies in Brazil to Brasilcel (the joint venture company). As a result of the impairment of the Company's investment in Telesp Celular (the mobile operator in Brazil previously owned by Portugal Telecom) during 2002 the carrying value of the companies contributed to Brasilcel was written down to their estimated fair values. As a result, no gains or losses were recognized under Portuguese GAAP as a result of the contribution.

Under U.S. GAAP this transaction was recorded based on the carrying amount of the nonmonetary assets transferred.

As a result of the transaction described above under Portuguese GAAP, Portugal Telecom's consolidated balance sheet as of December 31, 2004, 2003 and 2002 includes the proportional consolidation of 50% of Brasilcel's assets and liabilities. The consolidated net income of the Company for the year ended December 31, 2004 and 2003 also includes the proportional consolidation of 50% of Brasilcel's results. However, the consolidated net income for the year ended December 31, 2002 includes the full consolidation of Telesp Celular's results as Telesp Celular was controlled by the Company during that period until the date of contribution to the joint venture (December 27, 2002).

Accordingly, for purposes of the net income reconciliation between Portuguese and U.S. GAAP, Portugal Telecom has included 50% of the differences between Portuguese and U.S. GAAP related to Brasilcel for the years ended December 31, 2004 and 2003, and 100% of the differences related to Telesp Celular for the year ended December 31, 2002. For purposes of the shareholders' equity reconciliation between Portuguese GAAP and U.S. GAAP, Portugal Telecom has included 50% impact of the adjustments related to its investment in companies contributed to Brasilcel for the years ended December 31, 2004, 2003 and 2002.

For U.S. GAAP purposes, the investment in Brasilcel is accounted for using the equity method of accounting as required by Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" ("APB 18"). Such difference in consolidation method does not have any effect in our Portuguese GAAP or U.S. GAAP results. However, for purposes of the presentation of the differences between Portuguese GAAP and U.S. GAAP related to Brasilcel in the net income reconciliation for the periods ended December 31, 2004 and 2003 and shareholders' equity reconciliation for the years ended December 31, 2004, 2003 and 2002, such adjustments are included in one line named "U.S. GAAP adjustments of equity investees". For purposes of net income reconciliation between Portuguese GAAP and U.S. GAAP for the year ended December 31, 2002, the differences between Portuguese GAAP and U.S. GAAP related to Telesp Celular are included line by line.

**m) Subsidiaries excluded from consolidation**

Under Portuguese GAAP, subsidiaries which are deemed to be immaterial can be excluded from consolidation. Accordingly, the Company has excluded certain subsidiaries from consolidation as indicated in Exhibit I.2. to the consolidated financial statements. Under U.S. GAAP all investments for which the Company owns greater than 50% of the voting common stock (or otherwise demonstrates control) should be consolidated. The impact of this difference as of December 31, 2004, 2003 and 2002 is immaterial.

**n) Business combination**

In February 2000 PT Multimédia acquired the total share capital of Zip.net. The acquisition agreement contained an embedded option on shares of PT Multimédia with the vendors of Zip.net to put shares to PT Multimédia or Portugal Telecom. Furthermore, the Company determined that option qualified as a derivative instrument. Under U.S. GAAP, this embedded derivative represents a net written option. Under U.S. GAAP net written options must be recorded at fair value, with changes in

fair value recorded through earnings. As of the date of the business combination, the fair value of such net written option amounted to a liability of €32,218,907, and such value was recorded as a component of U.S. GAAP purchase price related to the acquisition of Zip.net. Subsequent to the date of acquisition, this net written option was recorded, for purposes of U.S. GAAP, at fair value, with changes in fair value being reported through earnings. On June 30, 2001, such net written option was exercised and the Company acquired from the vendors of Zip.net the PT Multimédia shares.

Under Portuguese GAAP, the Company is not required to record the fair value of a net written option as a component of the purchase price, nor does the net written option need to be subsequently recorded at fair value, with changes in fair value recorded through earnings. Instead, the Company is only required to record an accounting entry related to the net written option when the put or call option is exercised.

On the exercise date in 2001, the Company acquired the PT Multimédia shares, for a cash price of €161,683,951. Under Portuguese GAAP, the Company allocated entirely to goodwill the excess of purchase price over the carrying value of the shares acquired. Under U.S. GAAP the goodwill was recorded based on the fair value of the shares acquired at that date, considering the cash and liabilities assumed. The difference on the amount of goodwill recorded under U.S. GAAP generated a reduction on the goodwill amortization charge through December 31, 2001. The difference as of December 31, 2001 of the amount of goodwill, net of accumulated depreciation amounted to €144,554,615. Following the adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), on January 1, 2002, goodwill was no longer amortized for U.S. GAAP purposes (Note 36 q)).

During 2004, PT Conteúdos (a wholly owned subsidiary of PT Multimédia) acquired an additional 16.67% stake in Sport TV, for an amount of Euro 16.3 million, thereby increasing its ownership in Sport TV to 50%. For Portuguese GAAP, the Company allocated the excess of purchase price over the carrying value of the net assets acquired to goodwill. This goodwill is being amortized over 20 years. For U.S. GAAP, the excess of purchase price over the fair value of the net assets acquired, was allocated to intangible assets related to the television rights that Sport TV owns from the Portuguese football league until 2008 (amounting Euro 22,126,657). This intangible is being amortized for a four year period, corresponding to the period for which Sport TV has these rights.

**o) Revenue recognition**

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" ("SAB 101"). SAB 101 outlines the SEC's views on revenue recognition under U.S. GAAP. SAB 101 provides both general and specific guidance as to the periods in which companies should recognize revenues. In addition, SAB 101 also highlights factors to be considered when determining whether to recognize revenues on a gross or net basis. SAB 101, as amended by SAB 101/A, SAB 101/B and updated by SAB No. 104 in December 2003, was effective for the Company beginning the quarter ending December 31, 2000.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

SAB 101 requires the Company to record revenues from certain transactions in a different manner than under Portuguese GAAP, such as:

(i) Connection Fees:

Under Portuguese GAAP, the Company recognizes in earnings all non-refundable fees charged to customers for initial connection of services at the time that the initial connection is established since it considers that all services and goods relating to such installation have been provided. Under SAB 101, the Company is required to defer connection fee revenues as income ratably over the estimated average life of its customers.

The Company has estimated the following average lives of customers of its various businesses for which initial fees are being charged:

Cable / internet access: 5 years

Fixed line telephony: 15 years

The estimated average subscriber lives listed above are based on management's best estimates. Such estimates are subject to revision, based on changes in customer demographics, the introduction of increased competition, as well as other factors.

Although the Company believes that the average subscriber life in relation to its fixed line services is 15 years (based on Portugal Telecom's dominant position in the industry and geographic trends of Portuguese inhabitants) the Company only could obtain information related to connection fees charged to customers during the previous seven years from December 31, 2000. Estimations have been made regarding the amount of activation fees charged by the Company for the eight years prior to the date the last year actual information is available.

(ii) Prepaid phone cards:

Up to December 31, 2001 the Company for Portuguese GAAP recorded revenues from the sale of prepaid phone cards, at the time that the customer remits the cash payment for the card. Under SAB 101, the Company is required to recognize revenues from the sale of prepaid phone cards as the minutes on such cards are used. As of December 31, 2002 for Portuguese GAAP, the Company changed its method of recording revenue for prepaid phone cards and recorded an extraordinary provision corresponding to the estimated minutes to be used in future periods to determine the amount of income to be deferred. From January 1, 2003 the Company began to recognize revenues from prepaid phone cards based on minutes of usage.

(iii) Sales and cost of handsets:

Under Portuguese GAAP and U.S. GAAP sales and cost of handsets are being recorded in earnings, except for those sales of handsets to corporate clients with enforceable contracts, which are amortized over two years. However, under Portuguese GAAP the amount being amortized is recorded as a net operational cost. Under U.S. GAAP both deferred amounts are being recorded in earnings as respective revenues and cost of goods sold. Accordingly, this difference in accounting has no impact in net income (loss) nor in shareholders' equity reconciliation to U.S. GAAP.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

### (iv) Value-added and other sales taxes:

In Brasilcel's subsidiaries these taxes are recorded in revenue, net of related tax expense. Under U.S. GAAP, these taxes are recorded gross as revenue and related cost of services and goods. Accordingly, this difference in accounting has no impact in net income (loss) nor in shareholders' equity. The impact of this difference under U.S. GAAP was to increase both revenues and cost of goods and services by €274,248,096 for the year ended December 31, 2002. For the years ended December 31, 2004 and 2003 this difference had no effect for U.S. GAAP purposes, since Brasilcel's results were consolidated under the equity method (Note 36 I)).

### (v) Roaming charges

Brasilcel's subsidiaries have roaming agreements with other cellular service providers. When a call is made from within one coverage area by a subscriber of another cellular service provider, that service provider pays the Company for the service at the applicable rates. Conversely, when one of the Company's customers roams outside the coverage area, the Company pays the charges associated with that call to the cellular service provider in whose region the call was originated and charges the same amount to its subscriber. Under Portuguese GAAP, revenues for roaming charges are recorded net of the related costs when the services are provided. Under U.S. GAAP, revenues and costs for roaming charges should be recorded gross. Accordingly this difference in accounting policy has no impact on net income (loss) nor in the reconciliation of shareholders' equity. The impact of this difference under U.S. GAAP was to increase both revenues and cost of goods and services by €113,595,703 for the year ended December 31, 2002. For the years ended December 31, 2004 and 2003 this difference had no effect for U.S. GAAP purposes, since Brasilcel's results were consolidated under the equity method (Note 36 I)).

### (vi) Subscriber acquisition costs

Under Portuguese GAAP and U.S. GAAP, those direct inherent costs related to commission paid on activation of cellular handset have been deferred over the life of each respective contract (normally two years). These contracts are legally enforceable and binding.

Considering the future IFRS adoption, the Company under IFRS will be expensing these costs when incurred. Since both methods of accounting are acceptable under U.S. GAAP (deferral of direct inherent costs in relation to enforceable contracts during the contract period or expensing such cost when incurred). In order to facilitate the conversion between the future IFRS figures and U.S. GAAP, the Company has decided to change its accounting principle under U.S. GAAP during 2004 and has decided to record under U.S. GAAP all direct inherent costs in earnings when incurred.

The effect of such change of accounting principle in 1 January 2004, under U.S. GAAP, resulted in a decrease in current assets of €25,349,626 gross of tax effect and in an after tax loss of €18,378,479, of which €24,175,458 corresponds to the cumulative effect of a change in accounting principle.

### (vii) Revenue Arrangements with Multiple Deliverables EITF 00-21

Portugal Telecom has adopted the provisions of the Emerging Issues Task Force Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21") for multiple-

element revenue arrangements for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003.

EITF 00-21 requires that arrangements involving the delivery of bundled products or services be separated into individual component deliverables, each with its own separate earnings process. Revenue relating to the bundled contract is allocated among the different deliverables, based on their relative fair values (the relative fair value of each of the component deliverables to the aggregated relative fair value of the bundled deliverables). In addition, the amount allocable to a delivered item is always limited considering the contingent amount due the delivery of additional service or meeting any other specified performance conditions and/or to its fair value.

Handsets are sold many times in a bundled package to the customers, as the handsets and the air-time are price-sensitive and, thus, volatile in a competitive marketplace, the determination of fair values in the mobile phone sector business is quite complex.

Portugal Telecom has made an analysis, in accordance with EITF 00-21, to identify all products and services sold in bundled packages. For TMN (our mobile operator in Portugal) the main activities affected by this new literature related to the prepaid and contract cellular services.

For the mentioned activities, upon customer activation, arrangement consideration received is allocated to each unit of accounting based on their relative fair values. As nonrefundable, up-front connection fees charged do not meet the criteria of a separate unit of accounting, the additional arrangement consideration received from connection fees or up-front fees is allocated to the other delivered item(s) to the extent that the aggregate handsets and connection fee or up-front fee proceeds do not exceed the allocated fair value of the handsets. Any connection fee or up-front fees proceeds not allocated to the delivered handsets is deferred upon connection and recognized as service revenue over the expected customer relationship period. The amount allocable to a delivered item (the handset) is always limited to the amount that is not contingent upon the delivery of additional service (the airtime) or meeting other specified performance conditions (the non contingent amount).

Therefore, given the above, the effect of the application of the EITF 00-21 resulted in a total effect €1.5 million on December 31, 2004, which basically related to certain amounts that have been classified as revenue contingent upon the delivery of additional service.

**p) Derivative instruments under SFAS 133**

On January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") as amended. SFAS 133, as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair-value hedge relationship, the changes in the fair value of the derivative and the change in fair value of the hedged item for the risk being hedged are recognized immediately in earnings. If the derivative is designated as a cash-flow hedge, the effective portion of the changes in the fair value of the derivative will be recorded in other comprehensive income and is recognized in the income statement when the hedged item affects earnings. SFAS 133 defines requirements for designation and documentation of hedging relationships as

well as ongoing effectiveness assessments in order to use hedge accounting. For a derivative that does not qualify as a hedge, all changes in fair value are recognized immediately in earnings together with any ineffective portion of designated hedge strategies.

Even though the company uses derivatives as part of its risk management strategy in order to mitigate economic foreign currency and interest risks, those instruments have not been formally designated as accounting hedging relationships as required by SFAS 133. As a result, for U.S. GAAP purposes, all derivative instruments have been recorded at fair value with related changes in fair value recorded in earnings immediately.

**q) Accounting for goodwill non amortization and impairment**

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 eliminates the pooling-of-interest method of accounting for business combinations except for qualifying business combinations that were initiated prior to July 1, 2001. In addition, this statement further clarifies the criteria to recognize intangible assets separately from goodwill. The requirements of SFAS 141 are effective for any business combination accounted for by the purchase method that is completed after June 30, 2001 (i.e., the acquisition date is July 1, 2001 or after). Under SFAS 142, goodwill and indefinite lived intangible assets are no longer amortized but are required to be reviewed annually for impairment (or more frequently if impairment indicators arise). Identifiable intangible assets that are not deemed to have an indefinite life should continue to be amortized over their useful lives. The Company was required to adopt SFAS 141 and SFAS 142 for its fiscal year beginning January 1, 2002.

Upon adoption the Company performed an initial impairment assessment of the carrying values of historical goodwill as required by the transitional provisions of SFAS 142. This transitional impairment test consists of two steps. The first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired and the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been currently acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. The company's reporting units are generally consistent with the operating segments identified in Note 34. The impairment test for other intangible assets not subject to amortization consists of a comparison of the fair value of the intangible asset with its carrying value. If the carrying value of the intangible asset exceeds its fair value, an impairment loss

is recognized in an amount equal to that excess. For intangible assets subject to amortization, impairment is analyzed considering the estimated future cash flows on an undiscounted basis.

Because of this initial assessment, the Company recorded an impairment of approximately €1,038.9 million related to its investment in Telesp Celular. This impairment amount has been classified as a cumulative effect of a change in accounting principle in the reconciliation of net income for the year ended December 31, 2002.

During the fourth quarter of 2002, the Company performed its annual impairment review for goodwill for its media businesses and recorded an additional impairment of €226.2 million (net of minority interest). This impairment was reflective of the overall decline in estimated market values of the media business in the PT Multimédia segment based on trends in publicity investment in 2002. This charge was recorded net of minority interest of €174.4 million, and includes charges to reduce the carrying value of goodwill of those businesses by €400.6 million. The impairment amount of €400.6 million includes an amount of €337.0 million recorded under Portuguese GAAP. The difference amounting to €63.6 million was included in the reconciling item between Portuguese GAAP and U.S. GAAP and was included in the shareholders' equity reconciliation between Portuguese GAAP and U.S. GAAP as of December 31, 2004, 2003 and 2002.

In 2004, under Portuguese GAAP the Company has performed an impairment test based upon the cash-generating unit to which the goodwill has been allocated, which is a lower level than on a U.S. GAAP basis. As a result of such test, the Company has recorded a provision for impairment of goodwill related with audiovisuals business, amounting to €40 million. Under U.S. GAAP, impairment tests are performed at the reporting unit level, which is a higher level than the cash-generating unit related with audiovisuals business. This analysis concluded that the fair value of the reporting unit exceeds its carrying amount and the goodwill was not deemed to be impaired. Accordingly, for U.S. GAAP purposes, the Company reversed the provision recorded under Portuguese GAAP.

Additionally, in 2004, based on the impairment analysis over the goodwill on the equity investments, the Company, for U.S. GAAP purposes recorded an impairment on the goodwill of its Páginas Amarelas equity investment, amounting to €9 million. This impairment was recorded by comparing the fair value of the investment with its carrying value.

For the years ended December 31, 2004 and 2003 according with Company analysis there are no additional impairment situations in goodwill and intangible assets.

For purposes of adopting SFAS 142, the Company's measurement of fair value was based on an evaluation of future discounted cash flows, as well as recently-performed valuation studies. This evaluation used the best information available to the Company, including reasonable and supportable assumptions and projections. The Company's discounted cash flow evaluation used various discount rates that correspond to the weighted-average cost of capital in the countries and regions in which the underlying businesses operate.

The impairment charges are non-cash in nature and do not affect the Company's liquidity or result in the non-compliance with respect to any debt covenants.

Substantially all of the intangible assets recorded on Portugal Telecom's consolidated balance sheet under U.S. GAAP are intangible assets with finite useful lives and consist of telecommunications

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

licenses (UMTS license) and operating concessions (Basic network concession), which are amortized over the period of the license (Note 3 e)).

The carrying values of goodwill, net of accumulated depreciation, under U.S. GAAP by business segment and other companies as of December 31, 2004 and 2003 are as follows:

|                           | <b>2004</b>        | <b>2003</b>        |
|---------------------------|--------------------|--------------------|
| Wireline businesses       | 306,615,108        | 308,086,659        |
| Multimedia businesses     | 209,568,578        | 205,785,128        |
| Other businesses:         |                    |                    |
| Primesys                  | 27,175,959         | 26,873,163         |
| PT Sistemas de Informação | 11,312,991         | 12,154,908         |
| Cabo Verde Telecom        | 8,896,620          | 8,616,296          |
| Other                     | 6,002,558          | 5,160,641          |
| Equity Investments:       |                    |                    |
| Páginas Amarelas          | 79,287,531         | 88,635,279         |
| Unitel                    | 34,676,880         | 34,957,031         |
| Other                     | 10,543,798         | 951,038            |
|                           | <b>694,080,023</b> | <b>691,220,143</b> |

The Company recorded amortization expense related to intangible assets of €41.4 million and €30.7 million for the years ended December 31, 2004 and 2003. For the year ended December 31, 2002, the Company recorded amortization expense related to intangible assets amounting to €58.2 million, considering including the effects of Telesp Celular. The estimated intangible assets amortization expense for each of the following five years is approximately €44.2 million.

For Portuguese GAAP the Company recorded in its primary financial statements as of December 31, 2001, a provision for impairment, related with its investment in Telesp Celular. This provision was computed, under Portuguese GAAP, based on the difference between the carrying values of the Company's investments (including goodwill) and a fair value computed using a discounted cash flow methodology. For U.S. GAAP purposes, up to December 31, 2001 the Company had been applying the requirements of SFAS 121 for the analysis of impairment issues regarding goodwill generated on the acquisitions of its principal investments. Up to that date, no goodwill or intangible asset impairment was indicated, including the intangible assets related to the Company's investment in Telesp Celular. Accordingly, this provision for impairment recorded by the Company under Portuguese GAAP as of December 31, 2001, 2002 and 2003 was reversed for U.S. GAAP purposes. During 2004, under Portuguese GAAP, this provision has been assigned to certain loans granted to our equity investment in UOL (Note 10). Under U.S. GAAP, as explained in note 36.b1, the effect of the application of FIN 46(R) to our equity investment in UOL resulted in an effect of €7.8 million in addition to the provision already assigned under Portuguese GAAP. Therefore for the period ended December 31, 2004 this provision assigned under Portuguese GAAP has not been reversed for U.S. GAAP purposes and considered in connection with the application of FIN 46(R) to our equity investment in UOL.

**r) Progressive licenses amortization**

For Portuguese GAAP purposes, the value allocated to the licenses of band A owned by Vivo subsidiaries and the licenses of band B acquired by Global Telecom and TCO to operate in the Brazilian telecommunications market are being amortized on a progressive scale based on the expected revenues for each company. For U.S. GAAP purposes, the Company uses a straight-line method of amortization over the period of such licenses.

**s) Marconi goodwill**

Under Portuguese GAAP, the Company recorded the acquisition cost of its purchase of Marconi at a lower amount than it would be recorded under U.S. GAAP, due to the fact that this acquisition was paid in Portugal Telecom shares. As a result, the Company has a larger amount of goodwill from this acquisition under U.S. GAAP, resulting in additional amortization expense of €103,975 during 2001. From January 1, 2002, for U.S. GAAP purposes, goodwill was no longer amortized, but was subject to annual impairment testing under SFAS 142, as described above.

**t) Accounting for investee losses when the investor has loans to the investee**

As of December 31, 2004, the Company granted loans to affiliated companies accounted for by the equity method with negative equity position. For U.S. GAAP the Company has applied the guidance under EITF 98-13 and EITF 99-10 and considered that such a part of a loss arising from those affiliated companies had to be assigned to the respective loans granted. In addition, the application of FIN 46(R) resulted in consolidation of some affiliated companies accounted for by the equity method that previously had a reconciling effect of EITF 98-13 and EITF 99-10, which were no longer applicable for consolidated entities. Therefore in 2004, €54.2 million included in this adjustment attributable to such entities have been reclassified to Item 36.b1) since these investments had been consolidated under U.S. GAAP in 2004.

**u) Difference with Brasilcel investment**

Following the completion of the joint venture by Portugal Telecom and Telefónica Móviles for the Brazilian mobile telecommunications market (Note 1 b)), the carrying value under Portuguese GAAP of the investments contributed to Brasilcel was written down to their estimated fair values at the end of 2002.

Under U.S. GAAP, the carrying value of the investments contributed to Brasilcel was lower than the carrying value under Portuguese GAAP, as a result of the historical U.S. GAAP adjustments.

Therefore, the accumulated Portuguese GAAP to U.S. GAAP difference for the carrying amount of the investments contributed to Brasilcel, at the date of the formation of the joint venture, amounting to €455,883,040, has been reclassified and considered in connection with the other adjustments arising as from the contribution date as part of the U.S. GAAP adjustment of equity investees in our reconciliation presented in Note 37.

**v) Accounting for tax losses carryforwards**

In conjunction with the recognition of the 2001 impairment charge recorded under Portuguese GAAP, the Company considered the estimated tax benefits related to the impairment, considering the effects of future legal restructuring of the impaired entities. As a result, the Company considered the estimated tax benefit of €1 billion in determining the amount of the impairment provision. For U.S. GAAP purposes, Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109") does not allow recognition of future tax losses to be generated in future years. The tax losses related to the impaired entities were generated during 2002. As a result, this difference impacts the timing of the related deferred tax assets between Portuguese and U.S. GAAP.

**w) Offering expenses**

Under Portuguese GAAP, expenses incurred in connection with capital increase were recorded as net financial expenses. Under U.S. GAAP, costs related to an offering of equity securities should be reported as a reduction of the proceeds of the offering. The U.S. GAAP adjustment represents the reversal of the net financial expenses.

**x) Purchase accounting in Brasilcel's subsidiaries**

(Amounts stated in thousands of Brazilian Reais R\$)

(i)

Global Telecom's acquisition

During 2002, Telesp Celular Participações ("TCP") and Telesp Celular ("TC") made an intercompany loan to Global Telecom ("GT"). On December 27, 2002, after obtaining approval from ANATEL, TCP purchased the remaining 51% of the outstanding common stock of each of the holding companies (representing an economic interest of 17%) in accordance with a purchase commitment, for cash of R\$290,282 and began to consolidate the Holdings. The total purchase price, considered for U.S. GAAP purposes amounted to R\$827,772, representing the cash paid plus the minority interest in the intercompany loans held by Holdings immediately prior to the date of acquisition. Considering TCP's direct and indirect interests, TCP now owns 100% of the capital of GT. On December 30, 2002, R\$2,310,878 of the intercompany loan was capitalized, in exchange for additional shares of GT capital stock.

Under U.S. GAAP, the cost of an acquired entity is allocated to assets acquired, including identifiable intangible assets and liabilities assumed based on their estimated fair values on the date of acquisition. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill. Under U.S. GAAP, under SFAS 142, goodwill is not subject to amortization, but rather it is subject to at least an annual assessment for impairment by applying a fair-value-based test.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

For U.S. GAAP purposes, the purchase price of the remaining 51% of the outstanding common stock of the Holdings was allocated as follows:

|   | <b>Amount</b>  |
|---|----------------|
| Amounts representing 17% of the historical net assets of Holdings under U.S. GAAP | 273,387        |
| Fair Value Adjustments:   |                |
| Property and equipment  | 4,703(a)       |
| Intangible assets customer list   | 26,856(b)      |
| Debt  | 4,238(c)       |
| Intangible related to concession  | 97,190(d)      |
| Goodwill  | 421,398(e)     |
| Purchase Price  | <b>827,772</b> |

- (a) Difference being amortized over approximately 11 years, representing the weighted average remaining useful lives of the relating assets.
- (b) Difference being amortized on a straight-line basis over two years, representing the average customer life.
- (c) The adjustment to long-term debt is being amortized by the effective interest method over the remaining maturities of the underlying GT debt obligations.
- (d) The intangible asset related to the concession is being amortized on a straight-line basis over an 11 year period, representing the remaining term of the license.
- (e) The goodwill recorded for U.S. GAAP purposes represents the amount paid in excess of the fair value of the Holdings. Under Portuguese GAAP, TCP recorded goodwill amounting to R\$290,282 which is deductible for tax purposes.

TCP acquired the remaining interest in the Holdings pursuant to a purchase commitment that fixed the purchase price for the remaining 51% of the outstanding common stock of the Holdings (representing a 17% economic interest). At the date of the acquisition, the contracted purchase price exceeded the fair value of the acquired interest in the Holdings. On December 31, 2002, under Portuguese GAAP, TCP recorded a reserve for loss on its investments of R\$170,846. After the recognition of impairment, the remaining goodwill balance amounted to R\$722,693. Under U.S. GAAP, an impairment of R\$421,398 was recorded, representing the total amount of the goodwill balance at December 31, 2002. Under both Portuguese and U.S. GAAP, the fair value of the Holdings was estimated based on an independent valuation made by "BES Investimento do Brasil S.A."

The following table presents the Company's unaudited consolidated pro forma results under Brazilian GAAP of operations of the Holdings for the year ended December 31, 2002, as if the above acquisitions had been completed on January 1, 2002 and 2001, respectively. The consolidated pro forma information includes adjustments related to additional financing that was required to complete the acquisitions. The pro forma information is presented for comparative purposes only and does not

purport to be indicative of what would have occurred had the acquisition actually been made at such date, nor is it necessarily indicative of future operating results (amounts stated in R\$):

|   |             |
|---|-------------|
| Net operating revenues  | 3,897,106   |
| Operating loss  | (921,885)   |
| Net loss  | (1,248,999) |
| Basic and dilute earnings per thousands shares common and preferred | (1.82)      |

(ii) Acquisition of TCO

For U.S. GAAP purposes, the purchase price of the acquisitions of TCO described in Note 1 b), was allocated as follows:

|  | <u>Amount</u>    |
|--|------------------|
| Amounts representing 90.7% of the historical net assets of TCO under U.S. GAAP | 429,842          |
| Fair Value Adjustments:  |                  |
| Property and equipment   | 42,212(a)        |
| Intangible assets customer list  | 163,885(b)       |
| Debt   | 5,125(c)         |
| Intangible related to concession   | 605,230(d)       |
| Goodwill   | 831,052(e)       |
|  | <u>2,077,345</u> |
| Purchase Price   |                  |

- (a) Difference being amortized over approximately 10 years, representing the weighted average remaining useful lives of the relating assets.
- (b) Difference being amortized over two years, representing the average customer life.
- (c) The adjustment to long-term debt is being amortized by the effective interest method over the remaining maturities of the underlying TCO debt obligations.
- (d) The intangible asset related to the concession is being amortized on a straight-line basis over a period ranging from 5 to 11 years, representing the remaining term of the licenses of Areas 7 and 8, respectively.
- (e) The goodwill recorded for U.S. GAAP purposes represents the amount paid in excess of the fair value of TCO.

(iii) Purchase accounting in Tele Sudeste Celular Participações ("TSD") and Tele Leste Celular Participações ("TEL")

On November 30, 2000, in connection with the corporate restructuring, TSD and TEL acquired the minority interests in its subsidiaries in a transaction involving the exchange of shares. This transaction was recorded at the book value of the minority interests acquired. Under U.S. GAAP, the acquisition of minority interests was recorded using the purchase method of accounting pursuant to APB 16, "Business Combinations," and the related interpretations. Under U.S. GAAP, the purchase price was

determined based on the market price of the Holding Company's shares for a reasonable period before and after the date the terms of the acquisition were agreed to and announced publicly. The excess purchase price over the book value of the minority interests acquired was recorded based on management's estimate of the fair values of the underlying assets and liabilities.

**y) Cross border lease operations**

In 2003, the Company entered into a cross border lease operation related with terminal equipment of Wireline, Mobile and Cable businesses (Note 12). Pursuant this operation, the Company recorded a gain amounting to €5.7 million, corresponding to the upfront fee received. Under Portuguese GAAP this fee was considered as a non-refundable fee and it was recorded directly in earnings. Under U.S. GAAP this fee is recorded as a liability related to the guarantee surrendered and is being recognized for the period of the contract (6 years).

**z) Sale of real estate**

Under Portuguese GAAP, sale under operating lease of real estate property (office buildings) has been reflected as a disposal with a related net gain amounting to €38.9 million recorded for the year ended December 31, 2003 and a portion of €27 million deferred over the period of the lease.

Under U.S. GAAP, such transaction involving real estate, including real estate with equipment, must qualify as a sale under the provisions of FASB Statement No. 66 "Accounting for Sales of Real Estate" before it is appropriate for the seller-lessee to account for the transaction as a sale-leaseback under SFAS No. 98 "Accounting for Leases - Sale-Leaseback Transaction Involving Real State, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases".

Considering the appropriate guidance under U.S. GAAP the Company has considered that it has some continuing involvement with the property being sold. Therefore, under U.S. GAAP the Company has considered that this sale has not been considered consummated and, therefore, the respective consideration received is considered as a financing transaction.

**a1) Asset retirement obligation**

Under Portuguese GAAP there are no specific requirements to record such obligation, but provisions must be recorded when considered probable and reasonably estimated, based upon the principle of prudence.

Effective January 1, 2003, the Group adopted the provisions of SFAS No. 143, "Accounting for Asset Retirement Obligations". An asset retirement obligation represents a legal obligation associated with the retirement of a tangible long-lived asset that is incurred upon the acquisition, construction, development or normal operation of that long-lived asset. This standard requires the Company to recognize asset retirement obligations in the period in which they are incurred, if a reasonable estimate of fair value can be made. The asset retirement obligations are accreted to their present value at the end of each reporting period. The associated estimated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depreciated over its useful life.

The Company evaluated its leased and owned assets used in its operations in Portugal and overseas. During this evaluation, it was determined that it had legal obligations to return certain assets to their condition before the Company had obtained ownership or use of the related asset.

The effects of the adoption of this standard in the financial statements for the year ended December 31, 2003 resulted in an increase in non-current assets, current liabilities and non-current liabilities of €8,792,559, €2,817,506 and €19,671,207 gross of tax effect, respectively, and in an after-tax loss of €9,929,712, of €7,388,840 corresponds to the cumulative effect of a change in accounting principle.

#### **b1) FIN 46 R Variable interest entities and related transactions**

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 ("FIN 46"). The primary objectives of FIN 46 were to provide guidance on the identification of entities for which control is achieved through means other than through voting rights and how to determine when and which business enterprise should consolidate the variable interest entity ("VIE"). This Interpretation applies immediately to VIEs created after January 31, 2003.

In December 2003, the FASB published a revision to FIN 46 ("FIN 46R"), in part to clarify certain of its provisions. Among other things, FIN 46R deferred the effective date for VIEs created prior to February 1, 2003 to the end of the first reporting period that ends after March 15, 2004. FIN 46R requires consolidation of VIEs by business enterprises considered to be the primary beneficiary of the VIE. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are ownership, contractual, or other pecuniary interests in an entity. The primary beneficiary is required to consolidate the assets, liabilities, and results of the activities of the VIE. FIN 46R requires additional disclosures relating to transactions involving VIEs to be made by primary beneficiaries and enterprises holding significant variable interests in VIEs.

Portugal Telecom assessed the adoption of FIN 46R as of December 31, 2004, and given to the fact that Portugal Telecom provides more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the some of its equity investees, we concluded that, UOL, Sport TV and Sportinveste Multimédia should have been consolidated under the requirements of FIN 46 (R). Accordingly, for U.S. GAAP, the Company consolidated the assets, liabilities and results of these companies for the year ended 2004. The related impact of such on the consolidated financial statements would be as follows:

|                         | <b>Increase/<br/>(Decrease)</b> |
|-------------------------|---------------------------------|
| Current Assets          | 135,086,676                     |
| Total Assets            | 122,906,201                     |
| Current Liabilities     | 109,446,919                     |
| Total Liabilities       | 156,786,348                     |
| Net Income for the Year | (33,880,147)                    |
| Shareholders Equity     | (33,880,147)                    |

F-98

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In addition, considering that most of these entities had previous years accumulated loss for an amount higher than their respective shareholder's equity, the impact of the consolidation of such entities in accordance with FIN 46 (R) resulted in a reduction of our net income and shareholder's equity under U.S. GAAP for an amount of €33.9 million.

Portugal Telecom also determined that cross-leasing transactions with different third parties in the case of Qualified Technical Equipment ("QTE") leases include entities that are considered VIEs. Portugal Telecom concluded that, for this transaction, the Company is the primary beneficiary. Accordingly, the Company consolidated the respective VIEs. The related impact on the consolidated financial statements for the year ended December 31, 2004, was to increase the assets (cash deposit as a restricted asset) and financial liabilities, by €840.5 million. The effect of the consolidation of this VIE had no impact in net income (loss) nor in shareholders' equity reconciliation to U.S. GAAP.

F-99

---

**37. Reconciliation between Net Income and Shareholders' Equity Determined Under Portuguese GAAP and U.S. GAAP**

The following is a summary of the significant adjustments to net income for the years ended December 31, 2004, 2003, and 2002 which would be required if U.S. GAAP had been applied instead of Portuguese GAAP in the consolidated financial statements.

| Notes  | Year ended December 31, |              |              |              |               |
|--|-------------------------|--------------|--------------|--------------|---------------|
|  | 2004                    | 2004         | 2003         | 2002         |               |
|  | US\$                    | €            | €            | €            |               |
| Net income according to the consolidated financial statements prepared under Portuguese GAAP | 606,652,104             | 500,125,395  | 240,235,301  | 391,055,798  |               |
| Adjustments to conform with U.S. GAAP:   |                         |              |              |              |               |
| Increase (decrease) due to:  |                         |              |              |              |               |
| Pension benefits   | 36 a)                   | (32,996,451) | (27,202,350) | 20,702,350   | 23,577,801    |
| Health care benefits   | 36 a)                   | (11,918,731) | (9,825,829)  | (4,950,171)  | (3,405,000)   |
| Depreciation of revaluation adjustment   | 36 b)                   | 22,269,307   | 18,358,868   | 20,616,526   | 13,020,893    |
| Additional gains on sale of revalued fixed assets  | 36 b)                   | 1,471,022    | 1,212,714    | 9,442,102    | 3,987,665     |
| Intangible assets  | 36 c)                   | (241,853)    | (199,384)    | 8,109,414    | 25,184,929    |
| Deferred costs   | 36 c)                   | 2,077,258    | 1,712,496    | (1,801,817)  | 6,655,780     |
| Capitalized interest(1)  | 36 d)                   | (6,630,355)  | (5,466,080)  | (3,168,496)  | 2,357,454     |
| Unrealized gains on available for sale securities  | 36 e)                   | (849,100)    | (700,000)    |              |               |
| Employees' legal proceedings   | 36 f)                   |              |              |              | (111,577)     |
| Distribution of profits to employees   | 36 h)                   | (7,545,600)  | (6,220,610)  | (3,212,316)  |               |
| Provision for restructuring  | 36 j)                   | (1,432,867)  | (1,181,259)  | (4,856,176)  | 9,716,374     |
| Business combination   | 36 n)                   | (3,354,954)  | (2,765,832)  |              |               |
| Revenue recognition  | 36 o)                   | 18,880,179   | 15,564,864   | 12,152,241   | 65,413,638    |
| Derivative instruments under SFAS 133  | 36 p)                   | 18,261,594   | 15,054,900   | 8,887,254    | 78,035,474    |
| Goodwill amortization  | 36 q)                   | 70,945,399   | 58,487,551   | 57,536,150   | 97,133,799    |
| Reversal of provision for impairment   | 36 q)                   | 2,186,451    | 1,802,515    | (60,618,184) | (845,159,454) |
| Goodwill impairment  | 36 q)                   | (11,338,818) | (9,347,748)  |              |               |
| Progressive licenses amortization(2)   | 36 r)                   |              |              |              | (15,376,288)  |
| Accounting for tax losses carryforwards  | 36 v)                   |              |              |              | 1,349,519,000 |
| Offering expenses(2)   | 36 w)                   |              |              |              | 12,925,708    |
| Purchase accounting(2)   | 36 x)                   |              |              |              | 66,371,964    |
| Other adjustments related with Telesp Celular(2)   |                         |              |              |              | 4,831,514     |
| Cross border lease operations  | 36 y)                   | 1,166,758    | 961,878      | (5,545,556)  |               |
| Sale of real estate  | 36 z)                   | (2,687,115)  | (2,215,264)  | (36,996,469) |               |
| Asset retirement obligation  | 36 a1)                  | (2,382,377)  | (1,964,037)  | (2,668,035)  |               |
| Accounting for investee losses when the investor has loans to the investee                   | 36 t)                   | 52,849,844   | 43,569,533   | (54,242,901) |               |
| Application of FIN 46 R  | 36 b1)                  | (41,096,618) | (33,880,147) |              |               |
| U.S. GAAP adjustments of equity investees(2)   | 36 l)                   | (16,640,533) | (13,718,494) | 11,803,232   |               |
| Deferred tax effect on the above adjustments   |                         | (11,781,927) | (9,713,048)  | (55,284,405) | (61,962,866)  |
| Effect of U.S. GAAP adjustments on minority interests(3)                                     |                         | (27,379,650) | (22,571,847) | (10,597,285) | 91,533,653    |
| Net adjustments  |                         | 11,830,862   | 9,753,390    | (94,692,542) | 924,250,461   |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |                    |                    |                    |                    |
|---|--------------------|--------------------|--------------------|--------------------|
| Net income before change in accounting principles in accordance with U.S. GAAP                | 618,482,966        | 509,878,785        | 145,542,759        | 1,315,306,259      |
| Cumulative effect of a change in accounting principles SFAS 142 36 q)                         |                    |                    |                    | (1,038,939,986)    |
| Cumulative effect of a change in accounting principles SFAS 143 36 a1)                        |                    |                    | (7,388,840)        |                    |
| Cumulative effect of a change in accounting principles subscriber acquisition costs 36 o)     | (29,324,831)       | (24,175,458)       |                    |                    |
| <b>Net income after change in accounting principles in accordance with U.S. GAAP</b>          | <b>589,158,135</b> | <b>485,703,327</b> | <b>138,153,919</b> | <b>276,366,273</b> |
| Basic earnings per share before change in accounting principles US\$/Euro                     | 0.51               | 0.42               | 0.12               | 1.05               |
| Basic earnings/(losses) per share after change in accounting principles US\$/Euro             | 0.49               | 0.40               | 0.11               | 0.22               |
| Weighted average number of shares outstanding(4)  | 1,210,976,939      | 1,210,976,939      | 1,249,778,188      | 1,253,880,328      |
| Earnings per share before change in accounting principles assuming dilution US\$/Euro         | 0.50               | 0.41               | 0.12               | 0.99               |
| Earnings/(losses) per share after change in accounting principles assuming dilution US\$/Euro | 0.47               | 0.39               | 0.11               | 0.21               |
| Weighted average number of shares outstanding(5)  | 1,242,545,630      | 1,242,545,630      | 1,249,778,188      | 1,343,089,705      |

(1) Includes the effect of capitalized interest and the related depreciation amounting to €7,055,807, €7,937,678 and €7,950,239 for the years ended December 31, 2004, 2003 and 2002, respectively.

(2) As referred in Note 36 l), U.S. GAAP adjustments to net income related with the investment in Brasilcel for the years ended December 31, 2004 and 2003 are stated only in one line named "U.S. GAAP adjustments of equity investees", whilst in 2002 those adjustments referred only to Telesp Celular and were included in the appropriate line items by adjustment concept. The detail of the U.S. GAAP adjustments of equity investees as of December 31, 2004 and 2003, is as follows:

| Notes | 2004 | 2003 |
|-------|------|------|
|-------|------|------|

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|                                   | Notes | 2004         | 2003         |
|-----------------------------------|-------|--------------|--------------|
| Deferred costs                    | 36 c) | 1,361,000    | (5,189,330)  |
| Capitalised interest              | 36 d) | 89,113       | (3,327,287)  |
| Revenue recognition               | 36 o) | (3,613,332)  | (33,182)     |
| Application of SFAS 133           | 36 p) | (8,079,743)  | 34,775,488   |
| Reversal of goodwill amortization | 36 q) | 36,454,562   | 17,281,094   |
| Progressive licenses amortization | 36 r) | (15,156,465) | (15,419,568) |
| Purchase accounting(i)            | 36 x) | (24,773,629) | (16,283,983) |
|                                   |       | (13,718,494) | 11,803,232   |

- (i) This adjustment refers to differences arising in the carrying values of assets and liabilities with the adoption of the purchase accounting method.
- (3) Represents the net effect of the U.S. GAAP adjustments on minority interest in the income of the Company's subsidiaries.
- (4) The weighted average number of shares is considering the number of shares issued, excluding treasury shares.
- (5) For the years ended December 31, 2004 and 2002, the weighted average number of shares is computed considering the number of shares issued, excluding treasury shares, and the number of shares from the exchangeable bonds, assuming conversion in shares. For the year ended December 31, 2003, the effects of the exchangeable bonds have been excluded from the calculation of diluted earnings per share after change in accounting principles, since they would be antidilutive.



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The following is a summary of the significant adjustments to shareholders' equity as of December 31, 2004, 2003 and 2002 which would be required if U.S. GAAP had been applied instead of Portuguese GAAP in the financial statements.

| Notes  | Year ended December 31, |                 |               |               |
|--|-------------------------|-----------------|---------------|---------------|
|  | 2004                    | 2004            | 2003          | 2002          |
|  | US\$                    | €               | €             | €             |
| Shareholders' equity according to the consolidated financial statements prepared under Portuguese GAAP | 3,280,894,710           | 2,704,777,172   | 2,940,826,925 | 3,111,324,230 |
| Adjustments to conform with U.S. GAAP:   |                         |                 |               |               |
| Increase (decrease) due to:  |                         |                 |               |               |
| Pension benefits   | 36 a) (708,086,324)     | (583,748,000)   | (392,808,650) | (309,163,000) |
| Health care benefits   | 36 a) 88,899,557        | 73,289,000      | 83,114,829    | 88,065,000    |
| Revaluation of fixed assets  | 36 b) (212,080,175)     | (174,839,386)   | (196,957,276) | (227,015,904) |
| Intangible assets  | 36 c) (35,973,907)      | (29,656,972)    | (39,830,541)  | (47,939,955)  |
| Deferred costs   | 36 c) (3,054,898)       | (2,518,465)     | (5,172,960)   | (3,371,143)   |
| Capitalized interest(1)  | 36 d) 64,300,138        | 53,009,182      | 58,210,528    | 61,379,024    |
| Unrealized gains on available for sale securities  | 36 e) 4,792,130         | 3,950,643       | 961,763       | (2,800,000)   |
| Provision for restructuring  | 36 j) 1,455,600         | 1,200,000       | 7,860,198     | 12,716,374    |
| Business combination   | 36 n) (178,699,702)     | (147,320,447)   | (144,554,615) | (144,554,615) |
| Revenues recognition   | 36 o) (210,131,543)     | (173,232,929)   | (155,452,334) | (167,604,575) |
| Derivative instruments under SFAS 133  | 36 p) 32,256,915        | 26,592,675      | 11,537,775    | 2,650,521     |
| Goodwill amortization  | 36 q) 251,816,846       | 207,598,389     | 151,713,804   | 97,133,799    |
| Reversal of provision for impairment   | 36 q) 48,520,000        | 40,000,000      | 38,197,485    | 98,815,669    |
| Goodwill impairment  | 36 q) (118,454,496)     | (97,654,160)    | (88,306,412)  | (88,306,412)  |
| Marconi goodwill   | 36 s) 1,639,579         | 1,351,673       | 1,351,673     | 1,351,673     |
| Cross border lease operations  | 36 y) (5,170,980)       | (4,262,968)     | (5,545,556)   |               |
| Sale of real estate  | 36 z) (47,563,832)      | (39,211,733)    | (36,996,469)  |               |
| Asset retirement obligation  | 36 a1) (33,085,930)     | (27,276,117)    | (13,696,154)  |               |
| Accounting for investee losses when the investor has loans to the investee                             | 36 t) (12,946,795)      | (10,673,368)    | (54,242,901)  |               |
| Application of FIN 46  | 36 b1) (41,096,618)     | (33,880,147)    |               |               |
| U.S. GAAP adjustments of equity investees(2)   | 36 l) (548,990,427)     | (452,588,975)   | (442,931,730) | (453,482,381) |
| Deferred tax effect on the above adjustments   | 370,935,672             | 305,800,224     | 260,148,785   | 282,658,909   |
| Effect of U.S. GAAP adjustments on minority interests(3)   | (2,650,614)             | (2,185,172)     | 21,544,508    | 31,886,897    |
| Net adjustments  | (1,293,369,804)         | (1,066,257,053) | (941,854,250) | (767,580,119) |
| Shareholders' equity in accordance with U.S. GAAP  | 1,987,524,904           | 1,638,520,119   | 1,998,972,675 | 2,343,744,111 |

(1) Net of accumulated depreciation of €174,437,441, €167,646,368 and €175,961,244, for the years ended December 31, 2004, 2003 and 2002, respectively.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

(2)

As referred in Note 36 l), the adjustments related with the investment in Brasilcel as of December 31, 2004, 2003 and 2002 are stated in one line named "U.S. GAAP adjustments of equity investees". The detail of the U.S. GAAP adjustments of equity investees as of December 31, 2004 and 2003, is as follows:

|                                      | <u>Notes</u> | <u>2004</u>          | <u>2003</u>          |
|--------------------------------------|--------------|----------------------|----------------------|
| Deferred costs                       | 36 c)        | (3,891,986)          | (5,189,330)          |
| Capitalised interest                 | 36 d)        | 24,658,694           | 21,225,998           |
| Revenue recognition                  | 36 o)        | (4,629,544)          | (689,725)            |
| Application of SFAS 133              | 36 p)        | 3,288,144            | 9,855,544            |
| Reversal of goodwill amortization    | 36 q)        | 53,888,187           | 17,256,033           |
| Progressive licenses amortization    | 36 r)        | (56,347,982)         | (42,690,186)         |
| Purchase accounting(i)               | 36 x)        | (13,671,448)         | 13,182,976           |
| Difference with Brasilcel investment | 36 u)        | (455,883,040)        | (455,883,040)        |
|                                      |              | <u>(452,588,975)</u> | <u>(442,931,730)</u> |

(i)

This adjustment refers to differences arising in the carrying values of assets and liabilities with the adoption of the purchase accounting method.

(3)

Represents the net effect of the U.S. GAAP adjustments on minority interests in net equity of the Company's subsidiaries.

The changes in shareholders' equity for the three years ended December 31, 2004, 2003 and 2002 are as follows:

|   | <u>2004</u>          | <u>2003</u>          | <u>2002</u>          |
|---|----------------------|----------------------|----------------------|
| Shareholders' equity in accordance with U.S. GAAP as of beginning of the period | 1,998,972,675        | 2,343,744,111        | 3,736,542,351        |
| Net Income in accordance with U.S. GAAP   | 485,703,327          | 138,153,919          | 276,366,273          |
| Comprehensive income (loss)   | (94,680,729)         | (65,079,522)         | (1,582,907,687)      |
| Treasury stock acquisition  | (480,912,955)        | (210,040,062)        |                      |
| Dividends distribution  | (267,499,686)        | (200,685,600)        | (125,428,500)        |
| Other   | (3,062,513)          | (7,120,171)          | 39,171,674           |
| Shareholders' equity in accordance with U.S. GAAP as of ending of the period    | <u>1,638,520,119</u> | <u>1,998,972,675</u> | <u>2,343,744,111</u> |

The following presents summarized balance sheets as of December 31, 2004 and 2003 and income statements for the years ended December 31, 2004, 2003 and 2002 prepared in accordance with U.S. GAAP. These captions basically reflect the following:

The U.S. GAAP adjustments described above and in Note 36.

Reclassifications related to the use of the proportional method of consolidation for the company's investment in Brasilcel in order to present this investment on the equity method of accountings as discussed in Note 36 l) (see below for further detail).

Reclassifications of certain items such as amortization of goodwill (prior to the adoption of SFAS 142 on January 1, 2002), amortization of finite-lived intangibles, net gains and losses on disposals of fixed assets, and workforce reduction costs, which are excluded from operating



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

income under Portuguese GAAP, and are considered in the determination of operating income under U.S. GAAP.

Reclassifications of gains and losses on disposals of investments, which have been classified as extraordinary expenses in accordance with Portuguese GAAP. Under U.S. GAAP, these gains and losses on investments would not be considered extraordinary items, but would be included as other income and expenses.

Consolidation of certain equity investment as required by FIN 46(R).

### Balance sheet under U.S. GAAP:

|   | 2004                  | 2003                  |
|---|-----------------------|-----------------------|
| Current assets                                    | 4,732,083,936         | 4,604,694,594         |
| Investments, net                                  | 1,977,474,879         | 1,834,477,564         |
| Fixed assets, net                                 | 3,023,750,641         | 3,239,663,736         |
| Intangible assets, net                            | 1,348,996,123         | 1,360,586,492         |
| Other non-current assets                          | 782,376,572           | 724,836,343           |
| <b>Total assets</b>                               | <b>11,864,682,151</b> | <b>11,764,258,729</b> |
| Current liabilities                               | 3,008,725,352         | 2,807,297,794         |
| Accrued post-retirement liabilities               | 1,809,498,383         | 1,685,042,933         |
| Other long-term liabilities                       | 5,148,743,531         | 5,069,723,100         |
| <b>Total liabilities</b>                          | <b>9,966,967,266</b>  | <b>9,562,063,827</b>  |
| Minority Interests                                | 259,194,766           | 203,222,227           |
| Shareholder's equity                              | 1,638,520,119         | 1,998,972,675         |
| <b>Total liabilities and shareholder's equity</b> | <b>11,864,682,151</b> | <b>11,764,258,729</b> |

The balance sheets above are prepared considering the investment in Brasilcel consolidated under the equity method for U.S. GAAP. The reconciliation between the Company's balance sheet under

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Portuguese and U.S. GAAP as of December 31, 2004 considering the investment in Brasilcel accounted for by the equity method, is as follows:

|   | Portuguese GAAP<br>with proportional<br>consolidation | Proportional<br>consolidation | Portuguese GAAP<br>with<br>consolidation<br>under equity<br>method | Adjustments<br>for<br>U.S. GAAP | U.S. GAAP with<br>consolidation under<br>equity method |
|---|---|-------------------------------|--|---------------------------------|--|
| Current assets  | 4,667,050,200   | (986,352,366)                 | 3,680,697,834  | 1,051,386,101                   | 4,732,083,936  |
| Investments   | 432,612,676   | 2,160,350,906                 | 2,592,963,582  | (615,488,703)                   | 1,977,474,879  |
| Fixed assets, net                                     | 4,062,860,276   | (881,316,382)                 | 3,181,543,894  | (157,793,253)                   | 3,023,750,641  |
| Intangible assets, net                                | 3,212,854,903   | (1,794,266,075)               | 1,418,588,828  | (69,592,705)                    | 1,348,996,123  |
| Other non-current assets                              | 588,031,105   | (314,656,968)                 | 273,374,137  | 509,002,435                     | 782,376,572  |
| <b>Total assets</b>                                   | <b>12,963,409,160</b>                                 | <b>(1,816,240,885)</b>        | <b>11,147,168,275</b>  | <b>717,513,875</b>              | <b>11,864,682,151</b>                                  |
| Current liabilities                                   | 3,783,149,173   | (1,039,391,226)               | 2,743,757,947  | 264,967,405                     | 3,008,725,352  |
| Accrued post-retirement<br>liabilities                | 1,269,868,244   | (1,360,861)                   | 1,268,507,383  | 540,991,000                     | 1,809,498,383  |
| Other long-term liabilities                           | 4,624,589,940   | (450,989,903)                 | 4,173,600,037  | 975,143,494                     | 5,148,743,531  |
| <b>Total liabilities</b>                              | <b>9,677,607,357</b>                                  | <b>(1,491,741,990)</b>        | <b>8,185,865,367</b>   | <b>1,781,101,899</b>            | <b>9,966,967,266</b>                                   |
| Minority Interests                                    | 581,024,631   | (324,498,895)                 | 256,525,736  | 2,669,030                       | 259,194,766  |
| Shareholders' equity                                  | 2,704,777,172   |                               | 2,704,777,172  | (1,066,257,053)                 | 1,638,520,119  |
| <b>Total liabilities and<br/>shareholders' equity</b> | <b>12,963,409,160</b>                                 | <b>(1,816,240,885)</b>        | <b>11,147,168,275</b>  | <b>717,513,875</b>              | <b>11,864,682,151</b>                                  |

**Statements of profit and loss under U.S. GAAP:**

|   | 2004               | 2003               | 2002               |
|---|--------------------|--------------------|--------------------|
| Revenues  | 4,658,477,355      | 4,460,011,010      | 6,007,705,603      |
| Operating income  | 840,678,594        | 723,053,821        | 383,170,020        |
| Loss / (income) applicable to minority interests                                  | (80,747,517)       | (38,294,333)       | 166,154,317        |
| Consolidated net income / (loss) before change in<br>accounting principles        | 509,878,785        | 145,542,759        | 1,315,306,259      |
| Changes in accounting principles SFAS 142   |                    |                    | (1,038,939,986)    |
| Changes in accounting principles SFAS 143   |                    | (7,388,840)        |                    |
| Changes in accounting principles EITF 00-21                                       | (24,175,458)       |                    |                    |
| <b>Consolidated net income / (loss) after change in<br/>accounting principles</b> | <b>485,703,327</b> | <b>138,153,919</b> | <b>276,366,273</b> |

The statements of profit and loss above are prepared considering the investment in Brasilcel consolidated under the equity method for U.S. GAAP. The reconciliation between the Company's

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

statements of profit and loss under Portuguese and U.S. GAAP for the year ended December 31, 2004 considering the investment in Brasilcel accounted for by the equity method is as follows:

|   | Portuguese GAAP<br>with proportional<br>consolidation | Proportional<br>consolidation | Portuguese<br>GAAP<br>with<br>consolidation<br>under equity<br>method | Adjustments<br>for<br>U.S. GAAP | U.S. GAAP with<br>consolidation under<br>equity method |
|---|---|-------------------------------|---|---------------------------------|--|
| Revenues  | 6,022,853,971   | (1,479,163,463)               | 4,543,690,508   | 114,786,847                     | 4,658,477,355  |
| Operating income  | 1,368,588,773   | (228,511,417)                 | 1,140,077,356   | (299,398,762)                   | 840,678,594  |
| Loss / (Income) applicable to<br>minority interests               | (101,569,064)   | 43,014,109                    | (58,554,955)  | (22,192,562)                    | (80,747,517)   |
| Consolidated net income before<br>change in accounting principles | 500,125,395   |                               | 500,125,395   | 9,753,390                       | 509,878,785  |
| Changes in accounting<br>principles EITF 00-21                    |   |                               |   | (24,175,458)                    | (24,175,458)   |
| Consolidated net income after<br>change in accounting principles  | 500,125,395   |                               | 500,125,395   | (14,422,068)                    | 485,703,327  |

A condensed consolidated balance sheet of Brasilcel as of December 31, 2004 and 2003 and a statement of profit and loss for the years ended December 31, 2004 and 2003 under Portuguese GAAP are as follows:

|   | 2004                 | 2003                 |
|---|----------------------|----------------------|
| Balance sheets (amounts in €):                    |                      |                      |
| Current assets                                    | 2,100,750,790        | 1,734,127,350        |
| Non-current assets                                | 5,988,394,498        | 5,750,709,182        |
| <b>Total assets</b>                               | <b>8,089,145,288</b> | <b>7,484,836,532</b> |
| Current liabilities                               | 2,205,858,816        | 1,916,471,610        |
| Non-current liabilities                           | 911,676,932          | 900,361,242          |
| <b>Total liabilities</b>                          | <b>3,117,535,748</b> | <b>2,816,832,852</b> |
| Minority interest                                 | 648,997,790          | 838,402,466          |
| Shareholders' equity                              | 4,322,611,750        | 3,829,601,214        |
| <b>Total liabilities and shareholders' equity</b> | <b>8,089,145,288</b> | <b>7,484,836,532</b> |
|   | <b>2004</b>          | <b>2003</b>          |
|   | €                    | €                    |
| Statement of profit and loss (amounts in €):      |                      |                      |
| Revenues  | 3,005,953,877        | 2,723,075,795        |
| Operating income                                  | 457,022,520          | 509,398,857          |
| Loss/(Income) applicable to minority interests    | (86,028,217)         | (103,055,764)        |
| Consolidated net income                           | (118,381,004)        | (19,764,282)         |

**38. Additional Financial Statement Disclosures Required by U.S. GAAP and the SEC**

The following financial information is presented on the basis of U.S. GAAP:

**a) Comprehensive Income**

(i)

Statements of Comprehensive Income/(Loss):

|  | <u>2004</u>        | <u>2004</u>        | <u>2003</u>       | <u>2002</u>            |
|--|--------------------|--------------------|-------------------|------------------------|
|  | US\$               | €                  | €                 | €                      |
| Net Income under U.S. GAAP                             | 589,158,135        | 485,703,327        | 138,153,919       | 276,366,273            |
| Other comprehensive income (loss), net of tax effects  |                    |                    |                   |                        |
| Foreign currency translation adjustments               | 25,902,594         | 21,354,158         | 2,260,360         | (1,400,142,766)        |
| Minimum liability adjustment                           | (143,994,411)      | (118,709,325)      | (69,913,160)      | (164,645,130)          |
| Unrealized gains on available for sale securities, net | 3,244,093          | 2,674,438          | 2,573,278         | (18,119,791)           |
| Comprehensive income (loss)                            | <u>474,310,411</u> | <u>391,022,598</u> | <u>73,074,397</u> | <u>(1,306,541,414)</u> |

F-107

---

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

(ii)

Disclosure of Other Comprehensive Income for the period:

Year ended December 31, 2004

|  | Before-Tax<br>Amount | Tax (expense)<br>or benefit | Net-of-tax<br>Amount |
|--|----------------------|-----------------------------|----------------------|
| Foreign currency translation adjustments                               | 23,166,567           | (1,812,409)                 | 21,354,158           |
| Minimum liability adjustment (Note 36 a))                              | (163,737,000)        | 45,027,675                  | (118,709,325)        |
| Unrealized gains on available for sale securities, net<br>(Note 36 e)) | 3,688,880            | (1,014,442)                 | 2,674,438            |
|  | <b>(136,881,553)</b> | <b>42,200,824</b>           | <b>(94,680,729)</b>  |

Year ended December 31, 2003

|  | Before-Tax<br>Amount | Tax (expense)<br>or benefit | Net-of-tax<br>Amount |
|--|----------------------|-----------------------------|----------------------|
| Foreign currency translation adjustments                               | 16,091,185           | (13,830,825)                | 2,260,360            |
| Minimum liability adjustment (Note 36 a))                              | (104,348,000)        | 34,434,840                  | (69,913,160)         |
| Unrealized gains on available for sale securities, net<br>(Note 36 e)) | 3,761,763            | (1,188,485)                 | 2,573,278            |
|  | <b>(84,495,052)</b>  | <b>19,415,530</b>           | <b>(65,079,522)</b>  |

Year ended December 31, 2002

|   | Before-Tax<br>Amount   | Tax (expense)<br>or benefit | Net-of-tax<br>Amount   |
|---|------------------------|-----------------------------|------------------------|
| Foreign currency translation adjustments as restated                    | (1,376,588,429)        | (23,554,337)                | (1,400,142,766)        |
| Minimum liability adjustment as restated (Note 36 a))                   | (245,739,000)          | 81,093,870                  | (164,645,130)          |
| Unrealized losses on available for sale securities, net<br>(Note 36 e)) | (27,044,464)           | 8,924,673                   | (18,119,791)           |
|   | <b>(1,649,371,893)</b> | <b>66,464,206</b>           | <b>(1,582,907,687)</b> |

(iii)

Disclosure of Accumulated Other Comprehensive Income Balances:

|   | Foreign<br>Currency<br>Items | Minimum<br>liability<br>adjustment | Unrealized<br>Gain on<br>Securities | Total           |
|---|------------------------------|------------------------------------|-------------------------------------|-----------------|
| Beginning balance as of January 1, 2002 | (1,277,818,108)              | (135,876,000)                      | 16,243,793                          | (1,397,450,315) |
| Current year change 2002                | (1,400,142,766)              | (164,645,130)                      | (18,119,791)                        | (1,582,907,687) |
| Ending balance as at December 31, 2002  | (2,677,960,874)              | (300,521,130)                      | (1,875,998)                         | (2,980,358,002) |
| Current year change 2003                | 2,260,360                    | (69,913,160)                       | 2,573,278                           | (65,079,522)    |



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|  | Foreign<br>Currency<br>Items | Minimum<br>liability<br>adjustment | Unrealized<br>Gain on<br>Securities | Total                       |
|--|------------------------------|------------------------------------|-------------------------------------|-----------------------------|
|  | <u>                    </u>  | <u>                    </u>        | <u>                    </u>         | <u>                    </u> |
| Ending balance as at December 31, 2003 | (2,675,700,514)              | (370,434,290)                      | 697,280                             | (3,045,437,524)             |
| Current year change 2004               | 21,354,158                   | (118,709,325)                      | 2,674,438                           | (94,680,729)                |
|  | <u>                    </u>  | <u>                    </u>        | <u>                    </u>         | <u>                    </u> |
| Ending balance as at December 31, 2004 | <b>(2,654,346,356)</b>       | <b>(489,143,615)</b>               | <b>3,371,718</b>                    | <b>(3,140,118,253)</b>      |
|  | <u>                    </u>  | <u>                    </u>        | <u>                    </u>         | <u>                    </u> |

F-108

**b) Income Taxes**

The Company's operations are located primarily in Portugal and are subject to income taxes primarily in Portugal. Foreign components of pre-tax income, current income tax provision and deferred income tax provision are, therefore, not significant.

Under prevailing Portuguese tax regulations, operating losses may be carried forward for up to six years. Tax losses carry forwards as of December 31, 2004 expire as follows:

|      |               |
|------|---------------|
| 2005 | 4,931,202     |
| 2006 | 207,136,255   |
| 2007 | 47,467,108    |
| 2008 | 1,689,919,158 |
| 2009 | 331,558,618   |
| 2010 | 19,152,841    |
|      | 2,300,165,182 |

F-109

---

## c) Pension Benefits

The following table sets forth the reconciliation of beginning and ending balances of benefit obligation, fair value of plan assets and the funded status of the Company plans:

|  | December 31,           |                        |
|--|------------------------|------------------------|
|  | 2004                   | 2003                   |
| <b>Change in benefit obligation:</b>               |                        |                        |
| Benefit obligation at beginning of the year        | 3,357,720,000          | 3,015,107,000          |
| Service cost                                       | 18,617,000             | 20,618,000             |
| Interest cost                                      | 176,485,000            | 182,188,000            |
| Plan participants' contribution                    | 10,991,000             | 11,018,000             |
| Actuarial losses, net                              | 223,497,000            | 142,298,000            |
| Prior year service cost/(gain)                     | (66,787,000)           |                        |
| Benefits paid from the funds                       | (139,656,000)          | (137,681,000)          |
| Benefits paid directly by the Company              | (139,667,000)          | (140,182,000)          |
| Curtailment costs                                  | 151,178,800            | 264,354,000            |
|  | <b>3,592,378,800</b>   | <b>3,357,720,000</b>   |
| <b>Change in plan assets:</b>                      |                        |                        |
| Fair value of plan assets at beginning of the year | 1,828,066,000          | 1,664,249,000          |
| Actual return on plan assets                       | 147,482,000            | 137,004,000            |
| Employer contribution                              | 125,737,000            | 153,476,000            |
| Plan participants' contributions                   | 10,991,000             | 11,018,000             |
| Benefits paid from the funds                       | (139,656,000)          | (137,681,000)          |
|  | <b>1,972,620,000</b>   | <b>1,828,066,000</b>   |
| <b>Funded status of the plans:</b>                 |                        |                        |
| Funded status                                      | (1,619,758,800)        | (1,529,654,000)        |
| Unrecognized net transition obligation             | 88,225,000             | 111,185,000            |
| Unrecognized net loss                              | 1,014,438,944          | 842,332,000            |
| Unrecognized prior service gain                    | (62,559,000)           | (1,457,000)            |
|  | <b>(579,653,856)</b>   | <b>(577,594,000)</b>   |
| Accrued cost at end of the year                    | (579,653,856)          | (577,594,000)          |
| Additional minimum liability                       | (747,156,000)          | (669,479,000)          |
|  | <b>(1,326,809,856)</b> | <b>(1,247,073,000)</b> |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The components of the net periodic pension cost for the Company plans on a U.S. GAAP basis are as follows:

|  | December 31,       |                    |                    |
|--|--------------------|--------------------|--------------------|
|  | 2004               | 2003               | 2002               |
| Interest cost  | 176,485,000        | 182,188,000        | 170,483,000        |
| Net amortization and deferral                                | 36,961,000         | 33,446,000         | 27,329,000         |
| Service cost   | 18,617,000         | 20,618,000         | 18,303,000         |
| Estimated return on plan assets                              | (120,453,000)      | (118,256,000)      | (109,166,000)      |
| Estimated losses related to work force reduction programs(1) | 163,397,800        | 288,861,000        | 40,585,000         |
|  | <b>275,007,800</b> | <b>406,857,000</b> | <b>147,534,000</b> |

(1)

The Company has a long-term strategic plan to reduce workforce in its wireline business. Each year, the Company makes a determination as to the number and category of workforce to be made redundant. In the years ended December 31, 2004, 2003 and 2002, respectively, the Company reduced its workforce by approximately 651, 1,530 and 135 employees. In connection with each termination of employment, the Company offers termination benefits including one-time payments. The Company also incurs curtailment expenses associated with pension and other employees benefit plans related to the terminated employees. As the employees will provide no future service to the Company, all service cost for such terminated employees must be accrued at the moment the termination decision has been made and communicated to employees.

As from 2004 Portugal Telecom is required to disclose some additional information regarding expected future cash flows related with pension benefits. Expected gross benefit payments to be satisfied by Portugal Telecom's future cash flows and specific funds set up to cover these obligations from 2005 to 2014 are as follows (amounts in millions of Euros):

|           |         |
|-----------|---------|
| 2005      | 279.3   |
| 2006      | 273.5   |
| 2007      | 268.1   |
| 2008      | 261.4   |
| 2009      | 252.8   |
| 2010-2014 | 1,069.3 |

As of December 31, 2004, we have used an expected return on assets assumption of 6%. This rate was computed based on historical return on assets, the strategy and policies guidelines used in our investment funds and the target allocation of assets used in our funds. In addition we have also completed our analyses by comparing this expected return to yields available on financial markets with similar maturities as of our liabilities.

As of December 31, 2004, our target and actual allocation of assets was as follows:

|   | <b>December 31, 2004</b> |          | <b>Target Allocation</b> |
|---|--------------------------|----------|--------------------------|
|   | <b>Total</b>             | <b>%</b> |                          |
| Equities  | 681,516,951              | 34.5%    | 30.0%                    |
| Bonds   | 671,112,135              | 34.0%    | 40.0%                    |
| Property  | 259,565,035              | 13.2%    | 16.0%                    |
| Real estate investment funds                                  | 54,654,566               | 2.8%     | 3.0%                     |
| Cash, treasury bills, short-term stock and net current assets | 305,771,313              | 15.5%    | 10.0%                    |
|   | <b>1,972,620,000</b>     |          |                          |

Our plan assets are managed in accordance with our investing policy and strategy guidelines, which are as follows (i) demanding a clear definition on asset allocation, taking into consideration geographical and management criteria; (ii) adopting an integrated policy of exchange risk hedge; (iii) using passive investment strategies using index trackers; (iv) requiring annual portfolio rebalancing; (v) requiring the use of recognized asset fund managers, chosen in an independent contest; (vi) using a diversified portfolio with high liquidity; and (vii) defining some restrictions on tactical allocation. In addition all the investments/assets are managed in order to fulfil all of our liabilities in accordance with its maturity and value.

**d) Health care benefits**

The following table sets forth the reconciliation of beginning and ending balances of benefit obligation and the funded status of the Company plans:

|  | December 31,         |                      |
|--|----------------------|----------------------|
|  | 2004                 | 2003                 |
| <b>Change in benefit obligation:</b>         |                      |                      |
| Benefit obligation at beginning of the year  | 688,763,000          | 639,677,000          |
| Service cost                                 | 5,061,000            | 5,628,000            |
| Interest cost                                | 36,935,000           | 38,131,000           |
| Actuarial losses/(gains)                     | (8,004,000)          | 13,027,000           |
| Unrecognized prior service gain              |                      | (3,540,000)          |
| Benefits paid by the Company                 | (30,316,000)         | (31,523,000)         |
| Curtailement costs                           | 9,358,000            | 27,363,000           |
| <b>Benefit obligation at end of the year</b> | <b>701,797,000</b>   | <b>688,763,000</b>   |
| <b>Funded status of the plans:</b>           |                      |                      |
| Funded status                                | (701,797,000)        | (688,763,000)        |
| Unrecognized net transition obligation       | 85,059,000           | 96,933,000           |
| Unrecognized prior service cost              | 10,987,000           | 12,778,000           |
| Unrecognized net loss                        | 123,062,472          | 136,290,000          |
| <b>Pension liability at end of the year</b>  | <b>(482,688,528)</b> | <b>(442,762,000)</b> |

A summary of the components of the net periodic post retirement health care cost of the Company is presented in the following table:

|  | December 31,      |                   |                   |
|--|-------------------|-------------------|-------------------|
|  | 2004              | 2003              | 2002              |
| Interest cost  | 36,935,000        | 38,131,000        | 37,487,000        |
| Amortization of unrecognized transition obligation           | 8,813,000         | 9,579,000         | 9,611,000         |
| Service cost   | 5,061,000         | 5,628,000         | 6,193,000         |
| Amortization of actuarial gains and losses                   | 1,112,000         | 2,809,000         | 4,335,000         |
| Amortization of prior service cost                           | 1,309,000         | 1,641,000         | 1,646,000         |
| Curtailement losses related to work force reduction programs | 12,928,000        | 33,052,000        | 2,940,000         |
| <b>Net periodic post retirement benefit cost</b>             | <b>66,158,000</b> | <b>90,840,000</b> | <b>62,212,000</b> |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

As of December 31, 2004, one-percentage-point change in assumed healthcare cost trend rates would have the following effects:

|  | 1-Percentage<br>Point<br>Decrease | 1-Percentage<br>Point<br>Increase |
|--|-----------------------------------|-----------------------------------|
| <b>Restatement of Net periodic post-retirement benefit cost and Accumulated post-retirement obligation, assuming change in the health care cost trend rate</b> |                                   |                                   |
| Effect on total of service and interest cost components  | 35,258                            | 50,119                            |
| Effect on the post retirement benefit obligation   | 602,442                           | 819,310                           |

As from 2004 Portugal Telecom is required to disclose some additional information regarding expected future cash flows related with health care benefits. Expected benefit payments from 2005 to 2014 are as follows (amounts in millions of Euros):

|           |       |
|-----------|-------|
| 2005      | 33.6  |
| 2006      | 34.4  |
| 2007      | 35.4  |
| 2008      | 36.3  |
| 2009      | 37.4  |
| 2010-2014 | 198.4 |

**e) Fair value of financial instruments**

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Short term investments: the carrying amount approximates fair value because of the short period of time between the origination of the instruments and their expected realization.

Other investments not recorded by the equity method: for the Company's investments carried at cost, which are not publicly traded and do not have quoted market prices, an estimate of fair value was determined.

Loans: the fair value of these financial instruments was estimated based on the discounted value of future cash flows expected to be paid, considering the rates of interest at which the Company could borrow as of the balance sheet dates, unless there are quoted market prices for these debt securities.

Interest rate and foreign currency swap agreements: the fair value of these agreements has been estimated based upon quotes obtained from brokers.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Foreign currency forward and option agreements: the fair market value has been determined based on the projected cash flows of these instruments as of the balance sheet date.

Derivatives on our common stock: the fair value has been estimated based upon quotes obtained from brokers.

Total return swap with shares of PT Multimédia: the fair value has been estimated based upon quotes obtained from brokers.

The estimated fair values of the Company's financial instruments are as follows (See Note 31):

|  | December 31, 2004 |               | December 31, 2003 |               |
|--|-------------------|---------------|-------------------|---------------|
|  | Carrying value    | Fair value    | Carrying value    | Fair value    |
| Loans  | 5,063,061,979     | 5,154,602,849 | 5,746,692,727     | 5,848,565,328 |
| Interest rate and foreign currency swap agreements | 73,061,768        | 91,179,754    | (23,445,296)      | 10,267,688    |
| Foreign currency forward and option agreements     | (6,684,974)       | (5,731,885)   | (48,575,946)      | (47,896,622)  |
| Derivatives on our common stock                    | 557,993           | (6,018,302)   | 24,400,000        | (3,403,733)   |
| Total return swap with PT Multimédia shares        | 1,416,749         | (43,777,445)  | 3,900,000         | (15,485,733)  |

**f) Research and development**

Research and development expenditures, as determined under U.S. GAAP amounted to approximately to €10,594,165, €14,333,044 and €17,370,285, for the years ended December 31, 2004, 2003 and 2002, respectively.



**g) Reconciliation of Earnings per Share Computation**

The computation of basic and diluted earnings per share for the years ended December 31, 2004, 2003 and 2002, prepared in accordance with U.S. GAAP is as follows:

|   | <u>2004</u>                                      | <u>2003</u>          | <u>2002</u>          |
|---|--|----------------------|----------------------|
|   | (in € millions, except share and per share data) |                      |                      |
| <b>Numerator</b>  |  |                      |                      |
| U.S. GAAP income before cumulative effect of new accounting principles as restated  | 509.9  | 145.5                | 1,315.3              |
| Cumulative effect of a change in accounting principles SFAS 142                     |  |                      | (1,038.9)            |
| Cumulative effect of a change in accounting principles SFAS 143                     |  | (7.4)                |                      |
| Cumulative effect of a change in accounting principles subscriber acquisition costs | (24.2)   |                      |                      |
|   | <u>485.7</u>                                     | <u>138.2</u>         | <u>276.4</u>         |
| Financial costs related with exchangeable bonds (net of tax)(1)                     | 5.2  |                      | 11.9                 |
|   | <u>490.9</u>                                     | <u>138.2</u>         | <u>288.3</u>         |
| <b>Numerator for diluted earnings per share</b>                                     |  |                      |                      |
| <b>Denominator for basic and diluted earning per share (share amounts)</b>          |  |                      |                      |
| Weighted average common shares outstanding  | 1,210,976,939                                    | 1,249,778,188        | 1,253,880,328        |
| Effect of the exchangeable bonds(1)   | 31,568,691                                       |                      | 89,209,377           |
|   | <u>1,242,545,630</u>                             | <u>1,249,778,188</u> | <u>1,343,089,705</u> |
| <b>Denominator for diluted earnings per share adjusted weighted average shares</b>  |  |                      |                      |
|   | <u>1,242,545,630</u>                             | <u>1,249,778,188</u> | <u>1,343,089,705</u> |
| <b>Basic earnings per share</b>   |  |                      |                      |
| Before cumulative effect of adopting new accounting principles as restated          | 0.42   | 0.12                 | 1.05                 |
| Impact of cumulative effect of adopting SFAS 142                                    |  |                      | (0.83)               |
| Impact of cumulative effect of adopting SFAS 143                                    |  | (0.01)               |                      |
| Impact of cumulative effect of adopting EITF 00-21                                  | (0.02)   |                      |                      |
|   | <u>0.40</u>                                      | <u>0.11</u>          | <u>0.22</u>          |
| <b>Basic earnings per share</b>   |  |                      |                      |
|   | <u>0.40</u>                                      | <u>0.11</u>          | <u>0.22</u>          |
| <b>Diluted earnings per share</b>   |  |                      |                      |
| Before cumulative effect of adopting new accounting principles as restated          | 0.41   | 0.12                 | 0.99                 |
| Impact of cumulative effect of adopting SFAS 142                                    |  |                      | (0.78)               |
| Impact of cumulative effect of adopting SFAS 143                                    |  | (0.01)               |                      |
| Impact of cumulative effect of adopting EITF 00-21                                  | (0.02)   |                      |                      |
|   | <u>0.39</u>                                      | <u>0.11</u>          | <u>0.21</u>          |
| <b>Diluted earnings per share</b>   |  |                      |                      |
|   | <u>0.39</u>                                      | <u>0.11</u>          | <u>0.21</u>          |

(1)

For the year ended December 31, 2003, the effects of the exchangeable bonds have been excluded from the calculations of diluted earnings per share, since they would be antidilutive.

F-116

---

**h) Guarantees**

In the course of its business, Portugal Telecom and its subsidiaries grant certain guarantees to third parties. These guarantees are given to ensure the proper performance of contractual obligations by Portugal Telecom or its consolidated subsidiaries in the normal course of their business. As of December 31, 2004, we have given guarantees and comfort letters to third parties as follows (amounts in millions of Euros):

|   | <b>Total</b> | <b>Less than<br/>1 year</b> | <b>1 - 3<br/>years</b> | <b>3 - 5<br/>years</b> | <b>More than<br/>5 years</b> |
|---|--------------|-----------------------------|------------------------|------------------------|------------------------------|
| Bank guarantees given to Portuguese courts for outstanding litigation | 9.0          | 9.0                         |                        |                        |                              |
| Bank guarantees given to other entities:                              |              |                             |                        |                        |                              |
| By PT Comunicações  | 18.3         | 18.3                        |                        |                        |                              |
| By TMN to ANACOM  | 3.2          | 3.2                         |                        |                        |                              |
| By PT Multimédia and subsidiaries                                     | 9.3          | 7.7                         | 0.7                    | 0.3                    | 0.6                          |
| Other bank guarantees   | 1.5          | 1.5                         |                        |                        |                              |
| Comfort letters and other guarantees                                  | 116.7        | 39.0                        | 67.4                   | 10.3                   |                              |

The bank guarantees given by PT Multimédia and its subsidiaries relate mainly to bank loans. The bank guarantees given by PT Comunicações to third parties relate mainly to the Portuguese tax authorities in respect of certain contingencies. See "Item 8 Financial Information - Legal Proceedings".

In addition, as part of cross-leasing transactions ("QTE leases") with different third parties, Portugal Telecom has leased out and then leased back certain telecommunications equipment. The crossed flow of lease payments and Portugal Telecom's remuneration were prepaid at the outset of the contracts and, for this reason, are not shown in the table concerning minimum future lease payments. The remuneration is recognized as income over the period of the transaction. We estimate that the risk of the guarantee being called upon is negligible. At December 31, 2004, the guarantee represented €840.5 million.

**i) Stock option plan**

For periods prior to December 31, 2002, Portugal Telecom disclosed all relevant information regarding its stock option plans. In the years ended December 31, 2004 and 2003, Portugal Telecom did not have outstanding share option plans, as the ones existing before that date had expired, despite the fact that the benefits were vested in 2003, as described below, and the rights were not exercised, since the share strike price was higher than the market price.

A description of Portugal Telecom's incentive plans is as follows:

(a)

On April 21, 1998 at PT's annual shareholders' meeting an incentive plan was approved for the directors and certain employees of PT and its subsidiaries, consisting of options to purchase shares of PT. Under the terms of the plan its beneficiaries had the option to acquire 2,927,725 shares at a price of Euro 9.39 per share.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

The options were exercisable during three month periods commencing on the dates defined in the plan, as follows:

|              | <b>Percentage</b> |
|--------------|-------------------|
| June 8, 2000 | 10%               |
| June 8, 2001 | 20%               |
| June 8, 2002 | 30%               |
| June 8, 2003 | 40%               |

The options not exercised within the above periods could be exercised at a single time during the three month period commencing after the last exercisable date defined in the plan, that is June 8, 2003.

(b)

On September 27, 1999, at an extraordinary shareholders' meeting of PT, another incentive plan was approved for directors and senior managers of PT and its subsidiaries, consisting of shares and options to purchase shares of PT. This new plan allowed for the delivery of up to 6,120,000 shares and options to purchase shares (at a price of Euro 11.38) over a period of three years, with an effective starting date on April 27, 2000.

Prior to January 1, 2002, PT has adopted the disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") for its stock option plans, but opted to remain under the expense recognition provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25) in accounting for options granted under its plans. Under APB 25, compensation expense is determined based on the intrinsic value of the stock award at the measurement date. Intrinsic value is calculated as the difference between the market value of PT's common stock on the date of grant and the exercise price of the option. Awards under the PT's stock option plans have been made with exercise prices equal to the market value of PT's common stock on the date of grant. As the measurement date for these grants was the same as the date of grant, no compensation expense has been recorded under APB 25.

The following table presents the disclosures required by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation, Transition and Disclosure"

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

("SFAS 148") for the pro forma effects of applying SFAS 123 in determining compensation cost under the PT's stock options plans under U.S. GAAP for the years ended December 31, 2003 and 2002:

|   | <b>Years ended December 31,</b>                   |                |
|---|---|----------------|
|   | <b>2003</b>                                       | <b>2002</b>    |
|   | <b>(Euro Thousands, except per share amounts)</b> |                |
| U.S. GAAP net income as reported  | 138,154   | 276,368        |
| Deduct: Total stock-based employee compensation expenses determined under fair value based method for all awards (net of related tax effects) | 1,052   | 1,493          |
| <b>Pro forma net income</b>   | <b>137,102</b>                                    | <b>274,873</b> |
| Net income per share:   |   |                |
| Basic as reported   | 0.11  | 0.22           |
| Basic pro forma   | 0.11  | 0.22           |
| Diluted as reported   | 0.11  | 0.21           |
| Diluted pro forma   | 0.11  | 0.21           |

F-119

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|                                  | Portugal Telecom 1999 Plan          |                                 | Portugal Telecom 2000 Plan          |                                 |
|----------------------------------|-------------------------------------|---------------------------------|-------------------------------------|---------------------------------|
|                                  | Number of shares subject to options | Weighted-average exercise price | Number of shares subject to options | Weighted-average exercise price |
| Year ended December 31, 1998     | 2,857,745                           |                                 |                                     |                                 |
| Granted                          |                                     |                                 |                                     |                                 |
| Exercised                        |                                     |                                 |                                     |                                 |
| Cancelled                        |                                     |                                 |                                     |                                 |
| Outstanding at December 31, 1999 | 2,857,745                           |                                 |                                     |                                 |
| Granted                          |                                     | 9.39                            |                                     |                                 |
| Exercised                        | (121,420)                           |                                 |                                     |                                 |
| Cancelled                        | (534,330)                           |                                 |                                     |                                 |
| Outstanding at December 31, 2000 | 2,201,995                           | 9.39                            |                                     |                                 |
| Granted                          |                                     |                                 | 2,285,756                           | 11.38                           |
| Exercised                        | (148,586)                           |                                 |                                     |                                 |
| Cancelled                        | (668,740)                           |                                 |                                     |                                 |
| Adjustments(1)                   | 33,907                              |                                 |                                     |                                 |
| Outstanding at December 31, 2001 | 1,418,576                           | 9.39                            | 2,285,756                           | 11.38                           |
| Granted                          |                                     |                                 | 1,022,640                           | 11.38                           |
| Exercised                        |                                     |                                 |                                     |                                 |
| Cancelled                        | (17,165)                            |                                 |                                     |                                 |
| Outstanding at December 31, 2002 | 1,401,411                           | 9.39                            | 3,308,396                           | 11.38                           |
| Granted                          |                                     |                                 |                                     |                                 |
| Exercised                        |                                     |                                 |                                     |                                 |
| Expired                          | (1,401,411)                         |                                 | (3,308,396)                         |                                 |
| Outstanding at December 31, 2003 |                                     |                                 |                                     |                                 |

(1) Adjustments related with capital increases occurred in the year ended December 31, 2001 and the issuance of a convertible bond in December 2001.

The fair value of each option granted is estimated on the date of grant using the Black Scholes option-pricing model with the following weighted-average assumptions used for the grants made under each plan:

|                         | Portugal Telecom 1999 Plan | Portugal Telecom 2000 Plan |
|-------------------------|----------------------------|----------------------------|
| Risk free interest rate | 4.71%                      | 5.05% - 5.15%              |
| Dividend yield          | 2.10%                      | 2%                         |
| Volatility              | 25.10%                     | 45%                        |
| Expected term, in years | 4                          | 3.3                        |

F-120

**j) Reconciliation Net income to Operating Cash-Flow**

The reconciliation of net income to cash flow from operating activities for the year ended December 31, 2004, 2003 and 2002 prepared in accordance with IAS 7, is as follows (amounts stated in millions of Euros):

|   | <b>2004</b>    | <b>2003</b>    | <b>2002</b>    |
|---|----------------|----------------|----------------|
| <b>Consolidated Net Income Before Minority Interests</b>                  | 601.7          | 319.5          | 316.4          |
| Interest expenses, net  | 202.9          | 201.8          | 197.1          |
| Goodwill amortization   | 97.1           | 110.6          | 142.9          |
| Other net financing (income) losses                                       | 45.2           | (53.5)         | 24.0           |
| Losses/(Gains) on sales and disposals of fixed assets, net                | 12.0           | (28.6)         | (4.0)          |
| Equity in losses of affiliated companies                                  | (27.7)         | 19.2           | 160.9          |
| Extraordinary items   | 87.4           | 52.8           | 38.6           |
| Depreciation and amortization   | 957.3          | 954.0          | 962.8          |
|   | <b>1,976.0</b> | <b>1,575.7</b> | <b>1,838.7</b> |
| (Increase)/Decrease in Accounts Receivable trade                          | (48.2)         | (106.7)        | 109.5          |
| (Increase)/Decrease in Accounts Receivable other                          | (59.2)         | 76.9           | (328.3)        |
| (Increase)/Decrease in Inventories, net                                   | (74.2)         | 46.9           | 4.8            |
| (Increase)/Decrease in Prepaid Expenses and Other current assets          | (13.4)         | (5.9)          | (10.5)         |
| Increase/(Decrease) in Accounts Payable Trade                             | 40.4           | 231.0          | 1.0            |
| Increase/(Decrease) in Accounts Payable Other                             | 103.5          | (195.1)        | 21.8           |
| Increase/(Decrease) in Accrued expenses, excluding financial operations   | 33.6           | 95.2           | 14.1           |
| Increase/(Decrease) in Taxes payable                                      | (20.1)         | 31.9           | (82.5)         |
| Increase/(Decrease) in Deferred income                                    | 50.9           | 88.1           | (47.4)         |
| (Increase)/Decrease in Current deferred tax assets                        | (25.7)         | 71.8           | (214.2)        |
| (Increase)/Decrease in Non-current deferred tax assets                    | 91.5           | 293.8          | (449.9)        |
| Increase/(Decrease) in Current deferred tax liabilities                   | (4.8)          | (11.4)         | 0.9            |
| Increase/(Decrease) in Non-current deferred tax liabilities               | (12.0)         | (58.3)         | (218.3)        |
| Increase/(Decrease) in Accrued post retirement liability                  | 13.8           | 194.6          | (748.6)        |
| Change in intangible Asset post retirement liabilities                    |                |                | 761.9          |
| Changes in Consolidation (TCO)  |                | 18.8           |                |
| Increase in Provisions related with Taxes losses carryforward (Brasilcel) |                |                | 1.350.5        |
| Increase/(Decrease) in Other non-current liabilities                      |                | (50.9)         | 50.9           |
| Other   | (34.4)         | 37.6           | 37.9           |
|   | <b>41.8</b>    | <b>758.3</b>   | <b>253.6</b>   |
| <b>Cash flow from operating activities</b>                                | <b>2,017.8</b> | <b>2,334.0</b> | <b>2,092.3</b> |

**k) New U.S. GAAP Accounting Pronouncements**

**Statements of Financial Accounting Standards No. 123 (Revised 2004): Share-Based Payment**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Shared Based Payments (SFAS 123R). This statement eliminates the option to apply the intrinsic value measurement provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" to stock compensation awards issued to employees. Rather, SFAS 123R requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award the requisite service period (usually the vesting period). SFAS 123R applies to all awards granted after the required effective date, December 15, 2005, and to awards modified, repurchased, or cancelled after that date. SFAS 123R will be effective for our fiscal year ending December 31, 2005. The Company does not anticipate that adoption of this Standard will have a material effect on its financial position, results of operations, or cash flows.

**Statements of Financial Accounting Standards No. 128R, Earnings per Share, an amendment to FAS 128**

In December 2004, the FASB deferred the issuance of their final standard on earnings per share SFAS No. 128R, Earnings per Share, an amendment to FAS 128. The final standard is expected to be effective in 2005 and will require retrospective application for all prior periods presented. The significant proposed changes to the EPS computation are changes to the treasury stock method and contingent share guidance for computing year-to-date diluted EPS, removal of the ability to overcome the presumption of share settlement when computing diluted EPS when there is a choice of share or cash settlement and inclusion of mandatorily convertible securities in basic EPS. The Company is currently evaluating the proposed provisions of this amendment to determine the impact on its consolidated financial statements.

**Statements of Financial Accounting Standards No. 151: Inventory Costs An Amendment of ARB No. 43, Chapter 4**

On November 24, 2004, the FASB issued SFAS No. 151, "Inventory Cost, a revision of ARB No. 43, Chapter 4". The amendments to SFAS No. 151 aim to improve financial information, stating that the expenses of inactive facilities, transportation costs, manipulation costs and scrap material costs should be recorded in the statement of operation as expenses of the period. The application of fixed cost to inventories should be based on the normal capacity of the production facilities. SFAS No. 151 will be applicable to valuation of Inventories by the end of the first reporting period ending after June 15, 2005. The Company does not anticipate that the adoption of SFAS No. 151 will have a material impact on its financial position, cash flows or results of operations.



**Statements of Financial Accounting Standards No. 153: Exchanges of Non-monetary Assets An Amendment of APB Opinion No. 29**

On December 16, 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets an amendment of APB Opinion No. 29", which amends Accounting Principles Board Opinion No. 29 "Accounting for Nonmonetary Transactions". This amendment is based on the idea that exchange transactions should be valued in accordance with the value of the exchanged assets. The exception made for similar non-monetary productive assets is eliminated and substituted by a more extensive exception related to non-monetary assets with a non-commercial consideration. APB No. 29 stated that the exchange transaction of a productive asset for a similar one should be recorded at the book value of the exchanged asset. SAS No. 153 will be applicable for non-monetary asset exchange transactions occurring in fiscal periods beginning after June 15, 2005. The Company does not anticipate that the adoption of SFAS No. 153 will have a material impact on its financial position, cash flows or results of operations.

**Statements of Financial Accounting Standards No. 154: Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3**

In May 2005, the FASB issued FASB Statement 154, "Accounting Changes and Error Corrections", which replaces APB Opinion 20, "Accounting Changes", and FASB Statement 3, "Reporting Accounting Changes in Interim Financial Statements", and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

**SAB No. 107: Shared Based Payment**

On March 29, 2005, the SEC released a Staff Accounting Bulletin (SAB) relating to the FASB accounting standard for stock options and other share-based payments. The interpretations in SAB No. 107, "Share-Based Payment," (SAB 107) express views of the SEC Staff regarding the application of SFAS No. 123 (revised 2004), "Share-Based Payment" (Statement 123R). Among other things, SAB 107 provides interpretive guidance related to the interaction between Statement 123R and certain SEC rules and regulations, as well as provides the Staff's views regarding the valuation of share-based payment arrangements for public companies. The Company does not anticipate that adoption of SAB 107 will have any effect on its financial position, results of operations or cash flows.

**FIN No. 46 Consolidation of Variable Interest Entities an interpretation of ARB No. 51**

In January 2003, the Financial Accounting Standards Board ("FASB") released Interpretation No. 46 Consolidation of Variable Interest Entities ("FIN 46") which requires that all primary beneficiaries of Variable Interest Entities (VIE) consolidate that entity. FIN 46 is effective immediately for VIEs created after January 31, 2003 and to VIEs in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003 to VIEs in which an enterprise holds a variable interest it acquired before February 1, 2003. In December 2003, the FASB published a revision to FIN 46 ("FIN 46R") to clarify some of the provisions of the interpretation and to defer the effective date of implementation for certain entities. Under the guidance of FIN 46R, entities that do not have interests in structures that are commonly referred to as

special purpose entities are required to apply the provisions of the interpretation in financials statements for periods ending after March 14, 2004.

**FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations**

In March 2005, the FASB issued FASB Interpretation ("FIN") No. 47, "Accounting for Conditional Asset Retirement Obligations," which clarifies the term conditional asset retirement obligation as used in SFAS No. 143, "Accounting for Asset Retirement Obligations," as a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the Company. FIN No. 47 is effective no later than the end of fiscal years ending after December 15, 2005. The Company is currently evaluating the impact of adopting this interpretation.

**EITF 04-1: Accounting for Preexisting Relationships between the Parties to a Business Combination**

This Issue addresses the accounting for preexisting relationships between the parties to a business combination. The consensus in this Issue should be applied to business combinations consummated and goodwill impairment tests performed in reporting periods beginning after October 13, 2004. The application of this new accounting literature by Portugal Telecom had no impact on its financial position, cash flows or results of operations.

**EITF Issue No. 01-08 Determining Whether an Arrangement Contains a Lease**

In May 2003, the EITF reached consensus in EITF Issue No. 01-08 to clarify the requirements of identifying whether an arrangement should be accounted for as a lease at its inception. The guidance in the consensus is designed to mandate reporting revenue as rental or leasing income that otherwise would be reported as part of product sales or service revenue. EITF Issue No. 01-08 requires both parties to an arrangement to determine whether a service contract or similar arrangement is, or includes, a lease within the scope of SFAS No. 13, "Accounting for Leases." The application of this EITF has not had any effect on The Company's financial position, cash flows or results of operations.

## Exhibit I Details of Subsidiary, Affiliated and Investee Companies as of December 31, 2004

## 1. Companies included in the consolidation

The following companies were included in the consolidation as of December 31, 2004 and 2003 (Note2):

| Company   | Head Office   | Activity   | Percentage of ownership                    |         |         |
|---|---------------|--|--|---------|---------|
|   |               |  | 2004                                       |         | 2003    |
|   |               |  | Direct                                     | Total   | Total   |
| Portugal Telecom (parent company)<br>(Note 1)                                     | Lisbon        | Holding company.   |  |         |         |
| Açormedia Comunicação Multimedia e<br>Edição de Publicações,<br>S.A.("Açormedia") | Ponta Delgada | Providing services on edition of<br>publications, audiovisual<br>communication, multimedia services and<br>edition of books.       | Lusomundo Media (90%)                      | 44.18%  | 44.23%  |
| Cabo TV Açoreana, S.A.  | Ponta Delgada | Distribution of television signals by cable<br>and satellite in the Azores area.   | TV Cabo Portugal (83.82%)                  | 48.24%  | 48.24%  |
| Cabo TV Madeirense, S.A.  | Funchal       | Distribution of television signals by cable<br>and satellite in the Madeira area.  | TV Cabo Portugal (69%)                     | 39.71%  | 39.71%  |
| Cabo Verde Telecom, S.A.  | Praia         | Fixed and mobile telecommunications<br>services in Cabo Verde.   | PT Ventures (40%)                          | 40.00%  | 40.00%  |
| Clipanúncios Serviços de Gestão de<br>Informação, S.A.(a)                         | Lisbon        | Electronic management of<br>advertisements and services in the<br>electronic commerce area.  |  |         | 49.15%  |
| Contact Cabo Verde Telemarketing e<br>Serviços de Informação, S.A.(b)             | Praia         | Call and contact center services.  | PT Contact (100%)                          | 100.00% |         |
| CST Companhia Santomense de<br>Telecomunicações, S.A.R.L.                         | São Tomé      | Fixed and mobile telecommunication<br>services in São Tomé Príncipe.   | PT Comunicações (51%)                      | 51.00%  | 51.00%  |
| Directel Listas Telefónicas Internacionais,<br>Lda. ("Directel")                  | Lisbon        | Publication of telephone directories and<br>operation of related data bases.   | PT Ventures (100%)                         | 100.00% | 100.00% |
| Directel Cabo Verde Serviços de<br>Comunicação, Lda.                              | Praia         | Publication of telephone directories and<br>operation of related databases in Cabo<br>Verde  | Directel (60%)<br>Cabo Verde Telecom (40%) | 76.00%  | 76.00%  |
| Directel Macau Listas Telefónicas, Lda.   | Macau         | Publication of telephone directories and<br>operation of related databases in Macau.   | Directel (75%)<br>PT Asia (5%)             | 80.00%  | 80.00%  |
| Elta Empresa de Listas Telefónicas de<br>Angola, Lda.                             | Luanda        | Publication of telephone directories.  | Directel (55%)                             | 55.00%  | 55.00%  |
| Empracine Empresa Promotora de<br>Actividades Cinematográficas, Lda.(b)           | Lisbon        | Developing activities on movies<br>exhibition.   | Lusomundo SII (100%)                       | 57.48%  |         |
| Empresa Gráfica Funchalense, S.A.(c)  | Lisbon        | Services provider of graphic art namely<br>typography, lithography, plasticizing,<br>book binding, photocomposition and<br>offset. |  |         | 28.78%  |
| Global Notícias Publicações, S.A.   | Oporto        | Newspaper edition and publication.   | Lusomundo Media (99.72%)                   | 48.95%  | 49.01%  |



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |          |  |   |        |        |
|---|----------|--|---|--------|--------|
| Grafilme Sociedade Impressora de Legendas, Lda.                                 | Lisbon   | Providing services on audiovisual subtitling.  | Lusomundo Audiovisuais (55.56%)                         | 31.98% | 31.98% |
| Infonet Portugal Serviços de Valor Acrescentado, Lda.                           | Lisbon   | Commercialization of value added products and services in the area of information and communication by computer through access to the Infonet world network. | PT Prime (90%)  | 90.00% | 90.00% |
| Jornal do Fundão Editora, Lda.  | Fundão   | Newspaper edition and publication.   | Lusomundo Media (51.34%)                                | 25.20% | 25.24% |
| Kenya Postel Directories, Ltd.  | Nairobi  | Production, editing and distribution of telephone directories and other publications.  | Directel (55%)  | 55.00% | 55.00% |
| LTM Listas Telefónicas de Moçambique, Lda.                                      | Maputo   | Management, editing, operation and commercialization of listings of subscribers and classified telecommunications directories.                               | Directel (50%)  | 50.00% | 50.00% |
| Lusomundo Audiovisuais, S.A.  | Lisbon   | Import, commercialization, distribution and production of audiovisual products.  | PT Multimédia (100%)                                    | 57.56% | 57.56% |
| Lusomundo Cinemas, S.A.   | Lisbon   | Cinema exhibition.   | PT Multimédia (100%)                                    | 57.56% | 57.56% |
| Lusomundo Editores, S.A.  | Lisbon   | Movies distribution.   | PT Multimédia (100%)                                    | 57.56% | 57.56% |
| Lusomundo España, SL ("Lusomundo Espana")                                       | Madrid   | Management of investments relating to activities in Spain in the audiovisuals business.  | PT Multimédia (100%)                                    | 57.56% | 57.56% |
| Lusomundo Sociedade Investimentos Imobiliários, SGPS, S.A. ("Lusomundo SII")(b) | Lisbon   | Management of Real Estate.   | PT Multimédia (99.87%)                                  | 57.48% |        |
| Lusomundo Imobiliária 2, S.A.(b)  | Lisbon   | Management of Real Estate.   | Lusomundo SII (99.80%)                                  | 57.37% |        |
| Lusomundo Media   | Lisbon   | Management of investments.   | Lusomundo Serviços (74.97%)<br>Portugal Telecom (5.94%) | 49.09% | 49.09% |
| Lusomundo Moçambique, Lda.  | Maputo   | Cinema exhibition.   | Lusomundo Cinemas (100.00%)                             | 57.56% | 57.56% |
| Lusomundo Serviços  | Lisbon   | Management of investments.   | PT Multimédia (100%)                                    | 57.56% | 57.56% |
| Lusomundo.net Comércio Electrónico e Informática, Lda.(a)                       | Lisbon   | Providing multimedia and telecommunications services.  |   |        | 57.56% |
| Mascom Wireless Botswana (Proprietary) Limited ("Mascom")(d)                    | Botswana | Provision of mobile telecommunications services in Botswana.   |   |        | 50.01% |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |           |   |  |         |         |
|---|-----------|---|--|---------|---------|
| Mobitel, S.A.   | São Paulo | Call center services.   | PT Brasil (56.96%)                                   | 56.96%  | 56.96%  |
| Naveprinter Indústria Gráfica do Norte, S.A.(e)                       | Oporto    | Providing services on publishing and graphic art.   | Global Notícias (90.97%)                             | 44.53%  |         |
| Notícias Direct Distribuição ao Domicílio, Lda.                       | Lisbon    | Home delivery of publications and other services.   | Serviços Lusomundo (100%)                            | 57.56%  | 57.56%  |
| Ocasião Edições Periódicas, Lda. ("Ocasião")(e)                       | Almada    | Newspaper edition and publication.  | Global Notícias (99.98%)<br>Lusomundo Media (0.02%)  | 48.95%  |         |
| Plataforma Empresa de Trabalho Temporário, Lda. ("Plataforma")(d)     | Lisbon    | Supply of temporary labour to third parties, personnel selection and professional training.   |  |         | 100.00% |
| Portugal Telecom Ásia, Lda. ("PT Ásia")                               | Macau     | Promotion and marketing of telecommunications services.   | Portugal Telecom (95.92%)<br>PT Comunicações (4.04%) | 99.96%  | 99.96%  |
| Portugal Telecom Brasil, S.A. ("PT Brasil")                           | São Paulo | Management of investments.  | Portugal Telecom (99.95%)<br>PT Comunicações (0.05%) | 100.00% | 100.00% |
| Portugal Telecom Inovação, S.A. ("PT Inovação")                       | Aveiro    | Innovation, research, development and integration of telecommunications services and engineering solutions and training services in telecommunications. | Portugal Telecom (100%)                              | 100.00% | 100.00% |
| Portugal Telecom Inovação Brasil, Ltda.                               | São Paulo | Development of information technologies and telecommunications services.  | PT Inovação (100%)                                   | 100.00% | 100.00% |
| Portugal Telecom Internacional Finance B.V.                           | Amsterdam | Obtaining financing for the group in international markets.   | Portugal Telecom (100%)                              | 100.00% | 100.00% |
| Premium TV Portugal, S.A.   | Lisbon    | Development and promotion of "pay-TV" and multimedia services, including licensing of TV programs.  | PT Conteúdos (100%)                                  | 57.56%  | 57.56%  |
| Previsão Sociedade Gestora de Fundos de Pensões, S.A. ("Previsão")(e) | Lisbon    | Pension fund management.  | Portugal Telecom (78.12%)                            | 78.12%  |         |
| PrimeSys, Soluções Empresariais, S.A.                                 | São Paulo | Provision of services in the areas of information technology and telecommunications.  | PT Brasil (100%)                                     | 100.00% | 100.00% |
| PT Acessos de Internet Wi-Fi, S.A.(b)                                 | Lisbon    | Provides wireless Internet access services.   | Portugal Telecom (100%)                              | 100.00% |         |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |           |   |                              |         |         |
|---|-----------|---|------------------------------|---------|---------|
| PT Comunicações, S.A. ("PT Comunicações")   | Lisbon    | Establishment, management and operation of telecommunications infrastructures and provision of public telecommunication services and telebroadcasting services.         | Portugal Telecom (100%)      | 100.00% | 100.00% |
| PT Compras Serviços de Consultoria e Negociação, S.A.   | Lisbon    | Providing consultant and negotiation services related with the buying process.  | Portugal Telecom (100%)      | 100.00% | 100.00% |
| PT Contact Telemarketing e Serviços de Informação, S.A. ("PT Contact")                              | Lisbon    | Production, promotion and sale of information systems, including information products and services and related technical assistance.                                    | PT Comunicações (100%)       | 100.00% | 100.00% |
| PT Conteúdos Actividade de Televisão e de Produção de Conteúdos, S.A. (former TV Cabo Audiovisuais) | Lisbon    | Production and sale of television programs and advertising management.  | PT Televisão por Cabo (100%) | 57.56%  | 57.56%  |
| PT Corporate  | Lisbon    | Providing all services available in the Group, in the fixed line and mobile telecommunications and information systems.   | Portugal Telecom (100%)      | 100.00% | 100.00% |
| PT Investimentos Internacionais, S.A. ("PT II")(f)  | Lisbon    | Business advisory board service installment, consultation, administration and business management. Elaboration of projects and economic studies and manage investments. | Portugal Telecom (100%)      | 100%    |         |
| PT Meios Serviços de Publicidade e Marketing, S.A.  | Lisbon    | Purchase, sale and exchange of space advertising, analysis of marketing investment projects.  | Portugal Telecom (100%)      | 100%    | 100%    |
| PT Móveis, SGPS, S.A. ("PT Móveis")   | Lisbon    | Management of investments in the mobile business.   | TMN (100%)                   | 100.00% | 100.00% |
| PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A.                                 | Lisbon    | Management of investments in the multimedia business.   | Portugal Telecom (57.56%)    | 57.56%  | 57.56%  |
| PT Multimédia.com Brasil, Ltda. ("PTM.com Brasil")  | São Paulo | Management of investments.  | PT Brasil (100%)             | 100.00% | 100.00% |
| PT Prime, SGPS, S.A. (Prime SGPS)   | Lisbon    | Management of investments, under the business areas of corporate market and large customers.  | Portugal Telecom (100%)      | 100.00% | 100.00% |
| PT Prime Soluções Empresariais de Telecomunicações e Sistemas, S.A.                                 | Lisbon    | Provision of development and consultancy services in the areas of electronic commerce, contents and information technology.   | Portugal Telecom (100%)      | 100%    | 100%    |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |        |  |  |         |         |
|---|--------|--|--|---------|---------|
| PT Prime Tradecom Soluções Empresariais de Comércio Electrónico, S.A. ("Tradecom")(g) | Lisbon | Provision of development and consultancy services in the areas of electronic commerce, contents and information technology.                      | Prime SGPS (66%)   | 66.00%  | 66.00%  |
| PT Pro, Serviços Administrativos e de Gestão Partilhados, S.A.                        | Lisbon | Shared services center.  | Portugal Telecom (100%)  | 100.00% | 100.00% |
| PT Sistemas de Informação, S.A. ("PT SI")   | Oeiras | Provision of IT systems and services.  | Portugal Telecom (99.8%)<br>PT Comunicações (0.1%)<br>TMN (0.1%) | 100.00% | 100.00% |
| PT Televisão por Cabo, SGPS, S.A.(h)  | Lisbon | Management of investments in television by cable market.   | PT Multimédia (100%)   | 57.56%  |         |
| PT Ventures, SGPS, S.A. ("PT Ventures")   | Lisbon | Management of investments in international markets.  | Portugal Telecom (100%)  | 100.00% | 100.00% |
| PT.com Comunicações Interactivas, S.A.(i)   | Lisbon | Services rendered development and sale of communication product services, information and multimedia services.                                   | Portugal Telecom (100%)  | 100.00% | 100.00% |
| Rádio Notícias Produções e Publicidade, S.A. ("Rádio Notícias")                       | Lisbon | Developing activities on production of radio broadcast programs, including publicity products.   | Lusomundo Media (67.71%)<br>Global Notícias (15%)                | 40.58%  | 40.63%  |
| Rádio Press Comunicação e Radiodifusão, Lda.  | Oporto | Activities on radio broadcasting, edition and commercialization of records, and other kind of audiovisual material.                              | Rádio Noticias (100%)  | 40.58%  | 40.63%  |
| RJN Rádio Jornal do Norte, Lda.   | Oporto | Developing activities on production of radio broadcast programs, including publicity products.   | Rádio Noticias (100%)  | 40.58%  | 40.63%  |
| Saber e Lazer Informática e Comunicação, S.A. ("Saber e Lazer")(j)                    | Lisbon | Information management and development of software products.   |  |         | 100.00% |
| Simarc Promoções Imobiliárias, S.A.(b)  | Lisbon | Administration of real estate assets, real estate investment consultancy, management of property developments, purchase and sale of real estate. | Portugal Telecom (100%)  | 100.00% |         |
| Telemática Consultores de Telecomunicações e Informática, Lda.                        | Lisbon | Supply of computer equipment, training and installations.  | PT Contact (100%)  | 100.00% | 100.00% |



## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |        |   |   |         |         |
|---|--------|---|---|---------|---------|
| Telepac II Comunicações Interactivas, S.A.(j)           | Lisbon | Services rendered development and sale of telecommunications product services, information and multimedia services.   |   |         | 100.00% |
| Timor Telecom, S.A.(b)                                  | Timor  | Provider of telecommunications services in Timor  | TPT (50.10%)                            |         | 38.15%  |
| TMN Telecomunicações Móveis Nacionais, S.A.             | Lisbon | Provision of mobile telecommunications services and the establishment, management and operation of telecommunications networks.                             | Portugal Telecom (100%)                 | 100.00% | 100.00% |
| Tradecom, SGPS, S.A. ("Tradecom SGPS")(g)               | Lisbon | Management of investments.  |   |         | 100.00% |
| TSF Rádio Jornal de Lisboa, Lda.                        | Lisbon | Radio broadcasting including production of programs and publicity products.   | Rádio Notícias (100%)                   | 40.58%  | 40.63%  |
| TPT Telecomunicações Publicas de Timor, S.A. ("TPT")(b) | Lisbon | Purchase, sale and services rendering of telecommunications products and information technologies in Timor  | PT Ventures (75.16%)<br>PT Ásia (0.98%) |         | 76.14%  |
| TV Cabo Portugal, S.A.                                  | Lisbon | Distribution of television by cable, conception, realization, production and broadcasting of television programs, operation of telecommunications services. | PT Televisão por Cabo (100%)            | 57.56%  | 57.56%  |
| Warner Lusomundo Sociedade Ibérica de Cinemas, Lda.(k)  | Lisbon | Management of entertainment activities.   |   |         | 57.56%  |

- (a) These companies were liquidated in 2004.
- (b) These companies were fully consolidated due to their materiality for the presentation of the consolidated financial statements.
- (c) This company was excluded from consolidation as of December 31, 2004.
- (d) These companies were sold during 2004.
- (e) Portugal Telecom acquired or increased its participation in these companies during 2004.
- (f) This company was incorporated at March 31, 2004 as result of the reorganization of the international businesses.
- (g) In 2004, the company Tradecom SGPS was merged into PT Prime SGPS and, as result, all the participations of Tradecom SGPS were incorporated into PT Prime SGPS.
- (h) During the second half of 2004, GSF Gestão de Serviços Financeiros, Lda was renamed to "PT Televisão por Cabo, SGPS, S.A." and changed its activity.
- (i) As of May 7, 2004 this company changed its name from "PT Multimédia.Com SGPS, S.A." to the one it is using currently.
- (j) As of December 2004, these companies were merged into PT.com
- (k) During the second half of 2004 this company was merged into Lusomundo Cinemas.

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

These subsidiaries were included in the consolidation by the full consolidation method based on the provisions of line a), item 1, article 1 of Decree-law 238/91 of July 2 (majority of voting rights) except for Cabo Verde Telecom, which was consolidated based on line c), item 1, article 1 of that Decree-Law (dominant influence based on shareholders' agreements or similar contracts).

F-130

---

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

2. Companies excluded from the consolidation

The following companies were excluded from the consolidation as of December 31, 2004 and 2003 (Note 2):

| Company   | Head Office | Activity   | Percentage of ownership                         |         |         |
|---|-------------|--|---|---------|---------|
|   |             |  | 2004  |         | 2003    |
|   |             |  | Direct  | Total   | Total   |
| A Tentativa (Empresa Cinematográfica), S.A.(a)                              | Lisbon      | Cinema exhibition.   |   |         | 47.00%  |
| Academia Global, Ltda.(b)   | São Paulo   | Development and commercialization of technological goods and services in the areas of education and professional training, including support services. | PTM.com Brasil (100%)                           | 100.00% | 100.00% |
| Canal 20 TV, S.A.(b)  | Madrid      | Distribution of TV products.   | PT Multimédia (50%)                             | 28.78%  | 28.78%  |
| Cine Esplanada Ideal Olhanense, Lda.(a)                                     | Olhão       | Cinema exhibition.   |   |         | 57.56%  |
| Cinerg Sociedade Madeirense de Cinemas, Lda.(a)                             | Funchal     | Cinema exhibition.   |   |         | 57.48%  |
| Contact Cabo Verde Telemarketing e Serviços de Informação, S.A.(c)          | Praia       | Call and contact center services.  |   |         | 100.00% |
| DirectMedia Ásia, Lda.(b)   | Hong Kong   | Publishing of B2B directories.   | Directel (99%)<br>PT Ásia (1%)                  | 100.00% | 100.00% |
| Directel Uganda Telephone Directories, Limited(d)                           | Uganda      | Publication of telephone directories.  | Directel (90%)                                  | 90.00%  | 90.00%  |
| EJV Plataforma de Comércio Electrónico, S.A.(e)                             | Lisbon      | Creation and management of electronic commerce platforms for goods and services  |   |         | 100%    |
| Empracine Empresa Promotora de Actividades Cinematográficas, Lda.(c)        | Lisbon      | Cinema exhibition.   |   |         | 57.48%  |
| Empresa Cine Mourense, Lda.(f)  | Moura       | Cinema exhibition.   | PT Multimédia (99.46%)                          | 57.25%  | 57.25%  |
| Empresa de Recreios Artísticos, Lda. ("ERA")(b)                             | Lisbon      | Cinema exhibition.   | Lusomundo SII (87.90%)<br>PT Multimédia (4.03%) | 52.85%  | 52.85%  |
| Empresa Teatro Sá da Bandeira, Lda.(a)                                      | Santarém    | Management and promotion of public events.   |   |         | 34.53%  |
| Foliver Serviços de Telecomunicações e Transferência de Informação, S.A.(e) | Lisbon      | Production and multimedia edition of information about the wine market.  |   |         | 74.88%  |
| Grande Reportagem Sociedade Editora, Lda.(b)                                | Lisbon      | Edition, commercialization, distribution and import/export of both periodical and non-periodical publications.   | Lusomundo Media (100%)                          | 49.09%  | 49.15%  |
| Guinetel, S.A.(b)   | Bissau      | Provision of public telecommunications services.   | PT II (55%)                                     | 55%     |         |



Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |                  |  |  |         |         |
|---|------------------|--|--|---------|---------|
| Guiné Telecom Companhia de Telecomunicações da Guiné-Bissau, S.A.R.L.(g)        | Bissau           | Provision of public telecommunications services.   | PT Comunicações (51.14%)                       | 51.14%  | 51.14%  |
| GSF Gestão e Serviços Financeiros, Lda.(h)                                      | Lisbon           | Supply of financial services, management of investments and economical studies.  |  |         | 57.48%  |
| Hotel Video Prestação de Serviços, Lda.(b)                                      | Lisbon           | Establishment of video systems on Hotels and similar spaces.   | PT Multimédia (60%)                            | 34.53%  | 34.53%  |
| Janela Digital Informativo e Telecomunicações, Lda ("Janela Digital")(b)        | Caldas da Rainha | Development of IT solutions to the real estate market.   | PT.com (50%)                                   | 50.00%  | 50.00%  |
| Lusocine Sociedade Exibidora de Filmes, Lda.(a)                                 | V.R.S. António   | Developing activities on movies exhibition.  |  |         | 57.56%  |
| Lusomundo Sociedade Investimentos Imobiliários, SGPS, S.A. ("Lusomundo SII")(c) | Lisbon           | Management of real estate assets.  |  |         | 57.48%  |
| Lusomundo Imobiliária 2, S.A.(c)  | Lisbon           | Management of real estate assets.  |  |         | 57.37%  |
| Marconi France Telecommunications SAS(b)  | Paris            | Provision of telecommunications services.  | PT Comunicações (100%)                         | 100.00% | 100.00% |
| Marconi Luxembourg Telecommunications, S.A.R.L.(a)                              | Luxembourg       | Provision of telecommunications services.  |  |         | 100.00% |
| Marconi Sprint Serviços de Comunicação, Lda.(d)                                 | Lisbon           | Commercialization of data and voice transmission telecommunications services.  | PT Ventures (51%)                              | 51.00%  | 51.00%  |
| Marconi Suisse Telecommunications, S.A.R.L.(b)                                  | Lausanne         | Provision of telecommunications services.  | PT Comunicações (100%)                         | 100.00% | 100.00% |
| Motormédia Comércio, Publicidade e Serviços Multimedia, S.A.(b)                 | Lisbon           | Services rendered in connection with advertising, commercial and multimedia services in connection with the commercialization of a site dedicated to the car sector. | PT.com (100%)                                  | 100%    | 74.90%  |
| Portugal Telecom Argentina, S.A.(b)   | Buenos Aires     | Provision of telecommunications services.  | Portugal Telecom (10.01%)<br>PT Ventures (40%) | 50.01%  | 50.01%  |
| Portugal Telecom Europa, S.P.R.L. ("PT Europa")(b)                              | Brussels         | Technical and commercial management consultancy in the communication area with respect to the European market and community matters.                                 | Portugal Telecom (98.67%)                      | 98.67%  | 98.67%  |

F-132

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|  |                        |   |  |         |         |
|--|------------------------|---|--|---------|---------|
| Portugal Telecom North América, Inc.(f)  | Washington             | Promotion and marketing of products, preparation of projects, studies and assessments, and the development of investment projects in the telecommunications area. | Portugal Telecom (100%)                        | 100.00% | 100.00% |
| PT Acessos de Internet Wi-Fi, S.A.(c)  | Lisbon                 | Provide wireless internet access services.  |  |         | 100%    |
| PT Prestações Mandatária de Aquisições e Gestão de Bens, S.A. ("PT Prestações")(i) | Lisbon                 | Acquisition and management of assets.   | PT Comunicações (100%)                         | 100%    |         |
| PT Multimédia.com Participações, S.A.(b)   | São Paulo              | Management of investments.  | PT.Com (100%)                                  | 100.00% | 100.00% |
| PT Multimédia Serviços de Apoio à Gestão, S.A.(b)                                  | Lisbon                 | Providing management support services.  | PT Multimédia (100%)                           | 57.56%  | 57.56%  |
| Rádio Canal Aberto, Lda.(b)  | Ponta Delgada          | Radio broadcasting and communication activities.  | Açormedia (76%)<br>Rádio Comercial Açores (4%) | 35.34%  | 35.39%  |
| Radio Comercial dos Açores, Lda.(b)  | Ponta Delgada          | Radio broadcasting and communication activities.  | Açormedia (100%)                               | 44.18%  | 44.23%  |
| Regiforum Empreendimentos Comerciais e Culturais, Lda.(j)                          | Lisbon                 | Operation of the Forum Telecom building, having for that purpose a contract transferring the operation of the building to Portugal Telecom.                       | PT Comunicações (100%)                         | 100.00% | 100.00% |
| Simarc Promoções Imobiliárias, S.A.(c)   | Lisbon                 | Administration of real estate assets, real estate investment consultancy, management of property developments, purchase and sale of real estate.                  |  |         | 100%    |
| Sociedade Teatral Bejense, S.A.(a)   | Lisbon                 | Cinema exhibition.  |  |         | 48.74%  |
| Sportstat Informação Desportiva Independente, S.A.(b)                              | Lisbon                 | Collection, processing, consultant providing, production, promotion and sale of statistical data and information.   | PT.Com (99.98%)                                | 99.98%  | 99.98%  |
| Sport Notícias Organizações Desportivas, Lda.(a)                                   | Oporto                 | Organization of sport events.   |  |         | 49.01%  |
| Superemprego Sistemas de Informação para Gestão de Recursos Humanos, S.A.(b)       | Lisbon                 | Management and collection of information about the labor market.  | PT.com (63.75%)                                | 63.75%  | 63.75%  |
| Teat Flower Trading Ltd.(h)  | British Virgin Islands | International Business Trading Company.   | PT Comunicações (100%)                         | 100.00% | 100.00% |
| Techlab Electrónico, Lda.(h)   | São Paulo              | Provision of mobile aeronautical services.  | PT Brasil (100%)                               | 100.00% | 100.00% |
| Timor Telecom, S.A.(c)   | Timor                  | Operation of the public telecommunication services in Timor   | TPT (50.10%)                                   |         | 39.16%  |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |        |   |   |        |
|---|--------|---|---|--------|
| TPT Telecomunicações Publicas de Timor, S.A.(c) | Lisbon | Purchase, sale and services rendering of telecommunications products and information technologies in Timor  | PT Ventures (75.16%)<br>PT Ásia (0.98%) | 78.15% |
| VoxPop Música Interactiva, S.A.(d)              | Lisbon | Provision of services and establishment, development and operation of an interactive channel dedicated to music and commercialization of related goods. | PT.com (99.99%)                         | 74.9%  |

- (a) These companies were liquidated during 2004.
- (b) These companies were excluded from consolidation due to their immateriality (item 1, article 4 of Decree-law 238/91 of 2 July).
- (c) As of December 31, 2004 these companies were fully consolidated.
- (d) As of December 31, 2004 these companies were in liquidation process.
- (e) This company was merged into PT.Com.
- (f) These companies had no activity at the moment.
- (g) Given the political and economical situation of Guine Bissau, this company was excluded from the consolidation in 1998 and a provision in the amount of the investment has been recorded.
- (h) During the second half of 2004, GSF Gestão de Serviços Financeiros, Lda was renamed to "PT Televisão por Cabo, SGPS, S.A." and changed its activity.
- (i) This company was incorporated in 30 March 2004.
- (j) This company was consolidated by the equity method, because the nature of its business is not related to the group's (item 4, article 4 of Decree-Law 238/91 of 2 July).

### 3. Associated Companies

The associated companies as of December 31, 2004 and 2003 are as follows (Note 2):

| Company   | Head Office | Activity   | Percentage of ownership                   |        |        |
|---|-------------|--|---|--------|--------|
|   |             |  | 2004                                      |        | 2003   |
|   |             |  | Direct                                    | Total  | Total  |
| 24 Horas Inc.   | Newark      | Edition of publications.   | Global Notícias (51%)                     | 24.96% | 24.99% |
| Banco I.net, S.A.(a)  | São Paulo   | Developing activities providing internet financial services.   |   |        | 31.50% |
| BEST Banco Electrónico de Serviços Total, S.A. ("Banco Best") | Lisbon      | Provision of e.banking services.   | PT.com (34%)                              | 34.00% | 34.00% |
| CTM Companhia de Telecomunicações de Macau, S.A.R.L.          | Macau       | Provision of public telecommunications services, in Macau.   | PT Comunicações (3%)<br>PT Ventures (25%) | 28.00% | 28.00% |
| Distodo Distribuição e Logística, Lda.                        | Lisbon      | Stocking, sale and distribution of audiovisual material.   | Lusomundo Serviços (50%)                  | 28.78% | 28.78% |
| Diverfun Centros de Recreio, Lda. ("Diverfun")                | Lisbon      | Establishment and management of entertainment spaces.  | PT Multimédia (100%)                      | 57.56% | 28.78% |
| Empresa do Diário de Notícias, Lda.                           | Funchal     | Publications production and commercialization.   | Lusomundo Media (40%)                     | 19.64% | 19.66% |
| Empresa Gráfica Funchalense, S.A.                             | Lisbon      | Services provider of graphic art namely typography, lithography, plasticizing, book binding, photocomposition and offset.                                    | Lusomundo Serviços (50%)                  | 28.78  | 28.78% |
| Hungaro Digitel KFT   | Budapeste   | Provision of telecommunications services.  | PT Ventures (44.62%)                      | 44.62% | 44.62% |
| Idealyze, S.A.  | São Paulo   | Production and commercialization of internet products.   | PT.com (33.33%)                           | 33.33% | 33.33% |
| Infordesporto Informática e Desporto, S.A.(b)                 | Lisbon      | Commercialization of value added products and services in the area of information and communication by computer through access to the Infonet world network. |   |        | 50.00% |
| Lisboa TV Informação e Multimedia, S.A.                       | Lisbon      | Television operations, notably production and commercialization of programs and publicity.   | PT Conteúdos (40%)                        | 23.02% | 23.02% |
| Lusa Agência de Notícias de Portugal, S.A.                    | Lisbon      | News agency.   | Lusomundo Serviços (23.35%)               | 13.44% | 13.44% |
| Médi Telecom  | Casablanca  | Provision of mobile services in Morocco.   | PT Móveis (32.18%)                        | 32.18% | 32.18% |
| Multicert Serviços de Certificação Electrónica, S.A.          | Lisbon      | Supply of electronic certification services.   | PT Prime (20%)                            | 20.00% | 20.00% |
| Multitel Serviços de Telecomunicações, Lda.                   | Luanda      | Provision of data communications services and digital information communication services, in Angola.   | PT Ventures (35%)                         | 35.00% | 35.00% |
| Mundifun Centros de Recreio, Lda.                             | Lisbon      | Establishment and management of entertainment spaces.  | Diverfun (66.66%)                         | 37.70% | 19.19% |





Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |                                       |  |   |        |        |
|---|---------------------------------------|--|---|--------|--------|
| Naveprinter S.A.(c)                             | Indústria Gráfica do Norte,<br>Oporto | Providing services on publishing and graphic art.  |   |        | 18.85% |
| Octal TV, SA.                                   | Lisbon                                | Development, commercialization, training and consultancy in systems for interactive and broad band television.   | PT Multimédia (20%)   | 11.51% | 11.51% |
| Páginas Amarelas, S.A. ("Páginas Amarelas")     | Lisbon                                | Production, editing and distribution of telephone directories and publications.  | Portugal Telecom (24.88%)<br>PT Prime (0.125%)                            | 25.00% | 25.00% |
| Previsão Pensões, S.A. ("Previsão")(d)          | Lisbon                                | Pension fund management.   |   |        | 31.56% |
| SGPICE Internet e Consultoria de Empresas, S.A. | Lisbon                                | Developing activities providing global products and services for internet support.   | PT Comunicações (11.11%)<br>PT Multimédia (11.11%)<br>Prime SGPS (11.11%) | 28.61% | 28.61% |
| Sport TV Portugal, S.A.                         | Lisbon                                | Conception, production, realization and commercialization of sports programs for telebroadcasting, purchase and resale of the rights to broadcast sports programs for television and provision of publicity services | PT Conteúdos (50.00%)   | 28.78% | 19.18% |
| Sportinvest Multimedia, SGPS, S.A.              | Lisbon                                | Management of investments.   | Portugal Telecom (50%)  | 50.00% | 50.00% |
| Tele Larm Portugal S.A.                         | Lisbon                                | Provision of transmission, services, supervision of alarms, telementation, telecontrol and data exchange services.   | PT Prime (50%)  | 50.00% | 50.00% |
| Teledata de Moçambique, Lda.                    | Maputo                                | Operation and commercialization of public data telecommunications services and other telematic services.   | PT Ventures (50%)   | 50.00% | 50.00% |
| Telesat Satellite Communications, Limited       | Macau                                 | Operation of land based satellite stations, commercialization of private telecommunications network services.  | PT Ventures (18.52%)<br>PT Ásia (3.7%)                                    | 22.22% | 24.44% |
| Tradecom Brasil S/A(e)                          | São Paulo                             | Development services of electronic commerce in Latin America.  | Prime SGPS (20%)  | 20.00% |        |
| Tradecom International N.V.                     | Rotterdam                             | Development services of electronic commerce in Latin America.  | Prime SGPS (20%)  | 20.00% | 20.00% |
| TV Cabo Macau, S.A.                             | Macau                                 | Distribution of television and audio signals, installation and operation of a public telecommunications system and provision of video services, in Macau.  | PT Ventures (35%)<br>PT Ásia (40%)  | 74.98% | 74.98% |
| TV Lab Interactivos, S.A.                       | Lisbon                                | Developing digital tv interactive solutions.   | PT.com (50%)  | 50.00% | 50.00% |
| UOL, Inc.                                       | São Paulo                             | Provides Internet services and produces Internet contents.   | PT Brasil (28.11%)<br>PTM.com Participações (0.30%)                       | 28.41% | 17.94% |

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

|   |        |  |  |        |        |
|---|--------|--|--|--------|--------|
| Unitel  | Luanda | Mobile telecommunications services, in Angola.                                     | PT Ventures (25%)                                    | 25.00% | 25.00% |
| Vasp Sociedade de Transporte e Distribuições, Lda. ("Vasp") | Sintra | Providing distribution services of publications and other products.                | Lusomundo Serviços (33.33%)<br>PT Multimédia (0.01%) | 19.19% | 19.19% |
| Warner Cines de España, S.A.                                | Madrid | Management of entertainment activities.  | Lusomundo España (33.33%)                            | 19.19% | 19.19% |
| Web-Lab, SGPS, S.A.   | Lisbon | Management of investments.   | Portugal Telecom (90%)                               | 90.00% | 36.26% |
| Wisdown Tele Vision Serviços e Produtos de Televisão, Lda.  | Lisbon | Development of services and products related with new technology in the TV market. | PT.com (50%)   | 50.00% | 50.00% |

- (a) This company was sold during 2004.
- (b) This company was liquidated during 2004.
- (c) During the second half of 2004, Global Notícias increased its participation in this company to 90.97% and, as a result, the company was fully consolidated as of December 31, 2004.
- (d) During the first half of 2004, Portugal Telecom increased its participation in Previsão to 78.12% and, as a result, the company was fully consolidated as of December 31, 2004.
- (e) This participation was acquired in 2004.

## 4. Companies consolidated by the proportional method (Note 2)

| Company   | Head Office    | Activity  | Percentage of ownership   |        |        |
|---|----------------|---|---|--------|--------|
|   |                |   | 2004  |        | 2003   |
|   |                |   | Direct  | Total  | Total  |
| Avista(a)   | São Paulo      | Management of investments.  | Brasilcel (100%)  | 50.00% |        |
| Brasilcel, N.V.   | Amsterdam      | Mobile telecommunications services and establishment management and exploration of telecommunications network, in Brasil. | PT Móveis (50.00%)  | 50.00% | 50.00% |
| Celular CRT Participações, S.A. ("Celular CRT Participações") | Porto Alegre   | Management of investments.  | TBS (28.04%)<br>Brasilcel (24.45%)<br>Avista (15.84%)                         | 34.16% | 25.30% |
| Global Telecom, S.A.  | Coritiba       | Mobile cellular services operator.  | TCP (100%)  | 32.56% | 32.56% |
| Iberoleste Participações, S.A. ("Iberoleste")(b)              | São Paulo      | Management of investments.  |   |        | 50.00% |
| Intertelecom, Ltda ("Intertelecom")(c)                        | São Paulo      | Management of investments.  |   |        | 50.00% |
| Portelcom Fixa, S.A. ("Portelcom Fixa")(b)                    | São Paulo      | Management of investments.  |   |        | 50.00% |
| Portelcom Participações, S.A. ("Portelcom")                   | São Paulo      | Management of investments.  | Brasilcel (60.15%)<br>Ptelecom Brasil (39.85%)                                | 50.00% | 50.00% |
| Ptelecom Brasil, S.A. ("Ptelecom")                            | São Paulo      | Management of investments.  | Brasilcel (100%)  | 50.00% | 50.00% |
| Sudeste Celular Participações, S.A. ("Sudeste Celular")       | São Paulo      | Management of investments.  | Brasilcel (100%)  | 50.00% | 44.75% |
| Tagilo Participações, Lda. ("Tagilo")                         | São Paulo      | Management of investments.  | Brasilcel (100%)  | 50.00% | 50.00% |
| TBS Celular Participações, S.A. ("TBS")                       | São Paulo      | Management of investments.  | Brasilcel (73.27%);<br>Sudeste Celular (22.99%)                               | 48.13% | 48.13% |
| Tele Sudeste Celular Participações, S.A. ("Tele Sudeste")     | Rio de Janeiro | Mobile cellular services operator.  | Brasilcel (51.61%)<br>Sudeste (24.27%)<br>Tagilo (10.80%)<br>Avista (4.207%)  | 45.44% | 41.94% |
| Tele Leste Celular Participações, S.A. ("Tele Leste")         | Baia           | Mobile cellular services operator.  | Avista (22.73%)<br>Sudestecel (22.08%)<br>Brasilcel (3.37%)<br>Tagilo (2.41%) | 25.29% | 13.85% |
| Telesp Celular Participações, S.A. ("TCP")                    | São Paulo      | Management of investments.  | Brasilcel (57.26%)<br>Portelcom (7.86%)                                       | 32.56% | 32.56% |
| Telesp Celular, S.A. ("Telesp Celular")                       | São Paulo      | Mobile cellular services operator.  | TCP (100%)  | 32.56% | 32.56% |
| Tele Centro Oeste Celular Participações, S.A. ("TCO")         | Brasília       | Mobile cellular services operator.  | TCP (51.42%)  | 16.74% | 9.40%  |

(a)

In October 2004, a new holding company, Avista, was created with the purpose of acquiring additional interests in Brasilcel's subsidiaries. This company has a share capital of Reais 616 million, which was fully subscribed and paid by Brasilcel.

(b)

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

In the end of 2004, these companies were merged into Sudeste Celular Participações.

(c)

In the end of 2004, this company was merged into Ptelecom Brasil.

F-138

---

**Exhibit II Changes in the Group in 2004**

The following main changes in the composition of the companies included in the consolidation occurred during 2004, are as follows:

**a) Acquisitions**

During 2004, Portugal Telecom acquired in the stock market 1,600,000 shares of Media Capital, corresponding to 1.93% of its share capital, for an amount of Euro 6,960,000 (Note 10).

During 2004, PT Conteúdos acquired 250,000 shares of Sport TV, equivalent to 16.67% of its share capital, for an amount of Euro 16.3 million. This acquisition generated a goodwill amounting to Euro 22,126,657 (Note 12) and increased the ownership of PT Conteúdos in the share capital of Sport TV to 50%.

During 2004, Portugal Telecom acquired 325,920 shares of Previsão, for an amount of Euro 2,147,561, increasing its ownership to 78.12% of its share capital (Note 10).

In May 2004, Brasilcel acquired the remaining 10.5% of the share capital of Sudeste Celular Participações, S.A., for an amount of Euro 20,654,210.

On 13 May 2004 Global Notícias acquired 99.98% of the share capital of Ocasião Edições Periódicas, Lda, for an amount of Euro 4,756,279. This acquisition generated a goodwill amounting to Euro 4,763,278.

During the second half of 2004, Global Notícias increased its interest in Naveprinter from 38.47% to 90.98%, through the acquisition of 393,846 shares for an amount of Euro 5 million. As a result of this acquisition, this company was included in the consolidation of Portugal Telecom.

In the second half of 2004, PT Multimédia acquired the remaining 50% of Diverfun and now owns 100% of the share capital of this company.

On 8 October 2004 TCP concluded a tender offer for the acquisition of an additional interest in TCO. TCP paid an amount of 902 million Reais for this acquisition and increased its ownership in TCO from 29.3% to 51.4% (excluding treasury shares).

On 8 October 2004 Avista concluded a tender offer for the acquisitions of an interest in the share capital of Tele Sudeste, Tele Leste and Celular CRT. Brasilcel paid an amount of approximately 607 million of Reais for these operations and acquired a participation of 4.2%, 22.7% and 15.8% in Tele Sudeste, Tele Leste and Celular CRT.

At the end of 2004, Portugal Telecom increased its interest in Web-Lab from 36% to 90% of its share capital, through the acquisition of shares from several different entities.

**b) Incorporations**

During March 2004, PT Prestações was incorporated with a share capital of Euro 50,000, fully subscribed by PT Comunicações. This company will acquire and manage fund assets in relation to post retirement benefit obligations of PT Comunicações.

During March 2004, PT Investimentos Internacionais was incorporated, with a share capital of Euro 1,000,000, fully subscribed by Portugal Telecom. This company will render consultancy services and business management services in relation to the Group's international investments.

In October 2004, a new holding company, Avista, was created with the purpose of acquiring additional interests in Brasilcel's subsidiaries. This company has a share capital of 616 million of Reais, which was fully subscribed and paid by Brasilcel.

**c) Disposals**

On 28 October 2004 Portugal Telecom sold its interest in Banco1.net (Note 10), for an amount of 14,071,780 Reais.

In September 2004 the Botswana authorities granted approval for the sale of Mascom (Note 10), for an amount of Euro 45,672,309. As a result, a gain of Euro 24,764,670 was recorded related with this transaction (Note 27).

**d) Other operations**

In October 2004 Warner Lusomundo was merged into Lusomundo Cinemas.

In December 2004, Telepac, Saber & Lazer, EJV, Vox Pop and Foliver were merged into PT.com.

In December 2004, Iberoleste and Portelcom Fixa were merged into Sudeste Celular and, on the same date, Intertelcom was also merged into Ptelecom Brasil.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Portugal Telecom, SGPS, S.A.

By: /s/ ZEINAL ABEDIN MAHOMED BAVA

Name: Zeinal Abedin Mahomed Bava  
Title: Executive Board Member and Chief  
Financial Officer

Date: June 30, 2005

---



## EXHIBIT INDEX

| Exhibit<br>Number | Description   |
|-------------------|---|
| 1.1               | Articles of Association of Portugal Telecom, SGPS, S.A., as amended on April 29, 2005, together with an English translation thereof.  |
| 2.1               | Deposit Agreement, dated as of May 10, 1995, as amended and restated as of September 12, 1997, and as further amended and restated as of June 25, 1999, is incorporated by reference to Exhibit A of Portugal Telecom, S.A.'s Registration Statement on Form F-6 (Registration No. 333-10500) filed with the Commission on June 25, 1999.   |
| 2.2               | Amended and Restated Programme Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated April 29, 2003 among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Bilbao Vizcaya Argentaria, S.A., Banco BPI, S.A., Banco Espírito Santo de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, J.P. Morgan Securities Ltd., Citigroup Global Markets Limited, Tokyo-Mitsubishi International plc and UBS Limited, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.   |
| 2.3               | Fourth Supplemental Trust Deed in respect of a €5,000,000,000 Global Medium Term Note Programme, dated April 29, 2003, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.  |
| 2.4               | Amended and Restated Programme Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Bilbao Vizcaya Argentaria, S.A., Banco Espírito Santo de Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, Salomon Brothers International Limited, Tokyo-Mitsubishi International plc and UBS A.G. acting through its business group UBS Warburg, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002. |
| 2.5               | Third Supplemental Trust Deed in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.  |
| 2.6               | Keep Well Agreement in respect of a €5,000,000,000 Global Medium Term Note Programme, dated February 4, 2002, between Portugal Telecom, SGPS, S.A. and Portugal Telecom International Finance B.V., is incorporated by reference to Exhibit 2.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.   |
| 2.7               | Amended and Restated Programme Agreement in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, among Portugal Telecom, SGPS, S.A., Portugal Telecom International Finance B.V., PT Comunicações, S.A., Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., BCP Investimento-Banco Comercial Português de Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Deutsche Bank AG London, Merrill Lynch International, Salomon Brothers International Limited and UBS A.G. acting through its division UBS Warburg, is incorporated by reference to Exhibit 2.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.  |

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- 2.8 Second Supplemental Trust Deed in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS, S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited, is incorporated by reference to Exhibit 2.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 2.9 Keep Well Agreement in respect of a €4,000,000,000 Global Medium Term Note Programme, dated December 20, 2000, between Portugal Telecom, SGPS, S.A. and Portugal Telecom International Finance B.V., is incorporated by reference to Exhibit 2.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 2.10 Subscription Agreement relating to the issuance by Portugal Telecom International Finance B.V. of €1,000,000,000 4.625% Notes due 2009, dated March 31, 1999, among Portugal Telecom International Finance B.V., Portugal Telecom, S.A., Merrill Lynch International, UBS A.G. acting through its division Warburg Dillon Read, Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Caixa Geral de Depósitos, S.A., CISF-Banco de Investimento, S.A., Banco Santander Negócios Portugal, S.A., Deutsche Bank A.G. London and Salomon Brothers International Limited, is incorporated by reference to Exhibit 10.15 of Portugal Telecom, S.A.'s Registration Statement on Form F-1 (Registration No.333-10434) filed with the Commission on June 11, 1999.
- 2.11 Private Placement and Subscription Agreement, dated October 1, 1998, among Banco Nacional de Desenvolvimento Economico e Social, Telefonica Internacional, S.A., Iberdrola Energia, S.A. and Portugal Telecom, S.A., is incorporated by reference to Exhibit 10.16 of Portugal Telecom, S.A.'s Registration Statement on Form F-1 (Registration No. 333-10434) filed with the Commission on June 11, 1999.
- 2.12 Programme Agreement in respect of a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998, among Portugal Telecom, S.A., Portugal Telecom International Finance B.V., Banco Espírito Santo Investimento, S.A., Banco Português de Investimento, S.A., Banco Santander Negócios Portugal, S.A., Caixa Geral de Depósitos, S.A. Paris Branch, CISF-Banco de Investimento, S.A., Deutsche Bank A.G. London, Merrill Lynch International, Paribas, Salomon Brothers International Limited and UBS A.G. acting through its division Warburg Dillon Read, is incorporated by reference to Exhibit 2.11 of Portugal Telecom, S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999.
- 2.13 Deed of Purchase of Indebtedness relating to a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998 by Portugal Telecom, S.A., is incorporated by reference to Exhibit 2.12 of Portugal Telecom, S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999.
- 4.1 Consulting Agreement (Instrumento Particular de Prestação de Serviços de Consultoria), dated as of January 7, 1999, between Portugal Telecom, S.A. and Telesp Celular S.A. (English translation), is incorporated by reference to Exhibit 4.1 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 2, 2001.
- 4.2 Joint Venture Agreement, dated as of January 23, 2001, among Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A., Telefonica, S.A. and Telefonica-Móviles, S.A, is incorporated by reference to Exhibit 4.2 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on July 1, 2002.
- 4.3 Shareholders Agreement, dated as of October 17, 2002, by and among Telefónica Móviles, S.A., Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A. and Brasilcel B.V., in relation to Brasilcel B.V., is incorporated by reference to Exhibit 4.3 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
-

## Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

- 4.4 Subscription Agreement, dated as of October 17, 2002, by and among Telefónica Móviles, S.A., Portugal Telecom, SGPS, S.A., PT Móveis, SGPS, S.A. and Brasilcel B.V., in relation to Brasilcel B.V., is incorporated by reference to Exhibit 4.4 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
  - 4.5 English language summary of the Universal Service Convention, dated as of December 30, 2002, among PT Comunicações S.A., the Autoridade Nacional das Comunicações (ANACOM) and the Direcção Geral do Comércio e da Concorrência, is incorporated by reference to Exhibit 4.5 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
  - 4.6 English language summary of the Contract for the Purchase and Sale of the Ownership of the Basic Telecommunications Network and the Telex Network, dated December 27, 2002, between the Portuguese Government and PT Comunicações, is incorporated by reference to Exhibit 4.6 of Portugal Telecom, SGPS, S.A.'s annual report on Form 20-F filed with the Commission on June 30, 2003.
  - 8.1 List of Significant Subsidiaries.
  - 12.1 Section 302 Certification of Chief Executive Officer.
  - 12.2 Section 302 Certification of Chief Financial Officer.
  - 13.1 Section 906 Certification.
-

QuickLinks

[TABLE OF CONTENTS](#)

[CERTAIN DEFINED TERMS](#)

[PRESENTATION OF FINANCIAL INFORMATION](#)

[FORWARD-LOOKING STATEMENTS](#)

[PART I](#)

[Selected Consolidated Financial Data](#)

[Exchange Rates](#)

[Risk Factors](#)

[Overview](#)

[Our Businesses](#)

[ISDN Lines](#)

[Total Growth of Originated Traffic](#)

[Fixed Fees for Fixed Line Telephone Services\(1\)](#)

[Principal Prices for Domestic Fixed Line Telephone Services\(1\)](#)

[Principal Prices for Domestic Fixed Line Telephone Services: EU and Portugal](#)

[Selected Prices for the International Services\(1\)](#)

[Wholesale Domestic Traffic \(millions of minutes\)](#)

[Properties](#)

[Competition](#)

[Regulation](#)

[Overview](#)

[Results of Operations](#)

[Liquidity and Capital Resources](#)

[Contractual Obligations and Off-balance Sheet Arrangements](#)

[Capital Investment and Research and Development](#)

[Exchange Rate Exposure to the Brazilian Real](#)

[Directors and Senior Management](#)

[Compensation](#)

[Board Practices](#)

[Employees](#)

[Share Ownership and Share Option Plans](#)

[Major Shareholders](#)

[Related Party Transactions](#)

[Legal Proceedings](#)

[Distributions to Shareholders](#)

[Significant Changes](#)

[Price History of the Company's Stock](#)

[Markets](#)

[Memorandum and Articles of Association](#)

[Corporate Governance](#)

[Material Contracts](#)

[Exchange Controls](#)

[Taxation](#)

[Documents on Display](#)

[Debt Sensitivity to Interest Rates \(Euro million\) Expected Maturity Date](#)

[Derivatives Sensitivity to Interest Rate Risk \(Euro million\) Expected Maturity Date\(1\)](#)

Edgar Filing: PORTUGAL TELECOM SGPS SA - Form 20-F

Debt Sensitivity to Exchange Rates (Euro million) Expected Maturity Date

Derivatives Sensitivity to Exchange Rate Risk (Euro million) Expected Maturity Date(1)

Derivatives Sensitivity to Equity Price Risk (Euro million) Expected Maturity Date(1)

Fair Value of Derivatives Contracts in 2004 (EUR Million)

Fair Value of Derivatives Contracts in 2004 (EUR Million) Expected Maturity Date

PART II

PART III

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2004 AND 2003

PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF PROFIT AND LOSS FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004 (Amounts stated in Euros)

PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

PORTUGAL TELECOM, SGPS, S.A. AND SUBSIDIARIES NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 2004 (Amounts stated in Euro, Brazilian Real (BRL) and United States Dollar (US\$), except where otherwise stated)

SIGNATURES

EXHIBIT INDEX