

PORTUGAL TELECOM SGPS SA  
Form 20-F  
June 29, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 20-F**

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- 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, 2006

OR

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

Commission file number 1-13758

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

(Exact name of Registrant as specified in its charter)

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**The Portuguese Republic**

(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:**

**Title of each class**

**Name of each exchange on which registered**

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American Depositary Shares, each representing one ordinary share,  
nominal value €0.03 per share  
Ordinary shares, nominal value €0.03 each

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New York Stock Exchange  
New York Stock Exchange\*

\*

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

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 €0.03 per share	1,128,856,000
Class A shares, nominal value €0.03 per share	500

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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## 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

Our audited consolidated financial statements have been prepared in accordance with International Financial Reporting Standards, or IFRS, as adopted by the European Commission for use in the European Union. IFRS differs in significant respects from U.S. GAAP. For a discussion of the principal differences between IFRS and U.S. GAAP, as they relate to us, see "*U.S. GAAP Reconciliation and Recent Accounting Pronouncements*" below and Notes 47, 48 and 49 to our audited consolidated financial statements.

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. The Federal Reserve Bank of New York's noon buying rate in the City of New York for Euros was €0.7466 = US\$1.00 on June 21, 2007, and the noon buying rate on that date for Reais was R\$1.9197 = US\$1.00. 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, US\$ or R\$ amounts shown herein could have been or could be converted 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 and between Reais 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.

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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 further liberalization of the telecommunications sector in Portugal and Brazil;

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.

### RECENT DEVELOPMENTS

#### *Sonae Tender Offer*

The tender offer launched by Sonaecom, SGPS S.A. and Sonaecom, B.V. ("Sonaecom") for PT and PT Multimédia lapsed on March 2, 2007, as the proposed removal of the voting limitation in the bylaws of PT, which was a condition for the tender offer to succeed, was rejected by the majority of the votes cast at our general meeting of shareholders.

#### *Proposed Spin-Off of PT Multimédia*

On August 3, 2006, PT announced its intent to spin off its 58.43% interest in PT Multimédia Serviços de Telecomunicações e Multimédia, SGPS, S.A. ("PT Multimédia") through a distribution to shareholders, subject to shareholder approval. On March 21, 2007, the Board of Directors proposed to the shareholders a dividend in kind corresponding to 4 PT Multimédia shares for each 25 PT shares owned, rounded down, to be carried out under the specific terms to be determined by the Board of Directors. This spin-off proposal was approved by the shareholders at the Annual General Meeting held on April 27, 2007.

PT's management has concluded that the separation of PT Multimédia from PT should positively contribute to the development of the telecommunications market in Portugal, allowing the market to develop increasingly innovative and convergent services to consumers. The resulting market structure should provide regulatory relief for PT's wireline business, giving it flexibility to offer more and better services to its customers, while PT Multimédia would be able to pursue its own competitive strategy, domestically and abroad. By allowing the management of each company to focus on its core competencies, PT believes that this strategy is more likely to create greater value for shareholders over time. The proposed separation also addresses the long-standing objectives of the Portuguese regulators.

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The spin-off proposal approved by the shareholders grants the Board of Directors the authority to determine all the terms and conditions of the spin-off to the extent not otherwise contained in the shareholder approval. These terms and conditions are expected to include non-opposition from the competent regulatory authorities, including the Portuguese Securities Commission (*Comissão do Mercado de Valores Mobiliários* - CMVM), and we cannot assure you that these conditions will be met or that they will be met on a timely basis. In addition, the implementation of the proposal will be subject to market conditions and the financial and accounting situation of Portugal Telecom. The spin-off also involves the suppression of the special rights attributed to the class A shares of PT Multimédia held by Portugal Telecom by means of their conversion into ordinary shares or by other means, but we cannot assure you that this condition will be met.

Before the effective date of the spin-off, we expect to issue an information statement to holders of American Depositary Shares ("ADSs") representing ordinary shares of Portugal Telecom and to U.S. resident holders of Portugal Telecom's ordinary shares describing the spin-off. The information statement is expected to include, among other things, information regarding the spin-off; the business, financial condition and results of operations of PT Multimédia; certain tax considerations for holders of Portugal Telecom ADSs and U.S. holders of Portugal Telecom ordinary shares; certain relationships between Portugal Telecom and PT Multimédia; the expected management of PT Multimédia; and a description of the ordinary shares of PT Multimédia. We urge you to review the Information Statement when it is distributed.

The information statement will describe a number of risks relating to the spin-off. See also "*Item 3 Key Information Risk Factors Risks Relating to Our Wireline and Domestic Mobile Businesses After the Completion of the Proposed Spin-Off of PT Multimédia, the Competitive Strategy of PT Multimédia Could Adversely Affect Our Revenues and Cash Flows.*"





<b>Costs, expenses losses and income:</b>			
Wages and salaries	631.8	667.3	668.4
Post retirement benefits	58.8	(21.6)	(72.1)
Direct costs	852.0	881.2	908.4
Costs of products sold	595.8	652.3	596.5
Support services	203.8	230.2	230.0
Marketing and publicity	159.8	184.4	155.4
Supplies and external services	810.5	958.5	1,025.5
Indirect taxes	123.2	166.0	177.3
Provisions and adjustments	168.8	171.5	230.2
Depreciation and amortization	934.9	1,120.7	1,209.8
Impairment losses(1)	28.0		
Curtailed costs, net	165.6	314.3	20.3
Losses on disposals of fixed assets, net	9.2	1.2	8.1
Other costs, net	83.6	17.6	98.4
	<b>1,141.6</b>	<b>1,041.8</b>	<b>1,086.8</b>
<b>Income before financial results and taxes</b>			
Financial results	232.5	51.3	125.0
<b>Income before taxes</b>	<b>909.1</b>	<b>990.5</b>	<b>961.8</b>
Minus: Income taxes	210.0	323.3	7.7
<b>Net income from continued operations</b>	<b>699.1</b>	<b>667.2</b>	<b>954.1</b>
<b>Discontinued Operations</b>			
Net income from discontinued operations	26.1	21.7	
<b>Net income</b>	<b>725.2</b>	<b>689.0</b>	<b>954.1</b>
Attributable to minority interests	102.0	35.0	87.4
<b>Attributable to equity holders of the parent</b>	<b>623.2</b>	<b>654.0</b>	<b>866.8</b>
Income before financial results and taxes per ordinary share, A share and ADS(2)	0.98	0.92	0.96
Earnings per share, A share and ADS from continuing operations, net of minority interests:			
Basic(2)	0.51	0.55	0.78
Diluted(3)	0.50	0.54	0.77
Earnings per ordinary share, A share and ADS:			
Basic(2)	0.53	0.57	0.78
Diluted(3)	0.52	0.56	0.77
Cash dividends per ordinary share, A share and ADS(4)	0.35	0.475	0.475
Share capital	1,166.5	1,128.9	395.1

(1) We recorded an impairment loss on the goodwill of the Audiovisuals unit of PT Multimédia in 2004, calculated as the difference between the carrying value and management's estimates of the recoverable amount based on the discounted cash flows from this business.

(2) Based on 1,166,485,050 ordinary and A shares issued in the year ended December 31, 2004 and 1,128,856,500 ordinary and A shares issued in the year ended December 31, 2005 and 2006.

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(3) 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 the conversion of the bonds into ordinary shares.

(4) The amount shown for 2006 reflects the amount proposed by the Board of Directors and approved at the general meeting of shareholders on April 27, 2007. Cash dividends per ordinary share, A share and ADS for the years ended December 31, 2002, 2003, 2004, 2005 and 2006 were €0.16, €0.22, €0.35, €0.475 and €0.475, respectively. Cash dividends per ordinary share, A share and ADS for the years ended December 2002, 2003, 2004, 2005 and 2006 were US\$0.18, US\$0.26, US\$0.43, US\$0.60 and 0.64, respectively.

Year Ended December 31,

	2002	2003	2004	2005	2006
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(EUR Millions)

**Statement of Income Data:**

*Amounts in accordance with U.S. GAAP*

Operating revenues	6,007.7	4,460.0	4,498.5	4,453.7	4,346.3
Operating income	383.2	723.1	879.4	759.0	908.8
Net income before change in accounting principles	1,315.3	145.5	509.9	306.0	734.7
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			(24.2)		
<b>Net income after change in accounting principles</b>	<b>276.4</b>	<b>138.2</b>	<b>485.7</b>	<b>306.0</b>	<b>734.7</b>
Net income from continuing operations before change in accounting principles	1,315.3	145.5	485.7	424.5	734.7
Basic earnings per ordinary share, A share and ADS(1)	0.22	0.11	0.41	0.27	0.66
Basic earnings per share from continuing operations before change in accounting principles	1.05	0.12	0.41	0.37	0.66
Diluted earnings per ordinary share, A share and ADS(2)	0.21	0.11	0.41	0.27	0.65

(1) 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 1,253,880,328 shares for the year ended December 31, 2002, 1,249,778,188 shares for the year ended December 31, 2003, 1,173,266,406 shares for the year ended December 31, 2004, 1,138,250,826 shares for the year ended December 31, 2005 and 1,108,876,226 shares for the year ended December 31, 2006.

(2) 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 year ended December 31, 2003, the effects of the exchangeable bonds have been excluded from the calculation of diluted earnings per share since they would be antidilutive.

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As of and for the Year  
Ended December 31,

2004	2005	2006
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(EUR Millions)

**Cash Flow Data:**

*Amounts in accordance with IFRS*

Cash flows from operating activities	1,958.9	1,392.3	1,787.8
Cash flows from investing activities	185.5	(1,910.7)	1,147.8
Cash flows from financing activities	(1,958.2)	590.2	(2,992.7)

As of December 31,

2005	2006
------	------

(EUR Millions)

**Balance Sheet Data:**

*Amounts in accordance with IFRS*

Current assets	6,153.7	3,998.7
Investments in group companies	425.6	499.1
Other investments	96.1	132.4
Tangible assets	4,062.0	3,942.0
Intangible assets	3,601.6	3,490.9
Post-retirement benefits		134.1
Other non-current assets	2,289.8	1,974.1
<b>Total assets</b>	<b>16,628.8</b>	<b>14,171.2</b>
Current liabilities	4,947.5	3,888.4
Medium and long-term debt	5,168.6	4,467.5
Accrued post retirement liability	2,635.9	1,807.6
Other non-current liabilities	1,294.7	901.7
<b>Total liabilities</b>	<b>14,046.7</b>	<b>11,065.2</b>
Equity excluding minority interests	1,828.4	2,255.2
Minority interests	753.7	850.8
<b>Total equity</b>	<b>2,582.1</b>	<b>3,106.0</b>
Number of ordinary shares	1,128.9	1,128.9
Share capital(1)	1,128.9	395.1

(1)

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

As of December 31,

2002	2003	2004	2005	2006
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As of December 31,

(EUR Millions)

*Amounts in accordance with U.S. GAAP*

Total assets	12,554.2	11,764.3	11,864.7	13,649.5	11,695.9
Total liabilities	10,17.9	9,562.1	9,967.0	11,595.9	9,522.4
Total shareholders' equity	2,343.7	1,999.0	1,638.5	1,819.4	1,877.6
Share capital	11,254.3	1,254.3	1,166.5	1,128.9	395.1

**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, 2004, 2005 and 2006, 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 Reais. We have published our audited consolidated financial statements in Euros, and our shares trade in Euros on the regulated market Eurolist by Euronext Lisbon. 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 21, 2007, the Euro/U.S. dollar exchange rate was €0.7466 per US\$1.00.

Year ended December 31,	Average Rate(1)
	(EUR per US\$1.00)
2002	1.0561
2003	0.8786
2004	0.8022
2005	0.8082
2006	0.7905

(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, 2006	0.7612	0.7573
January 31, 2007	0.7737	0.7681
February 28, 2007	0.7586	0.7543
March 31, 2007	0.7525	0.7463
April 30, 2007	0.7358	0.7310
May 31, 2007	0.7455	0.7420

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.



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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 21, 2007, the Real/U.S. dollar exchange rate was R\$1.9197 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.

<u>Year ended December 31,</u>	<u>Average Rate(1)</u>
	<u>(R\$ per US\$1.00)</u>
2002	2.931
2003	3.072
2004	2.917
2005	2.434
2006	2.168

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

<u>Period</u>	<u>High</u>	<u>Low</u>
	<u>(R\$ per US\$1.00)</u>	
December 31, 2006	2.169	2.138
January 31, 2007	2.156	2.125
February 28, 2007	2.118	2.077
March 31, 2007	2.139	2.050
April 30, 2007	2.048	2.023
May 31, 2007	2.031	1.929

**Escudo**

As of January 1, 2002, we ceased to use the Escudo. For the years ended December 31, 2002, 2003, 2004, 2005 and 2006 the majority of our revenues, assets and expenses were denominated in 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

### General Risks Relating to Our Company

#### *We May Not Achieve Our Announced Shareholder Remuneration Goals*

In February 2007, in connection with our response to the tender offer by Sonaecom, we announced a shareholder remuneration package comprised of a €2.1 billion share buyback, a €0.475 per share dividend related to the year 2006, a €0.575 per share dividend related to years 2007 and 2008, and the spin-off of PT Multimédia. As of the date of filing of this annual report, we have paid the dividend relating to the year 2006, and as at June 15, 2007, we had entered into equity swap agreements with several financial institutions in connection with our share buyback program for 45,686,311 shares for a notional amount of €464.3 million, representing 4.05% of our share capital. In addition, our shareholders approved the spin-off of PT Multimédia at the annual general shareholders' meeting on April 22, 2007, but the spin-off has not yet been completed and is subject to conditions.

The completion of the remaining shareholder remuneration goals will depend on our ability to continue to generate cash flow in our domestic businesses, assumes that we are able to obtain regulatory relief for our domestic wireline business and that we are able to continue to streamline our operations to reduce our costs. In addition, our announced shareholder remuneration package assumes that the Real/Euro exchange rate will remain stable. The Real fluctuated significantly in relation to the Euro in recent years. See "*Risks Related to Our Brazilian Mobile Business Macroeconomic Factors in Brazil Could Reduce Expected Returns on Our Brazilian Investments and Potentially Lead to Impairment Charges*" and "*Fluctuations in the Real and increases in interest rates*".

If any of the assumptions described in the preceding paragraph proves not to be the case or if any other circumstances (including any risks described in this "Risk Factors" section) impedes our ability to generate cash and distributable reserves, you may not receive the full remuneration we have announced, and the price of our ordinary shares and ADSs could suffer.

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

All of our 500 A shares are held by the Portuguese State. Under our articles of association, the Portuguese State, as the holder of all of our A shares, may veto a number of actions of our shareholders, including the following:

Authorization for the acquisition of ordinary shares representing more than 10% of the share capital by shareholders that directly or indirectly perform competing activities with those of the companies within a control relationship with Portugal Telecom, SGPS S.A;

Amendments to the by-laws and share capital increases, as well as the limitation or suppression of pre-emptive rights and the establishing of standards for share capital increases to be resolved by the Board of Directors;

Issuing of bonds or other securities, establishing the issue value for these securities to be resolved by the Board of Directors and limitation or suppression of pre-emptive rights in the issuing of bonds convertible into shares, as well as establishing the standards for the issuing of bonds of such nature to be resolved by the Board of Directors;

The passing of resolutions on the application of the financial year results, in the events of a dividend distribution to the shareholders in a percentage superior to 40% of distributable profits;

Election of the Board of the General Shareholders' Meeting, as well as of the members of the Board of Directors;

Approval of the general goals and fundamental principles of the Company's policies;

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Definition of the general policy of shareholdings in companies, as well as, in the cases where authorized by a prior General Shareholders' Meeting, the passing of resolutions on the respective acquisitions and sales;

Moving the Company's registered offices within the municipality of Lisbon or to a neighbouring municipality.

In addition, the election of one-third of the total number of directors, including the Chairman of the Board of Directors, requires the votes issued by the State, in its capacity as holder of Class A shares.

In April 2006, the European Commission sent to the Portuguese State a formal request to abandon the special rights it held as the sole owner of our A shares. The European Commission believes that the special powers granted to the Portuguese State through the sole ownership of our A shares act as a disincentive for investment by companies from other EU Member States in a manner that violates European Community Treaty rules. Should the Portuguese State not take satisfactory steps to remedy this alleged infringement of EU Law, the European Commission may decide to refer the case to the European Court of Justice.

### ***Our Recent Ratings Downgrades and Any Future Downgrades May Impair Our Ability to Obtain Financing and May Significantly Increase Our Cost of Debt***

Immediately after the announcement by Sonaecom on February 6, 2006 of the tender offer for Portugal Telecom, Standard & Poor's placed our credit rating on CreditWatch with negative implications, while Moody's placed our credit rating on review for possible downgrade, due to the possible increased leverage that would result from the transaction. Following the presentation by our board of directors of an alternative shareholders' remuneration plan, increasing our indebtedness, Standard & Poor's and Moody's downgraded our ratings to BBB+ and Baa1, respectively, on March 8, 2006. On August 3, 2006, Standard & Poor's and Moody's downgraded our ratings to BBB- and Baa2, respectively, following the announcement of a further step-up in the shareholder remuneration plan. After the failure of the tender offer, the rating agencies confirmed our credit ratings as BBB- (Standard & Poor's) and Baa2 (Moody's), both with stable outlook.

We have four loans from the European Investment Bank (EIB) totaling €365 million as of December 31, 2006 that contain a provision under which the EIB has the right to require us to provide a guarantee acceptable to EIB in the event our ratings were downgraded to BBB/Baa2. In that circumstance, and after notice from the EIB, we would have 60 days to present an acceptable guarantee. If we fail to provide EIB the required guarantee, the EIB would have the right to accelerate the repayment of the loans. As a result of our ratings downgrade on August 3, 2006 to BBB- by S&P, to Baa2 by Moody's and to BBB by Fitch, we negotiated with EIB revised terms and conditions for these loans. The agreement with the EIB, signed on February 23, 2007, allows us to present the guarantee mentioned above only in the case of a downgrade from the current rating (BBB- by S&P, Baa2 by Moody's and BBB by Fitch).

Our recent ratings downgrades could adversely affect our ability to obtain future financing to fund our operations and capital needs. The downgrades could affect the marketability of any new debt securities we may wish to issue. As part of the agreement with EIB described above, the spreads on our EIB loans increased by between 1 and 28 basis points, increasing our interest expenses. In addition, the downgrades could affect the pricing terms we are able to obtain in any new bank financing or issuance of debt securities. In addition, any further downgrade of our ratings could have even more significant effects on our ability to obtain financing and therefore on our liquidity.

## **Risks Relating to Our Wireline and Domestic Mobile Businesses**

### ***Competition From Mobile Telephony and From Other Wireline Operators Has Significantly Reduced Our Fixed Telephone Revenues and Is Likely to Continue to Adversely Affect Our Revenues***

During 2006, approximately 30.1% of our consolidated revenues were derived from services provided by our wireline business in Portugal. As a result of the trend toward the use of mobile services instead of 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, and more than 61% of the total Portuguese voice traffic is originated in mobile networks. Some of our wireline customers are using mobile services as an alternative to wireline telephone services. Mobile operators can bypass 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 has significantly affected our overall revenues, and we expect these factors to continue to negatively affect our revenues. See "Item 4 Information on the Company Competition Competition Facing our Wireline Business".

### ***After the Completion of the Proposed Spin-off of PT Multimédia, the Competitive Strategy of PT Multimédia Could Adversely Affect Our Revenues and Cash Flows***

Following the spin-off of PT Multimédia, PT Multimédia's management may develop a business strategy that could conflict with the strategies of our wireline and domestic mobile businesses. In an attempt to gain market share in voice services, for example, management of PT Multimédia could pursue a price strategy that could place downward pressure on prices and adversely affect the revenues and cash flows of our wireline and domestic mobile businesses. PT Multimédia has significant market share in its businesses, and it could be a strong competitor of our wireline and domestic mobile businesses in Internet access and voice telephony after the completion of the proposed spin-off.

### ***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 and mobile traffic, which could harm significantly our voice telephony revenues.

In addition, in November 2005, ANACOM began a period of consultation regarding regulation of these services, and issued a report on the subject in February 2006. Since then, some operators, including affiliates of Portugal Telecom, have launched fixed and roaming VoIP commercial services.

### ***Reduced Interconnection Rates Have Negatively Affected Our Revenues for Our Mobile and Wireline Businesses and May Continue to Do So***

In February 2005, ANACOM declared all mobile operators to have significant market power in call termination in the mobile networks market. ANACOM has accordingly imposed price controls on interconnection rates for the termination of calls on mobile networks. In 2005, interconnection rates (both fixed-to-mobile and mobile-to-mobile) were reduced by an average of 23.5% compared with 2004

rates. In 2006, these rates were further reduced by an average of 18.5% compared to the 2005 rates. These reductions have had a significant impact on TMN's interconnection revenues and consequently its earnings. Both fixed-to-mobile and mobile-to-mobile interconnection rates reached €0.11 per minute in October 2006 and have not decreased since then. See "*Item 5 Operating and Financial Review and Prospects Results of Operations*". ANACOM is in the process of determining who has significant market power in call origination in the mobile networks market. We cannot predict the outcome of this process, and ANACOM's decision could negatively impact our revenues and results of operations.

ANACOM's price controls on fixed-to-mobile interconnection may also negatively affect our wireline retail revenues because we are required to reflect the reduction in these interconnection charges in our retail prices for calls from our fixed line network. We expect that the reduction in interconnection charges will continue to have a significant impact on our wireline retail revenues.

In addition, the lower interconnection rates have also reduced revenues for our wholesale wireline business because our wholesale wireline unit records revenue from incoming operating calls through our network that terminate on the networks of mobile operators. The prices we charge to international operators (and hence our revenues) depends on the interconnection fees charged by mobile operators for international incoming calls terminating on their networks, and these fees have been decreasing. We expect that the lower interconnection rates in 2007 will continue to have a negative impact on our wholesale wireline revenues.

ANACOM issued a decision in December 2006 requiring our wireline business to offer flat rate interconnection, which we believe will negatively affect our wholesale wireline revenues in the future.

#### ***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. We believe that our existing mobile competitors, Vodafone and Optimus (owned by Sonae and France Telecom) will continue to market their services aggressively. In mid-2005, Optimus introduced a low-cost brand "Rede 4" in response to our new brand "Uzo". Vodafone also launched a product called Directo in mid-2005 targeting the same market as Uzo and Rede 4.

In addition, the commercial introduction in Portugal of third generation mobile services has heightened competition and reduced the 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 (Global System for Mobile Communications) and UMTS (Universal Mobile Telecommunications System) services. We expect competition from VoIP-based operators also to place increasing price pressure on voice tariffs and lead to reductions in mobile voice traffic. 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. See "*Item 4 Information on the Company Competition Competition Facing TMN in Portugal*".

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

At the end of 2006, we had 685 thousand retail broadband subscribers using ADSL lines in our wireline business, which represented a growth of 17.1% over the number of broadband subscribers at the end of 2005. 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), including TV Cabo, a subsidiary of PT Multimédia whose triple-play service will compete against that of our wireline business, especially after the completion of the proposed

spin-off of PT Multimédia. We believe that with competition in Internet broadband access intensifying, and with the development of existing technologies such as broadband wireless access and mobile broadband through UMTS, we may face loss of market share in the broadband market, which could result in a loss of subscribers and a loss in revenues.

***The European Commission's Review of Roaming Charges May Lead to a Reduction in Domestic Mobile Revenues***

We receive approximately 7.1% of our domestic mobile revenues from incoming and outgoing roaming charges. The European Commission has determined that roaming prices in Europe should be reduced and has published new regulations that are effective June 30, 2007. These regulations set maximum roaming charges that may be charged in the wholesale market and the retail market. In the wholesale market, a maximum roaming charge of €0.30 per minute will apply from the date two months after the effective date of the regulations through the first anniversary of the effective date, a maximum roaming charge of €0.28 per minute will apply in the second year, and a maximum roaming charge of €0.26 per minute will apply thereafter.

In the retail market, maximum roaming charges of €0.24 per minute (for received calls) and €0.49 per minute (for outgoing calls) will apply in the first year, maximum roaming charges of €0.22 per minute (for received calls) and €0.46 (for outgoing calls) will apply in the second year, and maximum roaming charges of €0.19 per minute (for received calls) and €0.43 per minute (for outgoing calls) will apply thereafter. Under the new regulations, operators must inform their customers of these charges within one month from the effective date of the regulations and give their customers a two-month period to choose whether to be subject to these maximum charges or to an alternative pricing scheme offered by the operator.

We believe these regulations will have an adverse effect on the revenues of our domestic mobile business and of our company as a whole.

In addition, within the EU regulatory framework for electronic communications approved in 2002, the Portuguese telecommunications regulator has been analyzing concentrations of market power in various telecommunications markets in Portugal. Among the markets that the regulator has not yet analyzed is the market for roaming charges, and it is expected to do so after the European Commission's decision on the regulation of roaming prices. This decision could lead to the introduction of further price controls, both in the retail and in the wholesale market, which could adversely affect the revenues and results of our domestic mobile business and of our company as a whole.

***Burdensome Regulation in an Open Market May Put Us at a Disadvantage to Our Competitors and Could Adversely Affect Our Business***

The Portuguese electronic communications 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 pursuant to a new EU regulatory framework for electronic communications networks and services. In all but one of the 15 markets for which ANACOM has completed its analysis, the Portugal Telecom group has been found by ANACOM to have significant market power and consequently is subject to regulatory restrictions and obligations. Not all of these obligations and restrictions have 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.*"

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

We are regularly involved in litigation, 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 complaints before the Autoridade da Concorrência related to alleged anti-competitive practices in our wireline and multimedia businesses, including complaints against:

PT Comunicações for alleged abuse of dominant position in regards to the access to telecommunications ducts;

PT.com (this complaint was formerly against Telepac, which merged with PT.com in December 2004) and TV Cabo for alleged anti-competitive practices in the broadband Internet market; and

PT Comunicações for alleged anti-competitive practices in the public wireline telephone market and for granting discriminatory discounts on leased lines.

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 these or other regulatory inquiries, investigations, or litigation proceedings, that 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.

***The Portuguese Government Could Terminate or Fail to Renew Our Wireline Concession, Our Licenses and Our Authorization for Data Services***

We provide a significant number of services under a Concession granted to us by the Portuguese government and under licenses and authorizations granted to us by ANACOM. See "*Item 4 Information on the Company Regulation Portugal*". The Concession runs until 2025. 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 the Concession. The Portuguese government can also terminate our licenses under certain circumstances. If the Portuguese government took such actions, 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.

***Risks Related to Our Brazilian Mobile Business***

***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, 2006, cumulative foreign currency translation adjustments related to investments in Brazil were positive €652.3 million. A devaluation in the Brazilian Real in the future could result in negative adjustments to our balance sheet. See "*Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Equity*" and "*Exchange Rate Exposure to the Brazilian Real*".

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 these financial instruments may not prevent unexpected and material fluctuations of interest rates from having any material adverse effect on our earnings.

In addition, the purchase and sale of foreign currency in Brazil is subject to governmental control. In the past, the Central Bank has centralized certain payments of principal on external obligations. Many factors could cause the Brazilian government to institute a more restrictive exchange control policy, including, without limitation, the extent of Brazilian foreign currency reserves, the availability of sufficient foreign exchange, the size of Brazil's debt service burden relative to the economy as a whole and political constraints to which Brazil may be subject. A more restrictive policy could affect the ability of Brazilian debtors (including Vivo) to make payments outside of Brazil to meet foreign currency-denominated obligations.

***Macroeconomic Factors in Brazil Could Reduce Expected Returns on Our Brazilian Investments and Potentially Lead to Impairment Charges***

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, include:

*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.

*Fluctuations in the Real and increases in interest rates.* The Brazilian currency has historically experienced frequent devaluations. The Real devalued against the Euro 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 until the end of 2002. The Real appreciated against the Euro by 1.3%, 1.4% and 31.7% in 2003, 2004 and 2005 respectively, and depreciated 1.97% against the Euro in 2006. 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.

During 2004 and 2005, 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 basis points to 17.75% at the end of 2004, 18.05% at the end of 2005 and 13.19% at the end of 2006. Since then, the Brazilian Central Bank has eased its monetary policy, decreasing the SELIC basic interest rate to 13.25% at the end of 2006. However, 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 since most of the interest on Vivo's debt is floating.

*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 3.8% in 2006 compared to 1.2% in 2005, 12.1% in 2004, 7.7% in 2003 and 26.4% in 2002. If Brazil experiences 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.

*We could be required to record impairment charges relating to goodwill for our investment in Vivo.* Under IFRS, we are required to test our goodwill for impairment at least annually. If the carrying value of our investment exceeds the related recoverable amount, we are required to write down our goodwill. The recoverable amount is the higher of the estimated selling price of the asset less the related selling costs and value in use. See "Item 5 Operating and Financial Review and Prospects Overview Critical Accounting Policies and International Financial Reporting Standards". An increase in interest rates or other macroeconomic events (or an adverse event affecting the operations of Vivo) could decrease the estimated future cash flows from our investment in Vivo. An event that causes us to reduce our estimates of the future cash flows of Vivo could require us to record an impairment of this goodwill, and, depending on the size of the impairment, this could have a material adverse effect on our balance sheet and our results of operations.

***Our Strategy of Enhancing Our Mobile Operations in Brazil Through Our Joint Venture With Telefonica Moviles 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. On December 27, 2002, we and Telefónica 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 we and Telefónica will not agree on Vivo's strategy, operations or other matters. Any inability of Telefónica 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 is restricted from increasing some of the rates that they charge for services provided even if a devaluation of the Real or an increase of interest rates by the Brazilian government increases 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.

***Brazilian Tax Reforms May Affect Vivo's Prices***

The Brazilian government has proposed tax reforms that are currently being considered by the Brazilian Congress. If Vivo experiences a higher tax burden as a result of the tax reform, it may have to pass the cost of that tax increase to its customers. This increase may have a material negative impact on the dividends paid by Vivo's subsidiary to it and on its revenues and operating results.

***The Conditions Applying to Vivo 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. Vivo has migrated to the SMP regime and now holds a SMP license instead of their previous concessions.

In 2003, SMP operators were required to implement long distance carrier selection codes to allow customers to choose their carrier for domestic long distance services (for both "VC2" and "VC3" calls) and international cellular calls. VC2 calls are calls made to parties outside a caller's area code but inside the same state, and VC3 calls are calls made to parties outside the caller's state. As a result, Vivo no longer receives revenues from long distance services but instead 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 long distance revenues that Vivo formerly received from VC2 and VC3 calls, and this has had a negative impact on the overall revenues of Vivo. If Vivo were able to offer wireline long distance services in addition to mobile services, it might be able to mitigate the impact of carrier selection codes on its revenues. However, because ANATEL considers Vivo 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 Vivo.

We cannot predict whether the current regulatory regime will remain in place or whether any future regulatory change could have an adverse effect on our results of operations. See "*Item 4 Information on the Company Regulation Brazil SMP Regulation*".

***Interconnection Fees and Regulated Adjustments to Those Fees 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 are determined through free negotiation between Vivo and other telecommunications operators. If the parties do not reach an agreement, the matter is determined through arbitration, which is conducted by ANATEL. Interconnection agreements must be approved by ANATEL and may be rejected if they are contrary to the principles of free competition and applicable regulations relating to traffic capacity, use of the interconnection infrastructure by requesting parties and other matters.

In 2005, ANATEL approved provisional agreements among the local fixed line and mobile operators to determine the interconnection fees for local calls (known as "VC1" calls). These agreements provide for a 4.5% annual adjustment of interconnection fees for these calls. In March 2006, ANATEL approved a provisional agreement for interconnection fees for VC2 and VC3 long distance calls that also provides for a 4.5% annual adjustment to interconnection fees. The annual

adjustments under these agreements may not be sufficient to cover Vivo's costs and preserve its margins from interconnections with Vivo's network. In particular, because a significant number of mobile subscribers use prepaid mobile services and generally receive more calls than they make, Vivo derives 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.

In addition, ANATEL may further modify the regulatory regime governing interconnection fees. ANATEL has proposed to replace the partial Bill & Keep regime with a model based on the costs of mobile operators. ANATEL has proposed to implement this new model in mid-2007. We cannot predict whether this proposed model will be implemented and whether it will have an adverse effect on our operations. If this model were to result in lower annual adjustments to interconnection fees than under the provisional agreements reached in 2005 described above, our revenues and results of operations could be adversely affected. In July 2006, the partial Bill & Keep regime was discontinued, and now Vivo is under a "full billing" regime described in "*Item 4 Information on the Company Regulation Brazil SMP Regulation*".

ANATEL has also published specific proposals for regulations regarding interconnection charges that could adversely affect Vivo's revenues and results of operations. These proposals include (1) a proposal that two SMP operators controlled by the same economic group receive only one interconnection charge for calls originated and terminated on their networks rather than the current two charges, (2) a proposal for new negotiation rules for interconnection charges under which ANATEL would have a role in determining the charges rather than the current free negotiation of the charges and (3) a proposal for interconnection charge unification among SMP providers of the same economic group having significant market power according to criteria still to be defined. If new regulations along these lines take effect, they could have an adverse effect on Vivo's results of operations because (1) interconnection charges could drop significantly, thereby reducing Vivo's revenues, (2) ANATEL may allow favorable prices for economic groups without significant market power and (3) the prices Vivo charges in some regions in which it operates are higher than those in some other regions, and consolidation of those prices, competitive pressures and other factors could reduce Vivo's average prices and its revenues.

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

Competition may continue to intensify for Vivo as a result of the strategies of existing competitors, the possible entrance of new competitors and the rapid development of new technologies, products and services. Vivo's ability to compete successfully will depend on its marketing techniques and on its ability to anticipate and respond to various competitive factors affecting the industry, including new services that may be introduced, changes in consumer preferences, demographic trends, economic conditions and discount pricing strategies by its competitors. If Vivo does not keep pace with technological advances, or if it fails to respond timely to changes in competitive factors in its industry, it could continue to lose market share, and Vivo could suffer a decline in its revenue. Competition from other SMP communications service providers in the regions in which Vivo operates has also affected, and may continue to affect, its financial results by causing, among other things, a decrease in its customer growth rate, decreases in prices and increases in selling expenses.

These factors have already contributed to a negative effect on Vivo's market share and results of operations and could have a material adverse effect on our results of operations in the future. As a result of competitive pressures, for example, Vivo's market share decreased from 44.4% as of December 31, 2005 to 38.2% as of December 31, 2006, and Vivo's market share of net additions to its customer base decreased from 21.8% for the year ended December 31, 2005 to a negative percentage of 8.5% for the year ended December 31, 2006, based on information received from ANATEL.

Recently, there has been consolidation in the Brazilian telecommunications market, and we believe this trend may continue. Consolidation may result in increased competitive pressures within Vivo's market. Vivo may be unable to respond adequately to pricing pressures resulting from consolidation, which would adversely affect its business, financial condition and results of operations and could adversely affect our results of operations.

***Vivo's Results of Operations Have Been Negatively Affected by a Decrease in Its Customer Growth and Could Also Be Affected if Its Rate of Customer Turnover Increases***

Vivo's rate of acquisition of new customers has declined significantly, primarily due to competition and increased market penetration. For example, Vivo's net additions of customers decreased to a loss of 752 thousand customers in 2006, as compared to a gain of 3,262 thousand customers in 2005. This negative evolution was mainly due to a decrease in the rate of addition of new prepaid customers with a loss of 517,373 in 2006, compared to the addition of 2,703,995 new prepaid customers in the prior year. This decrease in the rate of new additions of customers has negatively affected Vivo's results of operations and could continue to do so in the future. In addition, if Vivo's rate of customer turnover were to increase significantly, its results of operations and or competitive position could be adversely affected. Several factors in addition to competitive pressures could influence Vivo's rate of acquisition of new customers and rate of customer turnover, including limited network coverage, lack of sufficient reliability of our services and economic conditions in Brazil.

**Risks Relating to PT Multimédia**

**The risks relating to PT Multimédia below relate to PT Multimédia's ongoing operations prior to the completion of the proposed spin-off of PT Multimédia. As described in "Recent Developments," we expect to issue an information statement to holders of Portugal Telecom's ADSs and to U.S. resident holders of Portugal Telecom's ordinary shares. The information statement will include a description of certain risks relating to the spin-off.**

**The spin-off proposal approved by the shareholders grants the Board of Directors the authority to determine all the terms and conditions of the spin-off to the extent not otherwise contained in the shareholder approval. These terms and conditions are expected to include non-opposition from the competent regulatory authorities, including the Portuguese Securities Commission (*Comissão do Mercado de Valores Mobiliários* CMVM), and we cannot assure you that these conditions will be met or that they will be met on a timely basis. In addition, the implementation of the proposal will be subject to market conditions and the financial and accounting situation of Portugal Telecom. The spin-off also involves the suppression of the special rights attributed to the class A shares of PT Multimédia held by Portugal Telecom by means of their conversion into ordinary shares or by other means, but we cannot assure you that this condition will be met.**

***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. If it is not successful in marketing and selling such products and services, 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 broadband wireless access. In 2005, AR Telecom (formerly Jazztel), a direct competitor of Portugal Telecom's wireline business, launched broadband wireless access service in Lisbon and Oporto and is expected to invest considerably in its network in the coming years. Video over ADSL is also expected to be a competitor of PT Multimédia's television services. Sonaecom, a direct competitor of Portugal Telecom's wireline business, has launched an IP television offer that competes with PT Multimédia's television services. When licenses are granted in the future, terrestrial digital television will be a direct competitor of PT Multimédia's subscription TV business. 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. See "*Item 4 Information on the Company Competition Competition Facing PT Multimédia's Pay TV and Broadband Internet Business*" and "*Competition Facing PT Multimédia's Audiovisuals Business*".

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

In September 2005, the Autoridade da Concorrência brought allegations against PT Multimédia and TV Cabo for practices allegedly in violation of Article 4 of Law 18/2003 (the Portuguese Competition Law) following the execution in 2000 of a partnership agreement among PTM, TV Cabo and SIC Sociedade Independente de Comunicação, S.A. (SIC) in connection with SIC's acquisition of Lisboa TV Informação e Multimédia, S.A. In response to this accusation, PT Multimédia and TV Cabo contested the allegations of the Autoridade da Concorrência. However, in August 2006, the Autoridade da Concorrência imposed a fine of €2.5 million on PT Multimédia. PT Multimédia and TV Cabo appealed to the Commerce Court of Lisbon on September 8, 2006. This appeal suspended the decision of the Portuguese competition authority.

***Risks Relating to Our ADSs***

***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.

#### 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, SGPS 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 21 500 0800. Portugal Telecom's agent for service of process in the United States is Puglisi & Associates at 850 Library Avenue, Suite 204, Newark, Delaware 19711. 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 services include:

wireline services, which include fixed line telephone services for retail and wholesale customers, leased lines, unbundled local loop access and wholesale line rental, interconnection, Internet access (dial-up and broadband), data and business solutions, portal and e-commerce services;

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

multimedia services, which consist of cable and satellite television services, telephony services (VoIP), broadband Internet and film distribution and screening;

sales of telecommunications and multimedia equipment; and

Portuguese-language television programming activities and provision of content.

In Portugal, we are the leading provider of all of these services according to data provided by ANACOM. The provision of wireline services in Portugal continues to account for a larger proportion of our revenues (30.1% during 2006) 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 according to data provided by ANATEL. To strengthen our position in the Brazilian mobile telecommunications market, we entered into a strategic alliance with Telefónica, pursuant to which we created, on December 27, 2002, a mobile telecommunications services company in Brazil, Brasilcel, which was rebranded Vivo on April 8, 2003. See " *Our Businesses Brazilian Mobile Business*", below.

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. The key elements of our strategy include:

enhancing the performance of our operations in the evolving domestic competitive landscape, including initiatives such as rolling out triple-play VoIP offers and offering differentiated broadband services;

completing the announced spin-off of our interest in PT Multimédia, which is described in more detail below;

seeking to promote a model of shared utilization of mobile networks, which would facilitate the further penetration of third generation services and rapid deployment of mobile TV capabilities;

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continuing our existing partnerships and seeking to manage our international assets in a proactive manner in selected markets where we have a clear competitive advantage;

continuing our focus on the operational enhancement of Vivo; and

seeking to concentrate and crystallize the value of selected assets in Africa.

Our specific strategies in our domestic market include the following:

***Wireline***

roll out triple-play services through the launch of IP television;

continue to develop and market voice services at flat rates;

continue to improve the attractiveness of our broadband services by offering exclusive content and value-added services rather than focusing only on price and speed;

in our data and corporate unit, increase our emphasis on value-added, integrated information technology and solutions to business; and

continue to implement cost control measures in the fixed network.

***Domestic Mobile***

continue to develop and bring to market innovative data and video services for third-generation mobile phones;

consolidate leadership in the mobile market, including by building on recent gains in the corporate and youth segments; and

seek operational savings through outsourcing and other strategies.

***Group-Wide Initiatives***

seek further company-wide operating efficiencies by centralizing common functions; and

continue to use workforce reductions to decrease our labor costs and increase our productivity over time.

In addition, we continue to seek avenues for growing our business in a manner consistent with the promotion of competition in the Portuguese telecommunications market.

One of such initiatives consists of the spin-off of PT Multimédia from the Portugal Telecom Group, which shall positively contribute to the development of the telecommunications market in Portugal, allowing the market to develop increasingly innovative and convergent services to consumers. The resulting market structure should provide regulatory relief for PT's wireline business, giving it flexibility to offer more and better services to its customers, while PT Multimédia would be able to pursue its own competitive strategy, domestically and abroad. By allowing the management of each company to focus on its core competencies, PT believes that this strategy is more likely to create greater value for shareholders over time. The proposed separation of PT Multimédia from PT also addresses the long-standing objectives of the Portuguese regulators.

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*".

***Multimedia Business***

In addition, in 2006 and early 2007, we articulated a strategy for PT Multimédia based on the following points:

grow triple-play services, which PT Multimédia's subsidiary TV Cabo launched in early 2007;

seek further penetration by focusing on under-served regions of Portugal;

seek to stimulate demand for pay TV services by promoting development of high-quality Portuguese language content; and

continue to focus on improvements in quality of service.

Following the completion of the proposed spin-off of PT Multimédia, that company will develop its own independent strategy that may differ from the strategy we have articulated.

## **Our Businesses**

### **Business Units**

Our market is characterized by increasing competition and rapid technological change. Portugal Telecom's business unit subsidiaries are held directly and indirectly by Portugal Telecom in its role as holding company. The diagram below presents our different businesses as of December 31, 2006.

- 
- (1) Providing wireline services in Portugal, including our fixed telephone service, Internet access services, wholesale services and data and business solutions services.
  - (2) Providing multimedia services in Portugal, including cable operations through TV Cabo and audiovisuals services through Lusomundo Audiovisuais and Lusomundo Cinemas. In our discussion of this business segment below, we have provided a diagram of the different businesses operating under PT Multimédia.
  - (3) In our discussion of this business segment below, we have provided a diagram of the organizational structure of Vivo.
  - (4) Various international investments, including global telecommunications operators in Cabo Verde Islands, São Tomé e Príncipe Islands and Macao, mobile operators in Namibia, Morocco and Angola, and other investments in various countries.
  - (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).

For additional information on Portugal Telecom's significant subsidiaries, see Exhibit 8.1, which is incorporated herein by reference.



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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, 2004, 2005 and 2006:

	2004	2005	2006	% Increase (Decrease from 2005 to 2006) of Item
(EUR millions)				
<b>Wireline Business:</b>				
Retail	1,379.4	1,318.8	1,173.5	(11.0)%
Wholesale	476.4	457.7	464.2	1.4%
Data and Corporate	242.0	244.9	250.5	2.3%
Directories	129.7	120.4	108.9	(9.6)%
Sales	36.1	34.2	32.8	(4.1)%
Other	41.5	37.7	41.8	11.0%
	2,305.2	2,213.6	2,071.8	(6.4)%
<b>Domestic Mobile Business:</b>				
Services	1,446.3	1,403.6	1,363.2	(2.9)%
Sales	153.3	146.3	129.7	(11.3)%
Other	6.7	7.1	9.4	32.4%
	1,606.3	1,557.1	1,502.4	(3.5)%
<b>Multimedia Business</b>				
Pay TV and Cable Internet	513.3	553.0	591.1	6.9%
Audiovisuals	53.7	53.4	52.6	(1.5)%
Cinema Exhibition	41.8	40.0	43.7	9.2%
Other and eliminations	(10.0)	(18.0)	(20.9)	16.1%
	598.8	628.5	666.5	6.0%
<b>Brazilian Mobile Business:</b>				
Services	1,425.3	1,737.8	1,789.8	3.0
Sales	136.6	233.8	254.8	9.0%
Other	37.3	65.3	60.2	(7.8)%
	1,599.1	2,036.9	2,104.7	3.3%
<b>Other Businesses</b>	163.2	215.2	238.2	10.7%
<b>Eliminations in consolidation</b>	(305.1)	(265.8)	(240.5)	(9.5)%
<b>Total consolidated operating revenues</b>	5,967.4	6,385.4	6,343.0	(0.7)%

### Wireline Business

Our wireline business consists of four operating companies, PT Comunicações, PT Prime, PT.com and PT Corporate, 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, interconnection services, unbundled access to our local loops, and transmission of television and radio signals;

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.

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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. 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. Before October 2003, we held 87.5% of the share capital of PT Prime. In October 2003, we acquired the remaining share capital of PT Prime from SIBS Sociedade Interbancária de Serviços, S.A., a Portuguese entity operating the ATM network and the inter-bank payment system in Portugal, for €39 million.

PT.com is the leading Internet company in Portugal, operating as an Internet Service Provider, or ISP, using our fixed line network and the brands SAPO and Telepac, as well as 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. In October 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.

PT Corporate, launched in July 2003, serves the largest economic groups and government-related entities in Portugal, and acts as a single interface for every company within the PT Group, with the authority to represent, negotiate and sign in the name of each PT Group company. PT Corporate offers these large corporate customers solutions for fixed and mobile telecommunications, internet, technologies and information systems and outsourcing. Due to the size and specific business requirements of its clients, PT Corporate was created to contribute to its clients' business success by assuring the integrated and optimized development of their systems and information processes.

**Fixed Line Network.** We had 4.404 million telephone and ADSL access lines in service at December 31, 2006, excluding external supplementary lines, direct extensions and active multiple numbers. We break down our fixed line network 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. We offer high-speed Internet access through ADSL lines. As of December 31, 2006, we had 749 thousand ADSL lines, of which 685 thousand were attributable to our ADSL retail business (which is operated by PT.com), and 3,316 thousand PSTN/ISDN lines, of which 74% were residential/small office home office clients, 18% were business and the remainder were mainly payphones, wholesale lines and other.

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

	As of December 31,				
	2002	2003	2004	2005	2006
Fixed line main lines in service (thousands)					
Traditional main lines	3,317	3,224	3,165	3,011	2,589
ISDN main line equivalents	826	813	783	758	727
ADSL	53	188	420	637	749
Unbundled local loop (ULL)			9	72	196
Wholesale line rental (WLR)					142
Total	4,196	4,225	4,377	4,478	4,404
PSTN/ISDN fixed line main lines per 100 inhabitants	41.9	41.2	40.6	40.5	40.4
Public pay phones (thousands)	43.8	41.4	47.3	57.8	67.7

Over past years, we have 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 has almost doubled from 20.9 fixed line main lines at the end of 1989 to approximately 40.4 fixed line main lines at the end of 2006.

We have offered ISDN services commercially since 1994. We offer a basic-rate service, which provides two communications channels, and a primary-rate service, which provides up to 30 communications channels. At the end of December 2006, we had 249,069 accesses to our basic-rate ISDN service and 7,640 accesses to its primary-rate ISDN service. By the end of 2006, ISDN lines represented 21.9% of our total equivalent fixed line main lines, as compared with 20.1% in 2005. The conversion of traditional main lines to ISDN lines results in increased quality of service, and our ISDN subscribers tend to produce higher levels of usage per line than traditional main line subscribers.

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.

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 2006, PT Comunicações was providing approximately 1,089 thousand voicemail boxes.

We launched ADSL service in Lisbon and Oporto in 2002 and now cover virtually all of Portugal. We offer ADSL lines both to retail customers, such as residential customers and small and medium-sized businesses, and to wholesale customers. During 2004, we 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. In 2005, we continued to improve the quality of services and customer care and to innovate, launching electronic billing with legal validity, VoIP and video services on SAPO Messenger, the group's instant messenger service. In 2006, we continued to deploy ADSL as one of our principal strategies, increasing geographic coverage to almost all of Portugal and increasing transmission speeds, namely through the launch of ADSL2+ services. We also introduced new pricing plans targeted to specific customer needs. The following chart shows the evolution of our ADSL retail and wholesale customer base for the periods indicated.

**ADSL Customers**  
(thousand)

We had 0.2 billing complaints per 1,000 bills and 12.9 reported faults per 100 main lines in the year ended December 31, 2006. The percentage of faults repaired in less than 12 working hours was 77.7% in 2006, compared with 79.4% in 2005. We offer residential customers detailed billing on request without extra charge.

**Traffic.** Total traffic originated on the network has been decreasing since 2002, primarily because consumers have increasingly used mobile services instead of fixed line services and because of the migration of dial-up Internet users to ADSL. The chart below sets forth the rate of growth or decrease of traffic originated on our fixed line network in terms of the percentage change in minutes.



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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.

### Total Growth of Originated Traffic

Year ended December 31,

	2002		2003		2004		2005		2006	
	Millions of minutes	%	Millions of minutes	%	Millions of minutes	%	Millions of minutes	%	Millions of minutes	%
Domestic	6,480	39.6	5,841	40.1	5,236	42.8	4,669	44.7	4,002	46.2
International	402	2.5	382	2.6	372	3.0	411	3.9	395	4.6
Fixed-to-mobile	1,119	6.8	1,023	7.0	918	7.4	844	8.1	730	8.4
Internet	6,581	40.3	5,023	34.5	3,151	25.3	1,818	17.4	920	10.6
Other	1,758	10.8	2,294	15.8	2,673	21.5	2,704	25.9	2,622	30.2
<b>Total</b>	<b>16,340</b>	<b>100.0</b>	<b>14,563</b>	<b>100.0</b>	<b>12,440</b>	<b>100.0</b>	<b>10,446</b>	<b>100.0</b>	<b>8,669</b>	<b>100.0</b>

We offer other ISPs access to our network under one of two regulated access regimes that may be chosen by the ISP: (1) the Reference Offer for Internet Access, which allows ISPs either to pay us a call origination charge and a fee for invoicing customers on their behalf or to pay a wholesale flat rate and bill their customers directly or (2) the Reference Interconnection Offer, which offers two different billing structures based on call origination, with variations based on the manner in which the ISPs' infrastructures are connected to our network and billing arrangements. For additional information, see " *Regulation Portugal Interconnection Internet Access*". Traffic under these access regimes is included in the line "Other" in the table above.

We are required to provide carrier selection to our customers for all kinds of traffic. See " *Regulation Portugal Number Portability and Carrier Selection*". Carrier selection has been an additional factor that has contributed to the reduction in traffic on our network. In addition, in January 2006, ANACOM published regulations permitting carrier pre-selection of non-geographic services, such as toll-free numbers.

Except for customer pre-selection and Internet traffic, we account for traffic originating on our network in our fixed line telephone services unit, and we allocate the revenue billed to customers to that unit. Traffic originating on other networks but terminating on our network, and the related revenue, is allocated to our wholesale unit.

**Marketing.** We have increased our marketing efforts aimed at customer loyalty and promoting increased use of our wireline telephone services.

**Promotional Efforts and Market Analysis.** We aggressively promoted the sale of products and services targeted to specific customers in 2006 through, among other things:

a 17.7% increase in 2006 of ADSL accesses to 749 thousand, with the rate of service coverage of our network reaching nearly 100% in 2006, compared to 99.4% in 2005;

the doubling of access speeds with the introduction of ADSL2+;

the launch of new flat-rate pricing plans allowing unlimited calls for various time slots, namely "PT Total 50%", "PT Fixo-Móvel Preferido" and "Noites Grátis+Local PT". In particular, the "PT Fixo-Móvel Preferido" plan allows customers to make calls to a selected mobile network at €0.15 per minute, while paying the usual price to the other two mobile networks with no additional fee. The total number of accounts subject to pricing plans reached 2.8 million at the end of 2006;

the expansion of "telesafety" and videosurveillance products through partnerships in the real estate sector;

the launch of the SMS Agenda, which allows wireline telephones to store the most frequently dialed telephone numbers;

the launch of the instant messenger service Instant Messaging of Sapo Messenger. Sapo Messenger had 641 thousand users at the end of 2006;

the launch of several campaigns with strong acceptance from customers, namely a Valentine's Day campaign, a campaign allowing free telephone calls placed on the days the Portuguese soccer team played in Germany during the 2006 World Cup and a Christmas campaign;

a summer Wi-Fi campaign offering 1,000 open hotspots with Wi-Fi access for our ADSL clients;

the development and launch of a new blog platform in line with international best practices; and

the launch of voice over Internet protocol (VoIP) with a monthly average of 13 thousand users.

We use market research programs to evaluate customer satisfaction and service quality and to help develop new products. We focus our marketing on different segments of the residential and business market. We have an advanced billing and customer information system and a marketing information database that combines usage and other data.

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

*Increased Selling Efforts.* We have developed a distribution network through our retail service centers and agents such as supermarkets and other retail outlets. Our customer support system allows us to develop and implement strategies to sell new and expanded services to our customers. We often use telemarketing to both the residential and small and medium-sized enterprise market segments to develop closer relationships with our customers.

In 2006, we continued to pursue our strategy of market segmentation, namely our residential and business market segments, and established partnerships between subsidiaries of Portugal Telecom to offer integrated telecommunications solutions to corporate customers, including simpler voice services and integrated website solutions. We also executed agreements with corporate associations to benefit small businesses.

## ***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 €1,173.5 million and €1,318.8 million to our wireline operating revenues during 2006 and 2005, 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 the amount and type of usage.

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

Since 2000, public switched fixed line telephone services in Portugal have been fully open to competition. As a result of this competition, as well as the trend toward use of mobile services instead of fixed line services, we have experienced, and expect to continue to experience, erosion of market share of both access lines and of outgoing domestic and international traffic. See "*Competition Competition Facing Our Wireline Business*".

### *Fixed Charges*

Our fixed charges to domestic fixed line telephone subscribers include a one-time installation charge and a monthly line rental fee. These fixed charges provided €568.1 million and €618.8 million to our wireline operating revenues during 2006 and 2005, respectively.

In July 2005, we created two different tariffs one for the residential market and another for the business market. The installation charge remained the same for both markets, €71.83. The standard line rental fee was €12.66 for the residential market and €12.98 for the business market. The fee for basic ISDN lines was €26.46 per month for both markets. The chart below illustrates changes in our prices and fees from 2002 through 2006. All prices are in Euros and exclude VAT.

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

	As at December 31,				
	2002	2003	2004	2005	2006
Installation fee	71.83	71.83	71.83	71.83	71.83
Line rental per month	11.85	12.3	12.66	12.66	12.66 (residential)
				12.98	12.98 (business)

(1) Amounts rounded to nearest hundredth.

### *Traffic*

Traffic contributed €425.1 million and €534.6 million to our wireline operating revenues during 2006 and 2005, respectively. Measured in minutes, total fixed line retail traffic originating on our fixed line network decreased by 17% during 2006 compared with 2005. The decrease was primarily due to the continuing effects of the trend toward use of mobile services instead of fixed line services and the migration of Internet users to ADSL.

**Domestic.** Domestic traffic contributed €372.7 million and €469.2 million to our wireline business's operating revenues in 2006 and 2005, respectively.

**Prices.** Since July 2006, we have had two domestic tariffs: local (former local + regional) and national. Between the end of 2001 and the end of 2006, weighted average prices for domestic fixed line telephone services decreased by 0.83% per year in nominal terms. Compared with 2005, domestic prices decreased a further 1.0% over the course of 2006 in nominal, annualized terms. See "*Regulation Portugal Pricing of Wireline Services*".

The chart below illustrates changes in our prices from 2002 through 2006. The call prices from 2002 through 2006 are for a three-minute call at peak rates in 2006 constant prices. All prices are in Euros and exclude VAT.

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

	As at December 31,				
	2002	2003	2004	2005	2006
Local call prices	0.12	0.12	0.13	0.12	0.12 (residential) 0.13 (business)
Regional call prices	0.23	0.21	0.16	0.12	0.12 (residential) 0.13 (business)
National call prices	0.33	0.29	0.20	0.19	0.19 (residential) 0.19 (business)

(1) Amounts rounded to nearest hundredth.

Our 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, 2006.

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

	As of December 31, 2006		
	EU Average(1)	EU Average(2)	Portugal
Local call prices:			
Residential		0.037(3)	0.036(3) 0.037(3)
Business		0.035(4)	0.036(4) 0.042(4)
National call prices:			
Residential		0.065(3)	0.064(3) 0.065(3)
Business		0.053(4)	0.055(4) 0.063(4)

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

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

(3) As of September 30, 2006.

(4) As of June 30, 2006.

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To increase its price competitiveness, we are promoting innovative differentiated pricing plans for market segments, including various plans specially designed for business customers and residential customers. We also offer a prepaid card and pricing plans suited for Internet users, as well as plans aimed at the development of education and the information society.

**International.** Revenues from international fixed line telephone services come primarily from charges to our individual and business subscribers in Portugal for outgoing calls. Revenues from international fixed line telephone services have generally decreased in recent years as a result of decreases in international traffic and prices for outgoing international calls, although traffic increased in 2005 as a result of growth in traffic from prepaid international calling cards.

**Accounting Rates.** Historically, the amount of incoming traffic has been significantly greater than the amount of outgoing traffic. As a result of this imbalance, we receive higher payments from other international telecommunications operators than we pay out to these operators. We periodically renegotiate the amount of the payments with these operators.

In recent years, the billing rates among operators have been declining steadily, both for incoming and outgoing traffic. We estimate that, on an aggregate basis in Euros, termination rates for international traffic at the end of 2006 decreased by a weighted average of approximately 17.0% for incoming traffic and 18.4% for outgoing traffic compared to the end of 2005.

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

**Prices.** We set traffic charges for international fixed line telephone services by groups of countries. Within each group, we charge different prices according to the time of day and the day of the week that the customer makes the call. Between the end of 2002 and the end of 2006, we experienced aggregate reductions in real terms of 3.7% in international traffic prices.

The table below shows changes in prices for our international fixed line telephone services to selected destinations since 2002. The prices for 2002 through 2006 are peak rate prices per minute on the basis of a three-minute call, set at 2006 constant prices. They are in Euros and exclude VAT.

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

	As of December 31,				
	2002	2003	2004	2005	2006
EU(2)	0.27	0.27	0.27	0.27	0.27
Other European countries(3)	0.61	0.61	0.61	0.61	0.61
United States	0.28	0.28	0.28	0.28	0.28
Canada	0.28	0.28	0.28	0.28	0.28
Brazil	0.57	0.57	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

We are the leader in providing Internet access in Portugal. As at December 31, 2006, we had approximately 685 thousand ADSL retail customers, which represented an overall increase of 17% over the previous year. We also offer dial-up paid and free Internet access services. In 2006, revenues from ADSL services grew 13% to €170.1 million, more than offsetting a 31.5% decline in dial-up revenues to €10.2 million as increasing numbers of people switched to broadband services.

**Application Service Provider (ASP).** We also provide ASP services in Portugal, which include remote applications services, web hosting and web design services to small and medium-sized enterprises. We had approximately 2,589 customers for our ASP business at December 31, 2006.



**ISP Traffic Revenues.** PT.com offers Internet access through the lines of PT's fixed line network. PT.com retains all of the revenues from Internet traffic and pays PT Comunicações for use of the fixed line network.

**Wholesale**

Our wireline wholesale services business, 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;

provision of carrier pre-selection and number portability;

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;

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

provision of co-location services and duct sharing to cable television companies; and

provision of wholesale line rental.

Wholesale services provided €464.2 million and €457.7 million to our wireline operating revenues in 2006 and 2005, respectively.

**Traffic.** Interconnection and narrowband Internet access traffic comprises about 45% 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, ISPs, value-added service providers and service providers whose international calls are terminated on or carried by our network. Providing interconnection services means allowing third parties to connect their networks to our network, and vice versa. We have interconnection rates for call termination, call origination, transits and international interconnection. In 2006, interconnection rates per minute for call termination included local transit rates equal to €0.0064, single transit rates equal to €0.0093 and double transit rates equal to €0.0144, each based on a three-minute call made during peak hours. We published the latest version of our reference offer for unbundled access to our local loops in September 2006 and since then have made available to its competitors, where technical and space conditions are available, all of our local switches, 191 of which are co-located. Co-location means providing space and technical facilities to competitors to the extent necessary to reasonably accommodate and connect the relevant equipment of the competitor. 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 6.5% in 2006 compared with 2005. 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 2002 through 2006.

**Wholesale Domestic Traffic**  
(millions of minutes)

	Year ended December 31,				
	2002	2003	2004	2005	2006
Mobile(1)	998	959	912	880	840
Internet	6,581	5,023	3,151	1,818	920
International(2)	1,420	1,318	1,413	1,581	1,779
Other(3)	2,831	3,008	3,753	4,139	4,328
<b>Total</b>	<b>11,830</b>	<b>10,308</b>	<b>9,229</b>	<b>8,418</b>	<b>7,867</b>

- (1) Reflects mobile-to-fixed calls terminated on our fixed line network.
- (2) Includes incoming international traffic (both fixed and mobile), outgoing international traffic from other operators using our network and transit traffic.
- (3) Includes fixed-to-fixed calls terminated on our fixed line network, calls originated on our network through indirect access through other operators and other traffic.

**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. We offer a minimum set of leased lines (up to 2 Mbps) at the retail level to medium and large businesses, plus larger capacities on a commercial basis. In addition, we offer terminating segments and trunk segments at the wholesale level to telecommunications providers. Our Concession requires us to provide leased lines to third parties.

The three current mobile telephone operators in Portugal, which include our subsidiary TMN, Vodafone Portugal, Optimus and our subsidiary TV Cabo, are among our wireline business's 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 7.8% in nominal terms in 2006 compared with 2005. International interconnection revenue per minute declined by 21.0% in nominal terms in 2006 compared with 2005. In accordance with EU and Portuguese regulations, our interconnection prices are based on our costs (which are audited by ANACOM) plus a margin.

**Data and Corporate**

We provide data and corporate services within our wireline business to top corporate and business customers that need complex telecommunications solutions, including:

digital leased lines;

broadband data and IP/MPLS Ethernet 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;

security and disaster recovery solutions;

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

telephone services using Internet protocol.

We are the leading supplier of the full range of these services in Portugal. Data and corporate operating revenues contributed €250.5 million and €244.9 million to our wireline operating revenues in 2006 and 2005, respectively.

**Services.** We have developed a full range of telecommunications services for businesses, and we integrate these services (together with other services we offer, such as fixed line services and domestic mobile services) to provide our customers with service packages. By combining our communications capabilities with our software-based integrated systems and applications, we offer integrated voice, data and image solutions, virtual private networks, convergence solutions, consultancy and outsourcing. We believe we are the primary service provider in Portugal capable of offering customers a full range of integrated and customized services. Despite increasing competition, overall demand for data and corporate services has been increasing. As a result of competition, we have reduced our prices for leased lines and data services.

We offer services in partnership with leading operators and service providers such as Telefónica, British Telecom, Orange and BT-Infonet. We use systems and networks in partnership with Siemens, Alcatel, Cisco Systems, Motorola, Nortel Networks and Matra/EADS Telecom.

We lease lines and broadband capacity to large businesses for data communications and other private uses and provide related services. We also provide integrated voice and data services to corporate customers. We offer 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, we offer a new range of data, voice and Internet services, such as Intranet, Extranet and managed services, including VoIP. We use IP-based solutions to improve interconnections between companies and their employees and between customers and commercial partners through remote access. 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 center solutions represents an evolution of the classic call center for customers.

We provide 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 our customers.

We also provide reporting services targeted to special customers to control service level agreements and the overall performance of the network.

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In addition, we provide outsourced corporate network services for our customers. For example, we operate and manage the SIBS network, as well as the corporate networks of our strategic partners Caixa Geral de Depósitos, Banco Espírito Santo and CATT.

**Networks.** We provide services over the largest IP/MPLS backbone in Portugal, with PT Prime leasing the necessary fixed line capacity from PT Comunicações. We have points of presence in all major cities throughout Portugal, and we link our network to our customers' premises through switches and access points that we own. This broadband data transmission network provides high capacity, flexibility and security and can progressively incorporate current voice and data infrastructures at lower costs than alternative networks. We also provide high speed Internet access through ADSL and ADS. PT Prime supplies full IP and broadband connectivity for the entire PT group.

When we receive revenues from services offered through lines leased by PT Prime from PT Comunicações, we typically divide the revenues between PT Prime's own direct billings to its customers and leased line revenues from the wholesale business of PT Comunicações. Revenues from fixed line voice services for corporate customers are not reflected in PT Prime's revenues, as they are included in retail revenues.

**Systems Integration.** We offer an integrated range of telecommunications and information technology services to the business market. Our goal is to service all of our customers' telecommunications needs and to leverage the traditional offering of products and services from our group.

We have a strong and competitive position in the development of information technology solutions where communications are an integral part of the services provided. To reinforce our position as a leader in this area, we are pursuing a partnership strategy with the primary information technology suppliers in the market, particularly software and hardware providers.

To support these new services and to respond to the increasing demand of e-business integrators, we developed Corporate Internet Data Centers in Lisbon and Oporto, and we are currently upgrading the Lisbon center. These facilities allow us to provide services, such as co-location, sophisticated web hosting, ISP services, data storage, disaster recovery and ASP services.

We also offer 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.** We focus significant resources on marketing and customer care. Account managers are given clear incentives to meet and exceed sales targets. We are upgrading our sophisticated customer relationship management platform to increase focus on market and Internet efficiency.

We seek to compete in Portugal on the basis of the quality of our services as well as our position as the leading supplier of integrated telecommunications and IT services. We price our various service offerings on the basis of volume, the duration of service agreements and the scope of the services offered to each customer.

We offer our corporate 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.

### **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 €108.9 million in 2006 and €120.4 million in 2005. 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.

**Sales of Telecommunications Equipment.** Revenues from sales of telecommunications equipment amounted to €32.8 million in 2006 and €34.2 million in 2005, 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 €1,502.4 million and €1,557.1 million to our domestic mobile business operating revenues in 2006 and 2005, respectively.

The use of mobile services has grown considerably in Portugal in recent years. As of December 31, 2006, there were approximately 115.7 active mobile telephone cards per 100 Portuguese inhabitants, according to ANACOM. This was more than the number of wireline main lines per 100 Portuguese inhabitants as of December 31, 2006, which was 39%, according to ANACOM. The table below provides statistical information relating to TMN.

	As of December 31,				
	2002	2003	2004	2005	2006
<b>TMN Portugal</b>					
Number of subscribers (thousands)	4,426	4,887	5,053	5,312	5,704
Subscribers growth per annum (%)	13	10	3	5	7
Number of subscribers per 100 inhabitants (including competitors' subscribers)(1)	81.9	89.8	95	108.7	115.7
Estimated market share by number of subscribers (%) (1)	51.9	48.7	48.8	46.4	46.7
Number of employees	1,192	1,109	1,133	1,184	1,140

(1)

Source: ANACOM and TMN.

**Services.** TMN provides mobile telephone services using the GSM and UMTS technologies. GSM and UMTS are European and worldwide standards using digital technology. Through roaming agreements, TMN's subscribers can use GSM and UMTS services to make and receive mobile calls throughout Europe and in many other countries around the world.

TMN provides GSM services in the 900 MHz and 1800 MHz band spectrums. TMN began to offer GSM 1800 services in 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 without compromising the quality of the network. Dual-band handsets, which select available channels from either frequency band, enable users to benefit from the wider range of available channels.

In 2000, the Portuguese government opened a tender for licenses for UMTS services, and TMN received one of these licenses. Licenses were also awarded to Vodafone Portugal and Optimus. In 2004, TMN began providing UMTS services to its customers, with an emphasis on new services, such as video telephony and high-speed data. In 2004, 2005 and 2006, we have pursued a strategy of gradual improvements to network coverage, using existing GSM sites where possible in order to minimize the need to install costly new sites. At the end of 2006, TMN's UMTS population coverage was approximately 80%, and its geographic coverage was about 33%, or 3,633 municipalities out of a total of 4,252 in Portugal, including every municipality with over five thousand inhabitants.

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In April 2006, TMN launched HSDPA (High Speed Downlink Packet Access), the first step in the evolution of mobile broadband UMTS services. This technology will evolve in the coming years, positioning mobile operators as competitors in the high speed internet services market.

TMN paid spectrum fees in 2005 and 2006 of €27 million and €26 million, respectively, for the use of its 900 MHZ and 1800 MHZ GSM network and its UMTS network. These spectrum fees are recorded as an operating expense under "indirect taxes" in our financial statements.

We expect the development of third generation services to require additional investments. TMN made direct investments of €77.1 million in 2005 and €114.2 million in 2006 in building out its third generation network and services. In 2006, the investments made by TMN in connection with UMTS represented more than 61% of its total capital expenditures in 2006.

During 2005 and 2006, TMN continued to introduce new products and services in Portugal, such as:

"+Perto" and "Plano", two new packages of minutes targeted to postpaid customers;

"Out Mail", access to e-mail service on a continuous basis: anywhere and anytime;

"Krava", a new service whereby prepaid and postpaid customers are allowed to make calls that will be paid by the receiver;

"Mix", a new tariff plan for prepaid and postpaid customers using a single card;

"Check in", a service to customers who mainly use international calls;

"Lost Calls Service", an automatic service that advises you which numbers tried to call you when your mobile phone is disconnected or is unavailable;

"Videosharing", the first commercial video sharing service launched in Portugal, in partnership with Nokia;

"TMN backup", a service that provides remote back-up of all personal content on a TMN customer's handset;

"Localizz", a new service of mobile localization for the corporate segment, which allows on-line visualization (through an Internet page) of all mobile phones of the company;

"Giga access", connectivity to e-mail or internet in a mobile basis;

"Music edition", a service that allows customers to share, hear and transfer music;

"Walkman", the first service in Portugal that allows customers to download up to 10 music CDs to their handsets;

"Waiting Ring", a service that allows customers to change waiting rings;

"Mobile TV", offering 26 TV channels, 24 hours a day, including news, music and sports. "Fast zapping" functionality was also introduced in order to improve the user's experience;

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"E-Ticketing", a service that allows customers to purchase cinema tickets via their mobile phones;

"Jogos Multiplayer", multiplayer games for mobile phones;

"Serviço Banda Larga TMN", a mobile phone service supported by the High Speed Downlink Packet Access technology, or 3.5G;

"Push E-Mail", which allows customers to receive e-mails in real time; and

"Casa T", the first home-zoned service in Portugal, which allows TMN customers to make free calls to the fixed and TMN networks after the first minute, in exchange for a monthly fixed fee.

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Peer-to-peer, or P2P, messaging services via SMS or MMS continue to account for a significant portion of TMN's data revenues and are 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 (myTMN), multimedia content services (including Logos & Ring Tones or Java games), access to third-party branded content, connectivity to e-mail or the Internet via GPRS/UMTS, corporate solutions and mobile payment services. GPRS, or General Packet Radio Service, is a mobile data service standard for GSM handsets.

TMN's multimedia portal I9-Inove optimizes the current capabilities of GPRS/UMTS systems to provide customers with faster, easier access and a wider range of services and content, such as Java Games, mobile TV, messaging services, goals from the Portuguese football league in video, TV Cabo's programming guide and the Lusomundo cinema ticketing service, the first m-commerce service in Portugal. As of December 31, 2006, I9-Inove had reached approximately 1.8 million TMN customers. On the myTMN website ([www.mytmn.pt](http://www.mytmn.pt)), TMN customers can also access and buy a wide range of content (such as logos, ring tones and alerts), allowing personalization of their mobile phones.

In keeping with its emphasis on innovation, TMN has a strong focus on offering services that meet customers' expectations. TMN recently launched a service called "tmn Backup", which provides remote backup of all personal content on a handset (such as contacts, SMS messages, photos, ring tones, games and other downloads) that would be lost if the handset were stolen or misplaced. In March 2006, TMN launched the "Waiting Rings" service, which allows customers to personalize ring tones when calling a TMN customer. The launch of "Mobile TV" in April 2006 is another example of TMN's focus on innovation, allowing customers to watch TV on their mobile phones wherever they are.

Another innovative service is the 12400 Video service, launched in 2004, which provides news and entertainment programs from the major Portuguese TV stations to customers through videocall. The 12400 Video is simple, practical and functional and is still the only such service in Portugal. To access the service, TMN's 3G clients need only make a videocall to the number 12400 and choose the content they wish from a simplified menu.

TMN also offers a variety of Internet access and multimedia services, such as Wi-Fi, GPRS and UMTS Internet access and the ability to receive or send a fax over a mobile handset. The launch of HSDPA in April 2006, which allows speeds of up to 1.9 Mbps, improved mobile Internet access. In October 2006, TMN made available speeds of up to 3.6 Mbps.

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 allows TMN corporate clients to use POS (point of sale) mobile equipment to receive debit or credit payments at any place with total security. TMN also launched Localliz, which is a location-based service that allows mobile management and localization of a company's resources (such as handsets, cars, machines and containers) through an Internet website.

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

Data service usage has grown considerably as customers have become increasingly familiar with TMN data services, service offerings have been expanded and access speed has increased through the introduction of UMTS. We are working to further increase 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.

In June 2005, TMN introduced a low-cost brand "Uzo" that targets low cost subscribers and uses TMN's GSM network. Uzo offers a very simple service to its customers with no obligatory recharges and one tariff for voice calls and SMS to all networks of 16 cents per minute and 8 cents per message, respectively. However, if the customer recharges its card with €15 or more, he or she is allowed to

speak and to send messages to all networks for 12 cents per minute and 6 cents per message, respectively, for a period of 30 days. Uzo focuses primarily on selling SIM cards and low-cost mobile phones to its customers. Uzo's products and services are offered through the Internet, Uzo's call centers (which are separate from TMN's call centers) and independent news stands and shops located throughout Portugal.

**Subscribers and Traffic.** TMN is the market leader in mobile services in Portugal. At December 31, 2006, TMN had approximately 5.7 million subscribers, representing an increase of 7.4% from December 31, 2005. At December 31, 2006, TMN's subscribers represented 46.7% of the total mobile subscribers in Portugal. During 2006, TMN's share of new mobile subscribers (net additions) was 50.2%, according to ANACOM.

In addition to the increase in the number of subscribers, mobile usage grew during 2006. TMN's voice traffic in terms of minutes grew by 4.2% to 7,802 billion minutes in 2006, compared to 7,486 billion minutes in 2005. Average monthly usage per subscriber decreased 1.1% to 120.3 minutes in 2006, compared to 121.6 minutes in 2005. In terms of traffic from data transmission services, SMS increased by 148.4% during 2006, and there were an average of 59.9 SMS messages per month per user in 2006, 135.6% more than the average of 25.4 SMS messages per month per user in 2005. Traffic from WAP services supported by GPRS and UMTS networks increased by 46.9% in 2006.

**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 90.2%, 8.6% and 1.2%, respectively, of TMN's revenues in 2006, and approximately 88.5%, 9.4% and 2.1%, respectively, of TMN's revenues in 2005. Monthly subscription fees range from €8.26 (+Perto; Plano) to €40.91 (Extra), excluding VAT.

However, fixed-to-mobile and mobile-to-mobile interconnection charges are regulated by ANACOM and have a significant impact on TMN's business. In February 2005, ANACOM declared all mobile operators to have significant market power in call termination in mobile networks market. ANACOM has accordingly imposed price controls on interconnection rates for the termination of calls on mobile networks. In 2005, interconnection rates (both fixed-to-mobile and mobile-to-mobile) were reduced by an average of 23.5% compared with 2004 rates. In 2006, these rates were reduced by an average of 18.5% compared to the 2005 rates. These reductions have had, and are expected to continue to have, a significant impact on TMN's interconnection revenues and consequently its earnings.

**Products and Marketing.** TMN offers a variety of innovative products. It was the first operator in the world to offer pre-paid services, and its prepaid and discount products are popular. We estimate that at the end of 2006, approximately 80.6% 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. TMN has been expanding its subscriber base through increased advertising and the use of its own distribution network. TMN has recently focused on encouraging the use of mobile services by young people through SMS incentive packages. TMN experienced a 17.5% increase in the number of postpaid subscribers in 2006 as a result of a promotional campaign aimed at stimulating a switch from prepaid to postpaid services and also as a result of continued marketing efforts directed at corporations and in the middle and high-end segment of the market.

TMN markets its services through more than 2,000 points of sale, including TMN's sales force, Portugal Telecom retail shops, TMN shops, supermarket chains and independent dealers.

**Network and Capital Investment.** In recent years, TMN has made significant investments in its second and third generation networks. 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 2006, TMN's digital network had 4,181 GSM base stations, including 79 base stations added during

2006, and 2,227 UMTS B nodes, including 333 B nodes added during 2006. As of December 31, 2006, these GSM base stations covered more than 98% of continental Portugal and 99% of the Portuguese population, and the UMTS B nodes covered approximately 33% of continental Portugal and 80% of the Portuguese population.

Since November 2005, TMN has been one of 18 operators in the world that are members of the Global Certification Forum, an industry group aimed at ensuring compatibility of mobile telecommunications systems.

**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 2006, TMN had entered into GSM roaming agreements with a total of 340 operators (in 192 countries or regions), 145 GPRS roaming agreements (in 101 countries or regions) and 62 3G roaming agreements (in 36 countries or regions).

**Equipment Sales.** TMN sells mobile phones and related equipment in Portugal. Equipment sales contributed €129.7 million and €146.3 million to TMN's operating revenues in 2006 and 2005, respectively.

### **Multimedia Business**

We provide multimedia services in Portugal through our subsidiary PT Multimédia and its subsidiaries. PT Multimédia and its subsidiaries contributed €666.5 million and €628.5 million to our multimedia business operating revenues in 2006 and 2005, respectively.

**Proposed Spin-Off.** On August 3, 2006, we announced our intent to spin off our 58.43% interest in PT Multimédia through a distribution to shareholders, subject to shareholder approval. On March 21, 2007, the Board of Directors proposed to the shareholders a dividend in kind of 4 PT Multimédia shares for each PT 25 shares owned, rounded down. This spin-off proposal was approved by the shareholders at the Annual General Meeting held on April 27, 2007.

Our management has concluded that the separation of PT Multimédia from PT should positively contribute to the development of the telecommunications market in Portugal, allowing the market to develop increasingly innovative and convergent services to consumers. The resulting market structure should provide regulatory relief for our wireline business, giving it flexibility to offer more and better services to our customers, while PT Multimédia would be able to pursue its own competitive strategy, domestically and abroad. By allowing the management of each company to focus on its core competencies, we believe that this strategy is more likely to create greater value for shareholders over time. The proposed separation also addresses the long-standing objectives of the Portuguese regulators.

Notwithstanding these potential benefits to PT Multimédia, the spin-off of PT Multimédia could have a negative impact on our wireline and mobile business performance. See "Item 3 Key Information Risk Factors Risk Relating to Our Wireline and Domestic Mobile Businesses."

**Incorporation 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;

advertising sales;

the provision of Internet access; and

our minority stake in the leading Portuguese telephone directories business.

Since its initial public offering in November 1999, PT Multimédia's ordinary shares have been traded publicly in Portugal. 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, 2005, and following the capital reduction after the share buyback program completed in May 2005, Portugal Telecom held 58.43% of PT Multimédia.

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, a media and entertainment company, through the execution of a promissory sale and purchase agreement with Controlinveste, SGPS, S.A. Through these companies, PT Multimédia previously ran a newspaper publishing and distribution business and a radio programming business. The sale was completed on August 25, 2005 after approval by the Portuguese Media Authority (Alta Autoridade para a Comunicação Social) and the Portuguese Competition Authority (Autoridade da Concorrência). The proceeds for PT Multimédia from the sale were €173.8 million, of which €10.1 million was paid to Portugal Telecom in connection with the acquisition of its 5.94% interest in Lusomundo Media, which was agreed prior to the closing of the transaction.

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

cable and satellite television through TV Cabo;

broadband Internet access through cable modem provided by TV Cabo;

telephony services (VoIP) provided by TV Cabo;

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

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

cinema exhibition through Lusomundo Cinemas.

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The diagram below shows PT Multimédia's major lines of business and the subsidiaries operating in each of those businesses as of December 31, 2006.

**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. On January 23, 2007, TV Cabo launched telephony services, establishing itself as an integrated triple-play operator. The bundled triple play offer comprises Pay TV, broadband Internet and telephony. PT Multimédia expects that the sale of voice services to existing broadband customers should allow TV Cabo to further grow ARPU, increase broadband penetration, reduce churn and better segment its offers to meet customer demands.

**Cable Television and Direct-to-Home Satellite Television Services.** TV Cabo is the leading cable television operator in Portugal. At December 31, 2006, TV Cabo's cable network passed, or provided potential access to, approximately 2.852 million homes, representing approximately 63% of the total TV households in Portugal. 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 or monthly 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 principal 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 served by TV Cabo's cable television network.

Because it offers cable and DTH satellite services, TV Cabo can distribute programming and advertising across Portugal. As of December 31, 2006, TV Cabo had approximately 1,480 thousand customers, of which 421 thousand were DTH satellite subscribers. At December 31, 2006, approximately 53% of TV Cabo's subscribers subscribed to its premium channels, for which it charges additional fees.

**Programming Content.** As of December 31, 2006, TV Cabo offered 65 channels in its extended basic package (of which 40 were included in its basic package) and nine premium channels to cable and

DTH satellite subscribers in continental Portugal. Over half of the channels distributed by TV Cabo, including Lusomundo channels (Premium, Gallery, Action and Happy) and Sport TV, which is described below, 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, with some channels in other European languages such as Spanish, French and German.

*Broadband Internet Service.* As of December 31, 2006, TV Cabo had approximately 362 subscribers for its broadband Internet access product. In addition to its postpaid service, TV Cabo launched the first prepaid broadband product in Portugal in 2004 under the brand name "Zzt". TV Cabo was also the first operator to offer 1Mbps downstream speed. In 2006, TV Cabo enhanced its position by being the first ISP to lift the traffic limits on its 4Mbps and 8Mbps products. TV Cabo launched a 24Mbps Internet access product, positioning Netcabo as the fastest broadband service in the Portuguese market. Simultaneously, the broadband portfolio was updated with the launch of a 1Mbps product and the doubling to 8Mbps of the download speed of the Netcabo standard broadband product, known as "Netcabo Mega Plus".

*Digitalization.* Throughout 2006, 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 TV channels and 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. PT Multimédia aims to stimulate the migration of its clients from analog to digital services by offering a greater selection of content and services, as in the introduction of its Funtastic Life package in 2005. TV Cabo completed the digitalization of its set top boxes during the first half of 2006, with the total number of digital set top boxes reaching 682 thousand at the end of December 2006. In 2006, "TV Cabo Funtastic Life", TV Cabo's 65-channel digital package, performed strongly and continued to drive new customer additions as well as ARPU expansion by enhancing the quality of the existing customer base. The digital package reached 270 thousand subscribers by the end of December 2006, with 160 thousand net additions in 2006.

*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 owned by our fixed line business 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 continued to invest in the expansion and upgrade of its network during 2006. The implementation of the "fiber to the hub" access network architecture in the greater Lisbon area was concluded, and five high-capacity optical fiber rings are now fully functional. At present, 97.1% of homes passed are bi-directional and therefore broadband-enabled, over 90% are digital TV-enabled and 80% are VoIP-compliant.

*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 Funtastic Life service 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 SIC Notícias, as described above. 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. PT Conteúdos launched Lusomundo Action in 2004 and Lusomundo Happy in 2005, as described above, and 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 Sportinveste, SGPS, S.A., 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 2006. 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 SIC Notícias. See " *TV Cabo*", above.

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 some of the channels it distributes, where it has acquired the right to sell advertising as part of its content acquisition contracts. PT Conteúdos also manages the sale of advertising for TV Cabo's channels in exchange for an agency fee.

**Lusomundo Audiovisuais.** Lusomundo Audiovisuais acquires rights for cinema, DVD, video, pay-per-view and television and also produces its own Pay TV premium movie channels and distributes DVDs and videos. Lusomundo Audiovisuais has the right to distribute the following audiovisual content in Portugal:

*Theatrical Exhibition:* Universal, Paramount (including Dreamworks), BUENA Vista International (Touchstone, Walt Disney Pictures) and independent producers; and

*Video:* BVHE (Walt Disney), Paramount (including Dreamworks) and independent producers.

In 2006, PT Multimédia reinforced its market position in the area of cinema distribution, increasing its share from 46% in 2005 to 50% in 2006, primarily due to the launch of a significant number of films with high potential and the increase in the number of films released. In 2006, PT Multimédia had 13 of the top 20 most seen films, compared to 10 films in 2005, and PT Multimédia released 122 films in 2006, compared to 95 in 2005.

**Lusomundo Cinemas.** Lusomundo Cinemas is the market leader in Portuguese cinema exhibition, with a 48.6% market share. In 2006, PT Multimédia continued its policy of market analysis, seeking opportunities for expansion and increased profitability of its business. As a result, PT Multimédia closed four unprofitable cinemas and opened 23 new cinemas in high population density areas. At the end of 2006, PT Multimédia had 86 film complexes, with a total of 195 screens. PT Multimédia's actions in the area of film exhibition were characterized by the steady improvement in the quality of its services: three complexes were renovated, improvements in ticket purchasing systems were introduced (with the innovation of the launch of the M-Ticket in collaboration with TMN), and the first cinema in Portugal equipped for 3D digital exhibition was opened, using advanced digital exhibition standards. In 2006, the number of tickets sold in Portugal increased 10.7%, reaching 8,026 thousand tickets.

As discussed above under "Multimedia Business," PT Multimédia completed the disposal of its interest in Lusomundo Serviços in August 2005, following clearance from the Portuguese competition authority. As from that date, PT Multimédia ceased to operate in the newspapers and magazine publishing and distribution business and in the radio programming business.

### **Brazilian Mobile Business**

We provide mobile telecommunications services in Brazil through Vivo Participações S.A., or Vivo, the leading mobile company in Brazil with a total of 29,053 million active mobile telephones at December 31, 2006. We hold 50% of Vivo, which is a joint venture with Telefónica. The joint venture operates in 19 states in Brazil and in the Federal district of Brasília, which provide more than 83.1% of Brazil's GDP. In its areas of operation, Vivo had an estimated market share of approximately 38.2% at the end of 2006. We believe that the joint venture facilitates our ability to serve our Brazilian subscribers on a seamless basis throughout Brazil.

**History and Organizational Structure.** 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. In January 2001, we entered into a strategic agreement with Telefónica Móviles (the former mobile subsidiary of Telefónica, which has since merged with and into Telefónica) to combine all of our mobile assets in Brazil to the extent permitted under Brazilian law. The strategic agreement was approved by the European Commission in March 2001. See "Regulation Brazil." In December 2002, ANATEL formally approved the migration of our Brazilian mobile subsidiaries from the former Mobile Cellular Service (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, named Brasilcel N.V. We and Telefónica Móviles transferred to this company all our and their interests in:

TCP, which controlled Telesp Celular (the band A operator in the state of São Paulo) and Global Telecom (the band B operator in the states of Paraná and Santa Catarina) and was contributed by Portugal Telecom (which had a controlling position) and by Telefónica Móviles;

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

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

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Celular CRT Participações S.A., or Celular CRT Participações, which controlled Celular CRT, S.A., or Celular CRT (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 Portugal Telecom.

We have described the arrangements by which we and Telefónica 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*".

Before the transfer of these assets to the joint venture, TCP had acquired an 81.61% indirect economic interest in Global Telecom in 2001 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 27, 2002, the same day as the transfer of the assets to the joint venture, TCP acquired the remaining 51% of the voting shares of the three holding companies that owned Global Telecom for US\$82.0 million. TCP then owned 100% of the voting and non-voting shares of Global Telecom.

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, 2004, 2005 and 2006 and our balance sheet as of December 31, 2003, 2004, 2005 and 2006 proportionally consolidate the results of Vivo.

On April 25, 2003, TCP acquired 61.1% of the voting capital stock of TCO (a band A operator in the midwestern and northern regions of Brazil) from Fixcel, a Brazilian company, for R\$1,529 million. As a result, TCO's assets and liabilities as of December 31, 2004, 2005 and 2006 are reflected in our consolidated balance sheets for these years through our proportional consolidation of Vivo, and TCO's income and cash flows for the years ended December 31, 2004, 2005 and 2006 are reflected in our consolidated statements of income and cash flows for the year ended December 31, 2004, 2005 and 2006 through our proportional consolidation of Vivo's statements of income and cash flows.

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.

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 total consideration of approximately R\$902 million. Concurrently with this transaction, 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 completed a tender offer for additional shares of Tele Sudeste, Tele Leste and Celular CRT Participações. As a result of the successful completion of the tender offer, Vivo increased its interest in Tele Sudeste to 91.0%, in Tele Leste to 50.7% and in Celular CRT Participações to 67.4%, for a total of approximately R\$607 million.

On February 22, 2006, the requisite percentages of the voting shareholders of the Vivo companies approved a corporate reorganization. The corporate reorganization consisted of a merger of shares under Brazilian law (*incorporação de ações*) of TCO with TCP and the merger of companies under Brazilian law (*incorporação de empresas*) of Tele Leste, Tele Sudeste and Celular CRT Participações with TCP. In connection with these mergers, TCP was renamed "Vivo Participações S.A." On March 31, 2006, common shares and preferred shares of Vivo began trading on the São Paulo Stock

Exchange under the ticker symbols "VIVO3" and "VIVO4", respectively, and ADSs of Vivo began trading on the New York Stock Exchange under the ticker symbol "VIV". Vivo undertook these mergers in order to align the interests of shareholders of the Vivo companies, to increase the liquidity of the securities held by those shareholders, to simplify the shareholding and organizational structure of the Vivo business and expand its shareholder base, and to take advantage of important synergies among the companies.

In October 2006, Vivo completed a further restructuring with the merger into Global Telecom (the company that provided mobile services in the states of Paraná and Santa Catarina and that was fully owned by TCP) of all other companies of Vivo that provided mobile services in the other states mentioned above. In connection with this transaction, Global Telecom was renamed "Vivo S.A."

The diagram below presents the simplified ownership structure of Vivo as of December 31, 2006:

As of December 31, 2006, Brasilcel held 88.85% of the common shares of Vivo Participações, 47.76% of its preferred shares and 62.77% of its total share capital.

**Regions.** Vivo provides mobile telecommunications services on the A and B Band frequency in 19 Brazilian states in addition to the federal district, representing a total of approximately 7.3 million square kilometers, or 85.6% of the Brazilian territory. This area includes more than 138.8 million people, representing 73.8% of Brazil's population, and 212 municipalities with a population in excess of 100,000.

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The following table sets forth population, gross domestic product (GDP), and per capita income statistics for each state in Vivo's service regions at the dates and for the years indicated:

Area	Frequency Range	At December 31, 2006		Last Available IBGE Data		
		Population (in thousands)(1)	Percent of Brazil's population(1)	GDP (in millions of reais)(2)(3)	Percent of Brazil's GDP(3)	Per capita income (in reais)(2)(3)
São Paulo state	A Band	41,361	22.0%	546,607	30.9%	13,725
Paraná state	B Band	10,450	5.6%	108,699	6.2%	10,725
Santa Catarina state	B Band	6,004	3.2%	70,208	4.0%	12,159
Goiás state	A Band	5,786	3.1%	41,316	2.3%	7,501
Tocantins state	A Band	1,346	0.7%	4,768	0.3%	3,776
Mato Grosso state	A Band	2,884	1.5%	27,935	1.6%	10,162
Mato Grosso do Sul state	A Band	2,315	1.2%	19,954	1.1%	8,945
Rondônia state	A Band	1,576	0.8%	9,744	0.6%	6,238
Acre state	A Band	690	0.4%	3,242	0.2%	5,143
Amapá state	B Band	626	0.3%	3,720	0.2%	6,796
Amazonas state	B Band	3,355	1.8%	35,889	2.0%	11,434
Maranhão state	B Band	6,225	3.3%	16,547	0.9%	2,748
Pará state	B Band	7,180	3.8%	34,196	1.9%	4,992
Roraima state	B Band	409	0.2%	1,864	0.1%	4,881
Federal district	A Band	2,409	1.3%	43,522	2.5%	19,071
Bahia state	A Band	14,017	7.5%	86,882	4.9%	6,350
Sergipe state	A Band	2,017	1.1%	13,121	0.7%	6,782
Rio de Janeiro state	A Band	15,650	8.3%	222,564	12.6%	14,639
Espírito Santo state	A Band	3,492	1.9%	34,488	2.0%	10,289
Rio Grande do Sul state	A Band	11,022	5.9%	142,874	8.1%	13,320
Vivo's service regions		138,814	73.8%	1,468,140	83.1%	10,210

Source: Instituto Brasileiro de Geografia e Estatística (IBGE)

- (1) Estimates from IBGE for the year end 2006.
- (2) According to the most recent IBGE data (2004).
- (3) Nominal Brazilian GDP was R\$1,766,621 million as of December 2004, calculated by IBGE.

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**Operating and Other Data.** The table below sets forth certain operating and other data for Vivo for 2004, 2005 and 2006.

	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>Vivo Operating Data</b>			
Cellular lines in service at year-end (in thousands)	26,543	29,805	29,053
Customer growth during year	5,887	3,262	(752)
Prepaid lines in service at year-end (in thousands)	21,357	24,061	23,543
Minutes of use (MOU)(1)	89	78	74
Average revenues per user (in Reais)(2)	32.8	28.7	27.2
Churn(3)	22.4%	21.8%	34.8%
Penetration at year-end(4)	37.0%	46.6%	55%
Estimated market share(5)	50.9%	44.4%	38.2%
Estimated market share of net additions(5)	38.1%	21.8%	(8.5)%
<b>Vivo Financial Data(6)</b>			
Net operating revenues (in millions of Reais)(6)	11,628.1	12,387.0	11,498.0
Net income (loss)(in millions of Reais)(6)	(61.5)	(814.7)	(144.5)

- (1) Monthly average, in minutes, of traffic per customer.
- (2) Net revenues from services per month divided by the monthly average of customers.
- (3) Churn is the number of customers that leave Vivo during the year, calculated as a percentage of the sum of the monthly average of customers.
- (4) Number of cellular lines in service in the region, including competitors, divided by the population of the region.
- (5) Source: ANATEL.
- (6) Reflects 100% of Vivo's results in accordance with IFRS.

**Services.** Vivo provides cellular telecommunications services using GSM/EDGE, CDMA and TDMA technologies. Its network provides both CDMA digital service and AMPS, an analog service that has been substantially phased out. All services are provided on the 850 MHz frequency.

Vivo provides voice and ancillary services, including voicemail and voicemail notification, call forwarding, three-way calling, caller identification, short messaging, limitation on the number of used minutes, cellular chat room, and data services such as wireless application protocol ("WAP") service through which clients can access WAP sites and portals. Vivo offers direct access to the Internet through either PCMCIA cards (Personal Computer Memory Card International Association, an organization consisting of some 500 companies that has developed small, standardized credit card-sized devices called PC Cards) designed to connect compatible PDAs (Personal Digital Assistant, a handheld device that combines computing, telephone/fax, Internet and networking features) and laptops or cellular phones through a cable connection that offers corporate subscribers secure access to their intranet and office resources. Vivo also offers some new services like Multimedia Message Service and MExE (Mobile Execution Environment), which enables the mobile handset to download applications and execute them along with a user interface for easier access to Vivo's services.

In 2006, Vivo launched:

"Vivo Localiza Familia" a location-based service that allows children to be located and monitored by their parents via cellular phones or the Internet;

"Vivo Localiza Amigos" a location-based service that enables customers to locate their friends, as well as to be located by their friends, using an address and a map of the applicable region;

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"Vivo Co-Piloto" a location-based service that assists the user in moving from one point to another in several Brazilian cities;

"Vivo Bolão" an interactive game that tests the user's knowledge of soccer;

"Instant Messenger" the most popular Internet instant messenger application (MSN), which is now made available for Vivo handsets through SMS;

"Vivo ao Vivo" new interface for Vivo GSM terminals;

"Vivo e Você na Copa" exclusive CBF (Brazilian Soccer Confederation) content, including games, tones, wallpaper, videos and a voice portal, during the World Cup;

"Vivo Chip" a service menu on GSM SIM Cards;

"Vivo Flash" a fixed-wireless connection to the Internet; and

"Vivo Torpedo E-Mail Corporate" a service that transforms the cellular phone number into an email address and enables users to receive every email sent to them as an SMS message.

Vivo has also improved its current product offerings, as follows:

"TV no Celular" (video streaming) now includes RTP (Radio e Televisão de Portugal) programming;

"Vivo Play 3G" now includes music content from Warner Music and Universal Music; and

"Vivo Portal de Voz" an auction service in partnership with SBT (Sistema Brasileiro de Televisão).

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 2006, there were approximately 99,918 million wireless subscribers in Brazil, and there was an estimated total market penetration rate of approximately 53% in Brazil as a whole, according to information published by ANATEL. In 2006, the Brazilian market experienced a 16% increase in the number of wireless subscribers and a 13% 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 Centro Oeste region. As of December 31, 2006, Vivo had approximately 29.1 million wireless subscribers, with an estimated market share of 38.2% in its areas of operation and 29.1% in Brazil.

The subscriber growth in Vivo's operating companies was also 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 and Sales.*** 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.



As of December 31, 2006, Vivo had 307 sales outlets (94 in São Paulo, 50 in the states of Rio de Janeiro and Espírito Santo, 33 in the state of Rio Grande do Sul, 37 in the states of Paraná and Santa Catarina, 24 in the states of Bahia and Sergipe, and 69 in the states that make up the midwestern and northern regions of Brazil). Vivo also has a network of 7,837 authorized retail and resales dealerships with a total of 8,144 points of sale.

Prepaid telephone card recharging was available at 322,863 locations, including Vivo's own stores, dealers, lottery shops, physical and online card distributors, and at smaller shops, drugstores, newspaper stands, book stores, bakeries, gas stations, bars and restaurants. Online recharging is also provided by several banks' websites.

**Customer Service.** In 2006, Vivo continued to outsource customer service, while maintaining management oversight. Customer service is available 24 hours from Vivo's call center and website.

Vivo's customer satisfaction is evaluated by regular satisfaction surveys. In the second half of 2006, 3,200 customers of Vivo and 2,200 customers of other non-affiliated companies were interviewed throughout Brazil about customer assistance, products and services. Vivo was ranked 8.21 on a scale from 1 to 10 for customer satisfaction, with the market average being 8.27. One of Vivo's most important objectives in 2006 was to retain its customers by increasing customer satisfaction. Towards this objective, Vivo took several actions. For example, one of the most frequent complaints from Vivo's customers was related to billing. Therefore, Vivo re-worked the billing process from the call center to the back office in order to speed up customer response time, to assure the quality of customer service and to increase the likelihood of first-call resolution. In addition, Vivo designed a new administrative structure to better track its premium customers and to suggest ways to improve retention.

**Network.** In 2006, Vivo began to implement a GSM network. Digitalization offers certain advantages, such as greater network capacity and additional revenue through the sale of value-added services. By December 31, 2006, Vivo's telecommunications network in the state of São Paulo, which provides both CDMA digital and GSM digital services, covered 100% of the municipalities. Vivo's network is connected primarily through a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, mainly from Telecomunicações de São Paulo S.A., or Telesp. The network consists of cellular switches, base stations and other network elements such as voicemail, prepaid service, Short Message Service, Home Location Registers, Signaling Transfer Point, PDSN and gateways. NEC do Brasil S.A., Nortel Networks Northern Telecom do Brasil, Motorola do Brasil Ltda., Lucent Technologies do Brasil, Ind. e Com. Ltda., Huawei do Brasil Telecomunicações Ltda. and Ericsson Telecomunicações S.A. are Vivo S.A.'s main suppliers in the state of São Paulo.

As of December 31, 2006, the telecommunications network in Parana and Santa Catarina, which provides both CDMA digital and GSM digital services, covered 59.8% of the municipalities, or 92.6% of the population, in its region. The Parana-Santa Catarina network is primarily connected by a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, mainly from fixed operating companies (Brasil Telecom and Embratel) and Copel Companhia Paranaense de Energia S.A. The network consists of cellular switches, base stations and other network elements, such as voicemail, prepaid service, Home Location Registers, Signaling Transfer Points and gateways. Motorola do Brasil Ltda., Huawei do Brasil Telecomunicações Ltda., Alcatel Telecomunicações S/A and Ericsson Telecomunicações S.A. are Vivo's main suppliers in the Paraná-Santa Catarina network.

As of December 31, 2006, Vivo provided CDMA Digital, GSM digital, TDMA digital and AMPS analog services in the midwestern and northern regions, covering 45.8% of the municipalities, or 80.9% of the population in its region. Vivo's network is connected primarily through a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, from incumbent wireline companies. The network consists of cellular switches, base-stations and other network elements such as voicemail, prepaid service, Short Message Service, Home Location Registers, Signaling Transfer Point

and gateways. Nortel Networks Northern Telecom do Brasil, Motorola do Brasil Ltda. (presently Motorola Industrial Ltda. and Motorola Services Ltda.), Huawei do Brasil Telecomunicações Ltda. and Ericsson Telecomunicações are Vivo's main suppliers in the midwestern and northern region.

As of December 31, 2006, the telecommunications network of Vivo in Bahia and Sergipe covered 44.7% of the municipalities, or 77.6% of the population, in its region. Its network provides both CDMA digital, GSM digital and AMPS analog services. The network is connected primarily through a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, mainly from Tele Norte Leste Participações S.A., or Telemar. The network includes cellular switches, base stations and other communication devices such as voicemail, prepaid service, Short Message Service and Home Location Registers. NEC do Brasil S.A., Ericsson Telecomunicações S.A., Nortel Networks Northern Telecom do Brasil, Motorola Industrial Ltda., Motorola Services Ltda. and Lucent Technologies do Brasil, Ind. e Com. Ltda. are Vivo's main suppliers in the Bahia and Sergipe regions.

As of December 31, 2006, the telecommunications network of Vivo in the states of Rio de Janeiro and Espírito Santo covered 100% of the municipalities in its area. Its network provides both CDMA digital, GSM digital and AMPS analog services. This network is connected primarily through a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, mainly from the incumbent wireline companies, and consists of cellular switches, base stations and other communication devices such as voicemail, prepaid service, Short Message Service, Home Location Registers, Signaling Transfer Point, PDSN and gateways. NEC do Brasil S.A., Nortel Networks Northern Telecom do Brasil, Ericsson Telecomunicações S.A., Huawei do Brasil Telecomunicações Ltda. and Lucent Technologies do Brasil, Ind. e Com. Ltda. are Vivo's main suppliers in Rio de Janeiro and Espírito Santo.

As of December 31, 2006, Vivo's network in the state of Rio Grande do Sul provides CDMA, GSM digital and TDMA digital and AMPS analog services, covering 70.1% of the municipalities, or 96.0% of the population, of this region. The Rio Grande do Sul network is connected primarily through a fiber-optic and radio transmission system, parts of which are owned and parts of which are leased, mainly from Brasil Telecom. The network consists of cellular switches, base stations and other communication devices such as voicemail, prepaid service, Short Message Service, Home Location Registers and gateways. Nortel Networks Northern Telecom do Brasil, Huawei do Brasil Telecomunicações Ltda., and Ericsson Telecomunicações S.A. are Vivo's main suppliers in Rio Grande do Sul.

Vivo's advanced network management technology increasingly ensures global management and supervision of all its network processes and network performance. The network management centers are located in São Paulo and Brasília. The network management center in São Paulo monitors the critical network operational parameters of São Paulo, Paraná, Santa Catarina and Rio Grande do Sul. The network management center in Brasília monitors the critical network operational parameters in the midwestern and northern regions, Rio de Janeiro, Espírito Santo, Bahia and Sergipe. These centers are able to identify abnormalities in both our network and in third parties' networks, using failure and signaling monitoring systems. In addition, quality and service standards are constantly monitored. The network management centers are integrated with maintenance and operations teams that maintain and operate cellular and radio network elements, computing bases, service platforms and communications backbones.

Vivo's network is prepared to provide continuity of service for its customers in the event of network interruptions. Vivo has developed contingency plans for potential catastrophes in our switching centers, power supply interruptions and security breaches.

Vivo is required to meet certain requirements for service quality and annual network expansion. See " *Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies.*" Vivo achieved all of its required network expansion obligations for 2006.

**Capital Expenditures.** The following table sets forth Vivo's total capital expenditures for the periods indicated:

Vivo	Year ended December 31,		
	2004(1)	2005(1)	2006(1)
	(in millions of reais)		
Switching equipment	582.1	523.0	375.9
Transmission equipment	623.8	862.8	844.4
Information technology	291.9	407.6	414.8
Other(2)	422.7	401.7	477.9
<b>Total capital expenditures</b>	<b>1,920.5</b>	<b>2,195.1</b>	<b>2,113.0</b>

(1) This financial information represents 100% of Vivo's capital expenditures, in accordance with IFRS.

(2) Consisting primarily of free handset rentals, network construction, furniture and fixtures, office equipment and store layouts.

Vivo's capital expenditures over the past three years have related primarily to increasing Vivo's network capacity and coverage. Vivo continued its projects for the improvement and expansion of the capacity of services rendered, which provided support to increase the CDMA 1XRTT and EVDO network, expansion of transmission routes, system centralization and integration (billing, collection and CRM, among others), development of new services and opening and renovating points of sale and terminals for the corporate segment.

In the aggregate, R\$2,113.0 million were invested during the year ended December 31, 2006, which included investments in the GSM/EDGE network and in the current CDMA/EV-DO network. This amount represented 18.4% of Vivo's net operating revenues.

Vivo's capital expenditures for 2007, estimated at R\$1.7 billion, are expected to include investments in network expansion (the GSM/EDGE overlay), introduction of new products and services to maximize the use of cellular phones, expansion of stores and improvement in the quality of services provided to customers. Vivo intends to pay these expenses with funds generated by operations and its available borrowing capacity.

**Interconnection Charges.** Vivo earns revenue from any call that originates from another cellular or fixed-line service provider's network connecting 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 " Business Overview Operating Agreements Interconnection Agreements". Tariff increases are subject to ANATEL review and approval.

In 2003, ANATEL adopted "Bill & Keep" rules for interconnection charges for traffic between the networks of SMP operators. Under these rules, an SMP mobile operator pays 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. In 2005, this regulatory regime contributed to a decrease in Vivo's revenues from interconnection fees charged to other companies. In July 2006, the Bill & Keep regime was discontinued. The current rule is "full billing," pursuant to which the SMP operator pays the entire call termination fee of the other mobile network. The partial "Bill and Keep" rule is still used between the SMP and SME (trunking) networks.

**Roaming Fees.** Vivo has agreements with major fixed-line providers for automatic roaming with all mobile 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. See " *Operating Agreements Roaming Agreements*".

**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. 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 will expire. Vivo has the same right to apply for renewal as other SMP license holders that migrate to the SMP regime from their existing concessions.

**Equipment Sales.** Vivo sells CDMA dual-mode (800MHz CDMA-1xRTT/AMPS and 800MHz CDMA/AMPS), GSM and tri-mode (800/1900 CDMA and 800MHz AMPS), and dual technology (CDMA and GSM) cellular handsets and data devices in CDMA EVDO technology (PCMCIA, USB and deskmodem) through its stores and dealers. Vivo has overlaid its TDMA network with a CDMA network and has stopped selling TDMA handsets. Although Vivo still has some customers using analog service (approximately 0.1% of its total customer base as of December 31, 2006), Vivo 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 encourage analog and TDMA customers to transfer to CDMA service. Vivo's current suppliers for handsets are Motorola, LG, Samsung, Nokia, Pantech, SonyEricsson, BenQ-Siemens, Aiko and Kyocera.

**Management.** In accordance with the shareholders' agreement between Portugal Telecom and Telefónica, Portugal Telecom is responsible for the appointment of Vivo's chief executive officer and Telefónica is responsible for the appointment of Vivo's chief financial officer. Following the mergers in February 2006, Vivo Participações S.A. (formerly TCP) continues to be managed by a Board of Directors and a Board of Executive Officers. Vivo's shareholders elect the members of the board of directors. The Board of Directors must have between three and twelve members, each serving a three-year term. The Board of Vivo Participações S.A. continues to consist of nine members, and the terms of the current members of the Board will expire in April 2009. The board of directors holds regular quarterly meetings, and the chairman or two board members may call special meetings.

## Operating Agreements

Vivo has agreements with major fixed-line and mobile operators in Brazil in order to lease physical space, real estate, air conditioning, energy, security and cleaning services. Vivo also leases transmission capacity necessary to complete the construction of our network infrastructure.

**Interconnection Agreements.** The terms of Vivo's interconnection agreements include provisions with respect to the number of connection points and traffic signals. See " *Regulation of the Brazilian Telecommunications Industry Obligations of Telecommunications Companies*" and " *Regulation of the Brazilian Telecommunications Industry Interconnection*".

**Roaming Agreements.** Vivo is a member of the Brazilian Roaming Association, a group composed of all companies providing cellular services in Brazil. This association was created to standardize roaming services in Brazil and elsewhere. The roaming agreements require Vivo and the other cellular service providers to provide service to roaming customers on the same basis that each member provides to its own customers, and to carry out a monthly reconciliation of roaming customer usage charges. Vivo offers CDMA automatic international roaming in the United States, Argentina, Uruguay, Chile, Canada, China, Mexico, Venezuela, Puerto Rico, New Zealand, the Dominican Republic and South Korea. Vivo also provides international GSM services through third-party partners using GSM handsets in most parts of Europe, Africa, the Americas, Asia and Oceania.

### **International Investments**

In 2004, we created Portugal Telecom Investimentos Internacionais Consultoria Internacional, S.A., or PT II, to manage all of our international businesses other than our investment in Vivo described above.

#### ***Investments in Brazil***

We have certain additional investments in Brazil, in addition to our investment in Vivo described above, including, most significantly, Mobitel, a call center company, and UOL, a leading Internet Service Provider.

**Mobitel.** Mobitel provides call center services in Brazil primarily to Vivo. Mobitel's gross operating revenues were R\$267 million in 2006 (€98 million) and R\$255 million in 2005 (€84 million). At the end of 2006, our participation in Mobitel was 100%.

**UOL.** UOL is a leading Internet Service Provider in Brazil. In December 2005, we sold a 16% stake in UOL in its initial public offering in Brazil and received net proceeds of R\$201.0 million. At the end of 2006, our participation in UOL was 29%. Revenues in 2006 were R\$480.7 million.

#### ***Investments in Africa***

We have certain investments in Africa, including most significantly, our investments in Angola, Cape Verde Islands, Namibia and Morocco.

**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, 2006, Unitel had 2,049 thousand subscribers of which 99.6% were prepaid cards.

Unitel's total gross operating revenues were US\$649.3 million in 2006 (€517.1 million) and US\$445 million in 2005 (€357.5 million).

**Cabo Verde Telecom.** We own 40% of the share capital of Cabo Verde Telecom. Cabo Verde Telecom provides fixed, mobile and data services in the Cabo Verde Islands, a Portuguese-speaking country off the coast of West Africa.

At December 31, 2006, Cabo Verde Telecom had 73.1 thousand fixed lines in service, which represents approximately 15 fixed main lines per 100 inhabitants. Cabo Verde Telecom had 108.9 thousand active mobile telephone cards at December 31, 2006 (approximately 22 active mobile telephone cards per 100 inhabitants), of which 99.5% were prepaid customers. At December 31, 2006, Cabo Verde Telecom reached 7.4 thousand active Internet users.

Cabo Verde Telecom's total gross operating revenues were €63.3 million in 2006 and €55.3 million in 2005.

**MTC in Namibia.** In September 2006, Portugal Telecom acquired 34% of the capital of MTC, the Namibian mobile operator. In connection with this transaction, we entered into an agreement with the other shareholders of MTC that allows us to set and control the financial and operating policies of this company. As of December 31, 2006, MTC had 610,000 customers, of which 91.6% were customers under prepaid plans. MTC revenues were 999.6 million Namibian dollars (€116 million) in 2006 and 824.8 million Namibian dollars (€104.3 million) in 2005.

**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%. At the end of 2005, Medi decreased its share capital from 8.834 million Dirhams (€803.0 million) to 4.683 million Dirhams (€425.0 million) in order to fulfill required capital ratios in Morocco. Portugal Telecom's share of Medi Telecom's capital remained the same (32.18%).

Medi Telecom began operations at the end of March 2000. By the end of 2006, it had 5,169 thousand subscribers, which corresponds to an estimated market share of approximately 32.6%. Approximately 97.1% of its active mobile telephone cards are prepaid. We manage the operations of Medi Telecom jointly with Telefónica.

Medi Telecom's total gross operating revenues were 4,691 million Dirhams (€425.1 million) in 2006 and 4,373 million Dirhams (€397.0 million) in 2005.

#### **Investments in Asia**

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

**CTM.** We have a 28% 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, 2006, CTM had 177.3 thousand fixed main lines in service. This figure represents approximately 39 fixed main lines per 100 inhabitants. CTM's mobile telephone services are growing rapidly, with 297 thousand active mobile telephone cards at December 31, 2006 and 66 active mobile telephone cards per 100 inhabitants. CTM uses GSM digital mobile technology.

CTM's total gross operating revenues were 2,101 million Patacas (€209.1 million) in 2006 and 1,895 million Patacas (€190.0 million) in 2005.

## 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 hold 100% of the share capital of PT SI. In recent years, PT SI has subcontracted certain information technology services to DCSI-Dados, Computadores e Soluções Informáticas, or DCSI, an information technology company controlled by IBM. In March 2006, we signed a contract with IBM to purchase DCSI.

**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 infrastructure 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 implementation 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.

For a list of Portugal Telecom's significant subsidiaries, see Exhibit 8.1 to this Annual Report of Form 20-F, which exhibit is incorporated herein by reference. For further details on our percentage interest in our subsidiaries and their business activities, see the exhibits to our audited consolidated financial statements.

## 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. 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 Brasilcel through PT

Móveis, and Telefónica holds its interest through Telefónica Móviles. Our agreements governing the ownership and management of Brasilcel have been entered into by those entities.

Brasilcel is managed by a Managing Board of four members and a Supervisory Board of 12 members. We and Telefónica each appoint two members of the Managing Board and six members of the Supervisory Board, and in each case the Chairman is appointed by Telefónica and the Vice Chairman is appointed by us. The Managing Board acts by unanimous decision so long as each party holds at least a 40% interest in Brasilcel, and for certain important decisions, the Managing Board requires the approval of the Supervisory Board. The Supervisory Board acts by majority vote, except that generally so long as each party holds at least a 40% interest in Brasilcel and for six months following the dilution of a party's interest below 40% due to a capital increase, at least one member of the Supervisory Board appointed by each party must approve any action by the Supervisory Board.

In the event that either our or Telefónica's 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, Brasilcel would be managed on an equal basis. We or Telefónica can maintain our share ownership percentage by contributing with cash or liquid assets. Should the percentage of the share capital in Brasilcel 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 of Brasilcel's subsidiaries, as applicable, as described below.

If a deadlock over an important issue in the decision-making of Brasilcel 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".

Potential acquisitions of wireless and mobile telephone operators in Brazil may be pursued by Brasilcel or by us or Telefónica and subsequently contributed to Brasilcel. New acquisitions by Brasilcel require the approval of a majority of the board of directors of Brasilcel. 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.

Under the agreement, we select the CEO of each subsidiary of Brasilcel, including Vivo Participações S.A. (formerly known as TCP), and Telefónica selects the CFO. So long as the board of directors of any subsidiary of Brasilcel consists of nine members (as is the case with Vivo Participações S.A.), we and Telefónica will each nominate three members to the board of directors. We and Telefónica have agreed to coordinate our votes for meetings of the boards of directors of Brasilcel's subsidiaries at the level of Brasilcel.

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 Brasilcel to the affected party at a value determined pursuant to an independent appraisal. A change of control occurs if 15% or more of the voting rights of Portugal Telecom or Telefónica S.A. are acquired by another telecom operator not acting in concert with the other party, if a corporate transaction is affected by virtue of which the voting share capital of Portugal Telecom or Telefónica S.A. is at least doubled and there is a change in the majority of the board of directors of that party or, in the case of any entity or affiliate of the Portugal Telecom or Telefónica group that holds an interest in Brasilcel (other than Portugal Telecom and Telefónica S.A.), if the majority of the voting rights of that entity or affiliate is transferred to another telecom operator and there is a change in the majority of its board of directors. In addition, if we are diluted to below a 40% interest in Brasilcel and fail to increase our interest to 40% within a six-month period, we will have the right to sell our interest in Brasilcel to Telefónica within one year from the expiration of the applicable six-month period at a price to be determined by a third party.

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If either party wishes or is required to transfer all or part of its equity interest in Brasilcel to a third party, the non-transferring party will have a right of first refusal to purchase the equity interest or, alternatively, a tag-along right to sell its equity interest under specified conditions.

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, 2006, Telefónica's interest in our share capital was 9.96%. As of December 31, 2006, 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, 2006, BES owned 7.77% 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. General Humberto Delgado, 342/368, Coimbra, Portugal (13,321 square meters);

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

R. Andrade Corvo, <sup>10</sup>/<sub>14</sub>, Lisboa, Portugal (10,300 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).

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

Av. Fontes Pereira de Melo, <sup>38</sup>/<sub>40</sub>, 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);

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," "Sapo," "TMN," "PT Multimédia," "TV Cabo," "Netcabo", 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 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. We describe the competitive conditions of each of our business segments below.

#### *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 wire lines in Portugal. At the end of 2006, there were approximately 115.7 active mobile telephone cards per 100 inhabitants in the Portuguese market. This growth is a result of residential subscribers adding mobile cards for family members and businesses adding mobile cards for their employees. Vodafone Portugal and Optimus are already marketing their mobile services as an alternative to our wireline telephone services, and we compete with them for market share. For example, Optimus and Vodafone have launched services called "Optimus

Home" and "Vodafone Casa," respectively, that use their GSM mobile networks but use fixed line phone numbers. TMN requested an authorization to launch a similar service and received that authorization in 2007. The low-cost brands launched by TMN, (Uzo) Optimus, (Rede 4) and Vodafone (Directo) are designed to reach the lower end segment of the mobile

market and have also had an effect on our fixed line retail service, exacerbating the trend among consumers toward switching from fixed line to mobile service.

Vodafone Portugal and Optimus (owned by Sonae and France Telecom) have major shareholders that can provide them with substantial resources. In addition to strengthening their position in the mobile telephone market, these resources enable them to compete directly and aggressively with our fixed-line telephone services.

According to ANACOM figures, on December 31, 2006, PT Comunicações, which provides retail services as part of our wireline business, had an estimated 78.7% market share of access lines (89.3% in 2005). According to ANACOM figures and our estimates at December 31, 2006, PT Comunicações had an estimated 78.2% market share of total outgoing traffic (in minutes), a decrease of 6.3 percentage points from December 31, 2005. In addition, PT Comunicações had an estimated 70.5% market share of domestic outgoing voice traffic (in minutes), a decrease of five percentage points from December 31, 2005.

Our primary competitors in the wireline voice market include Tele 2, Novis (owned by Sonae and France Telecom), Oni Telecom Infocomunicações, S.A. (owned by certain investment funds), AR Telecom (formerly Jazztel) and Colt. 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.

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, 2006, we estimate that there were approximately 430 thousand lines in pre-selection. For example, Tele 2 has been effective in using carrier pre-selection to increase its market share.

We are losing 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, 2006, according to ANACOM data and our estimates, PT Comunicações had an estimated 76.4% market share of international traffic (in minutes), an increase of 4.7 percentage points from December 31, 2005, although the market share of PT Comunicações decreased by an estimated 4.4 percentage points from December 31, 2004 to December 31, 2005. 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 also 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 2006, prices reduced by 5.9% for regional calls and 16.0% for domestic long distance on average, compared with 2005. 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*". 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, and we see the same trends in Portugal.

**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.

**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, Colt, AR Telecom (formerly Jazztel) and Vodafone Portugal. These companies compete with us in providing data communications, voice services 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 and complex virtual private network services with data, voice and video integration.

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 are focusing on value-added solutions based on Internet Protocol Virtual Private Networks, or IP VPN.

#### ***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 2006, in terms of the number of active mobile telephone cards in the Portuguese market, TMN had a 46.7% market share. TMN has made maintaining its market share a priority. As a result of a very competitive market, TMN's market share of mobile subscribers increased 0.3 percentage points in 2006 compared to 2005.

TMN's competitive strategy includes focusing on excellent subscriber care and innovative services. As a result of its customer service, TMN received the "Call Centre 2006" award for best practices. In addition, TMN and Tektronix Inc., which designed the software that allows TMN to evaluate the performance and efficiency of its second and third generation networks, received an award for the "Best Network Quality Initiative" at the GSM Association Awards 2006 in February 2006.

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. Sonae and France Telecom are the major shareholders in Sonaecom, the holding company that controls Optimus.

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 has heightened competition and reduced the 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 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 mid-2005, Optimus introduced a low-cost brand "Rede 4" in response to our new brand "Uzo". Vodafone also launched a similar product called Directo in mid-2005 targeting the same market as Uzo and Rede 4.

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

Certain cable television operators are authorized to provide services in Portugal in addition to PT Multimédia's subsidiary, TV Cabo. PT Multimédia's competitors operate principally in Portugal's major cities and include Cabovisão, Pluricanal Santarem, Pluricanal Leiria, TV TEL and Bragatel. According to ANACOM figures, we estimate that at the end of 2005, TV Cabo's competitors had approximately 17% of the total number of subscribers in the pay-TV market.

TV Cabo currently has control over nine cable authorizations covering 125 counties in seven regions in continental Portugal and the Madeira and Azores Islands, all of which expire in May 2009. In February 2004, a new regulatory framework was introduced under which no specific authorizations or licenses for the provision of cable television services are required. After the current authorizations expire, the existing licenses will not be renewed and the new regulatory framework will apply. See " *Regulation TV Cabo's Cable Television Authorizations*". We therefore expect competition to increase as a result of this regulatory flexibility.

PT Multimédia competes for advertising revenue with terrestrial television companies (free-to-air channels) 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. In 2005, the Portuguese government announced that it intends to reopen competitive bidding for a license to provide digital terrestrial television services in Portugal, which could result in increased competition for TV Cabo. In 2007, the Portuguese government is expected to open competitive bidding for one or more licenses for the provision of digital terrestrial television services.

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 2005, Ar Telecom (formerly Jazztel), a direct competitor, launched broadband wireless service in the geographic areas where it operates. Also, we expect video over ADSL to increase competition. Novis launched an IP television offer in 2006 that competes with PT Multimédia's television services, and Portugal Telecom launched IPTV service at PT Comunicações in June 2007.

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

In the four main sub-segments of this business segment (film distribution, cinema exhibition, video 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 Vitoria 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, according to ICAM, the Portuguese Cinema, Audiovisual and Multimedia Institute.

***Competition Facing Vivo in Brazil***

Vivo faces intense competition in all the areas in which it operates, principally from other mobile service providers and also from fixed-line operators. Many of these competitors are part of large, national or multinational groups and therefore have access to financing, new technologies and other benefits that are derived from being a part of such a group. Fixed-line operators generally charge much lower tariffs than mobile service providers.

Vivo's main mobile competitor in the state of São Paulo is Claro. Claro is controlled by a consortium led by the Telecom Américas Ltd. (controlled by América Móvil S.A. de C.V.). Claro began providing cellular telecommunications services in this region at the end of 1998. Although Claro provides only digital service, its customers use TDMA dual mode cellular handsets that can operate on an analog network and GSM handsets. The main fixed-line operator in this state is Telecomunicações de São Paulo S.A. Telesp, known as Telefónica.

Vivo's principal cellular competitor in the states of Paraná and Santa Catarina is Tele Celular Sul Participações S.A., or TIM Sul. The main fixed-line operator in those states is Brasil Telecom S.A. Vivo's principal mobile competitor in the region encompassing the states of Mato Grosso do Sul, Mato Grosso, Goiás, Tocantins, Rondônia and Acre and the Federal District is Claro, and its principal competitor in the region encompassing the states of Amazonas, Roraima, Pará, Amapá and Maranhão is TIM. The main fixed-line operators in this area are Brasil Telecom S.A., in the region encompassing the states of Mato Grosso do Sul, Mato Grosso, Goiás, Tocantins, Rondônia and Acre and the Federal District, and Telemar Norte Leste S.A. Telemar, in the region encompassing the states of Amazonas, Roraima, Pará, Amapá and Maranhão. Other competitors include Oi, the Telemar mobile operator.

In the Salvador and Sergipe service areas, Vivo's main mobile competitor is Oi (TNL PCS S.A.). Other mobile competitors are TIM (Maxitel S.A.), which also operates in the state of Minas Gerais, and Claro (Stemar Telecomunicações Ltda.). The principal fixed-line competitor in this area is Telemar Norte Leste S.A.

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In the Rio de Janeiro and Espírito Santo service areas, Vivo's main mobile competitor is Claro. The principal fixed-line operator in this area is Telemar Norte Leste S.A. Oi also competes in the mobile market and is integrated with Telemar.

In Rio Grande do Sul, Vivo's primary mobile competitor is Claro, and its other mobile competitors are Brasil Telecom S.A. and TIM. Vivo's main fixed-line competitor in this area is Brasil Telecom.

Vivo also competes with certain other wireless telecommunications services in specific segments, such as mobile radio (including digital trunking technology, offered by Nextel), paging and beeper services, which are used by some operators in its areas as a substitute for cellular telecommunications services. These competing wireless telecommunications services are generally less expensive than mobile telecommunications services.

Satellite-operated services, which provide nationwide coverage, are also available in Brazil. Although these services have the advantage of covering much larger areas than those covered by the cellular telecommunications services, they are considerably more expensive than the mobile telecommunications services Vivo offers and do not provide competitive coverage inside buildings.

### 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 1990 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, relate to:

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; and

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

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 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 as part of Law 5/2004, the Law of Electronic Communications (which we refer to as "Law 5/2004"). The fifth directive was adopted into law on August 18, 2004. In 2006, the European Commission began a review of the new EU framework, and a new version of the European directives is expected by the end of 2007.

The implementation of the new EU framework is changing 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 all of these markets, the new regulatory regime could result in an increase in the regulatory measures affecting our businesses and operations. Under the EU framework directive, ANACOM is required to 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 analyzed 16 of the 18 retail and wholesale markets. ANACOM considers the Portugal Telecom group to have significant market power in all the markets it has analyzed except for one in which it did not find any operator to have significant market power (wholesale transit services) and one in which the results of its analysis are pending (the wholesale broadcasting transmission market). These markets include the following: (1) 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), publicly available international telephone services provided at a fixed location (residential and business), and leased lines; and (2) 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, wholesale leased lines (trunk segments and terminating segments) and wholesale broadband access. 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, such as toll-free 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. Likewise, all mobile network operators were found to have significant market power in the call termination on individual mobile networks. ANACOM has not yet started the analysis of the two remaining wholesale markets, which are roaming services and access and call origination on mobile telephone networks. Final decisions with respect to the existence of significant market power in access and call origination on the mobile networks market is expected during the course of 2007.

In addition, Law 5/2004 has made more flexible 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.

### ***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.

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.

**European 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. In 2005, Sonaecom filed a complaint with the Directorate-General for Competition of the European Commission relating to our activities and the regulatory framework of the Portuguese government. However, the Commission responded that the complaint should be addressed by the Portuguese Autoridade da Concorrência. To our knowledge, proceedings before the European Commission relating to this complaint are now closed. 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 provided PT Comunicações with the exclusive right to use public rights-of-way free of municipalities' fees and taxes. However, the rights-of-way regime was modified in 2004 through Law 5/2004, as described below in "*Summary of Our Concession and Existing Licenses*". Since we have not been party to the communications between the Directorates-General and the Portuguese government, we are unable to assess whether or not Law 5/2004 has resolved any concerns the Directorates-General may

have had regarding the regulation of rights-of-way in Portugal. We further understand that the Directorate-General for Information Society of the European Commission requested information from the Portuguese government regarding the designation of the universal service provider (currently, PT Comunicações) and regarding the Portuguese government's intention to launch a transparent procedure in order to appoint the universal service provider.

In April 2006, the European Commission sent to the Portuguese government a formal request to abandon the special rights the Portuguese government holds as the sole owner of our A shares. The European Commission believes that the special powers granted to the Portuguese government through the sole ownership of our A shares act as a disincentive for investment by other EU member states in a manner that violates European Community Treaty rules. Should the Portuguese authorities not take satisfactory steps to remedy the alleged infringement of EU law, the European Commission may decide to refer the case to the European Court of Justice.

**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 related to pricing, 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 related to our activities pending before the Autoridade da Concorrência, including complaints against: (i) PT.com (this complaint was formerly against Telepac, which merged with 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; and (iii) PT Comunicações for alleged anti-competitive practices in the public wireline telephone market and for granting discriminatory discounts on leased lines.

In addition, in 2004 the Autoridade da Concorrência initiated a proceeding against PT Comunicações, referred to as a "statement of objections", alleging that PT Comunicações was denying access to the ducts in which the basic telecommunications network is installed. PT Comunicações has responded to this "statement of objections" and does not believe it has violated applicable law and regulations. In June 2005, the Autoridade da Concorrência issued a revised "statement of objections" on this matter. In September 2005, the Autoridade da Concorrência also brought allegations against PT

Multimédia and TV Cabo for practices allegedly in violation of Article 4 of Law 18/2003 (the Portuguese Competition Law) following the execution in 2000 of a partnership agreement among PTM, TV Cabo and SIC-Sociedade Independente de Comunicação, S.A. (SIC) in connection with SIC's acquisition of Lisboa TV Informação e Multimédia, S.A. In response to this accusation, PT Multimédia and TV Cabo contested the alleged by the Competition Authority. However, in August 2006, the Competition Authority imposed a fine of €2.5 million on PT Multimédia. PT Multimédia and TV Cabo appealed to the Commerce Court of Lisbon on September 8, 2006. The appeal suspended the decision of the Portuguese Competition Authority.

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

ANACOM established a new pricing regime for wireline services on December 14, 2004 in accordance with the terms of the new EU regulatory framework. This pricing regime created the following regulatory obligations for 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 within this price cap became effective as of July 1, 2005);

The fixed component of fixed-to-mobile calls (residential and non-residential) is 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, which was financed by the Portuguese government until December 2006.

In 2006, our wireline business, PT Comunicações, submitted to the regulator a new pricing scheme that included a flat-rate plan with unlimited off-peak calls on weekdays.

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.

***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. During 2006, PT Comunicações published its reference interconnection offer for the provision of interconnection at a flat rate. See also "*Interconnection*" below.

***Prices for Leased Lines.*** Prices for our leased lines are subject to price controls as a result of obligations imposed by ANACOM, based on its finding that we have significant market power in retail leased lines, wholesale termination and trunk segments. Our leased line prices must be cost-oriented and follow the retail-minus rule (which provides for a 26% minimum margin between our wholesale and retail leased line prices).

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

Law 5/2004 and the Concession impose 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, publishing directories and making available at least one telephone directory enquiry service covering all public voice telephone subscribers' numbers.

According to Law 5/2004, if ANACOM determines that the provision of universal service obligations has become an excessive burden, it may compensate us accordingly. PT Comunicações has submitted to ANACOM the annual universal service costs (from 1996 to 2003) in order to obtain compensation. Since 2004, it has been the responsibility of ANACOM to calculate the costs of providing the universal service. We believe that obtaining significant compensation under this provision of the law will be very difficult and may not be possible.

### ***Interconnection***

***The Interconnection Framework.*** The EU Access and Interconnection Directive requires that interconnection services be made available in a non-discriminatory manner. The EU Access and Interconnection Directive encourages commercial negotiations among operators but requires national regulatory authorities to establish mechanisms for effective dispute resolution. According to the EU Access and Interconnection Directive, all telecommunications companies with significant market power in the call origination or termination markets 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.

Law 5/2004 implemented the EU Access and Interconnection Directive in Portugal 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.

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.

***Wireline Interconnection.*** 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. As a result, we are subject to price controls in these markets based on our costs and other factors and must publish a reference offer that includes these prices and quality of service standards.

***Mobile Interconnection.*** In February 2005, all mobile operators were declared to have significant market power in call termination in mobile networks market. ANACOM has accordingly imposed price controls on interconnection rates for the termination of calls on mobile networks. In 2005, interconnection rates (both fixed-to-mobile and mobile-to-mobile) were reduced by an average of 23.5% compared with 2004 rates. In 2006, these rates were reduced by an average of 18.5% compared to the 2005 rates. These reductions have had, and are expected to continue to have, a significant impact on TMN's interconnection revenues and consequently its earnings. See "*Item 5 Operating and Financial Review and Prospects Results of Operations*".

ANACOM is in the process of analyzing call origination on the mobile networks market in order to determine who has significant market power in such market. A decision is expected in 2007.

**Internet Access.** The interconnection regime for access to our network by ISPs provides for a number of different billing structures. Under the first method, ISPs pay us a call origination charge, and, if the ISPs request that we invoice customers on their behalf, they also pay us the corresponding charge for the invoicing service. Under a second method, we charge 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, which previously applied only to interconnection for voice telephony services. Accordingly, we now offer two access regimes to ISPs: (1) the Reference Offer for Internet Access, which includes the two pricing methods described above, and (2) 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 with ISPs now include two billing structures. The primary differences between the two billing structures relate to origination prices, the manner in which ISP infrastructures are connected to our 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 us to maintain billing arrangements with ISPs. The ISPs determine which billing regime will apply to their arrangements to connect with our wireline network.

#### ***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.

Number portability regulations were revised in 2005 through Regulation 58/2005 of August 18, 2005, but the revisions did not have a significant impact on our business. New regulations for carrier pre-selection were also published in early 2006, extending carrier pre-selection to non-geographic 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 regularly publishes updated versions of the reference offer for unbundled access to our local loops in accordance with terms established by ANACOM.

We have made available to our competitors all of the local switches for remote and physical co-location where technical and space conditions are available. Co-location means providing space and technical facilities to competitors to the extent necessary to reasonably accommodate and connect the relevant equipment of the competitor.

#### ***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. In addition, a new Regulation of Quality of Service for voice services at fixed locations was published in June 2005 (Regulamento 46/05).

#### ***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. A new Data Protection Directive was adopted by the European Commission in 2006, imposing data-retention obligations on operators. 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 Competition Directive***

The European Commission issued a directive on September 16, 2002 (Directive 2002/77/EC) that requires member states to enact legislation directing incumbent telecommunications operators to separate their cable television and telecommunications network operations into distinct legal entities. We believe that steps already taken to operate our cable television business in Portugal through PT Multimédia, a separate legal entity, have satisfied the requirements of the directive implemented in Portugal. In addition, we believe that the proposed spin-off of our interest in PT Multimédia will address the long-standing objections of the Portuguese regulators in this regard.

#### ***Licensing Framework***

The EU Authorization Directive (Directive 2002/20/EC of March 7, 2002) prohibits any limitation on the number of new entrants in telecommunications markets, except as required to ensure an efficient use of radio frequencies.

Pursuant to this Directive, which is part of the EU electronic communications framework, Law 5/2004 has established a new authorization regime, whereby an operator must have a general authorization for the provision of electronic communications networks or services. A license can be required for the use of radio frequencies or numbering resources. ANACOM is responsible for issuing regulations to implement this authorization regime.

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

Our Concession is for the provision of universal service and for the operation of 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) in 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. 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 would be

entitled to 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.

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. 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. This regime was implemented in 2005 pursuant to Regulation No. 38/2004, which was published in September 2004. The new regime replaces Law 91/97, which granted us an exemption 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 still being challenged in the Portuguese courts by the Municipality of Oporto. See "*Item 8 Financial Information Legal Proceedings Claims for Municipal Taxes and Fees*".

We are required to provide special telephone prices to certain eligible retired and pensioner Portuguese citizens. Until December 31, 2006, the costs of providing these special prices were 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 €7.8 million in 2005 and €6.4 million in 2006.

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 €5,000,000 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.

***Our Data Licenses and Registrations.*** Our subsidiary PT Prime holds:

a non-exclusive license to provide wireline services;

a non-exclusive license to be a "Public Telecommunications Networks" operator; and

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

Our data communications license authorizes us 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 us to provide value-added services such as electronic data interchange and videotext services. In addition, the license authorizes us 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, unless our wireline Concession is terminated earlier. 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 Law 5/2004, 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.

**Our Mobile Service Licenses.** Mobile telephone service licenses are valid for 15 years and are issued by ANACOM under Law No. 5/2004 (which revoked Decree Law 381-A/97). These licenses authorize the use of radio spectrum and 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. The authorization for the use of GSM radio spectrum was renewed in December 2006 and is now valid until 2021. 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.

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 information about our mobile telephone operations, including the number of customers, number and average duration of calls on a quarterly basis. We are also required to provide annual information to ANACOM about the development of infrastructure.

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 enables 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 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, and TMN's license expires in January 2016. In addition, TMN and the other mobile operators have committed to making contributions to the Portuguese information society. 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 TMN, Vodafone and Optimus requested that the Oniway license be transferred to them, dividing the cost and the resulting spectrum. This request was granted by a special ministerial order in January 2003.

In April 2004, TMN launched UMTS in Portugal with an emphasis on new services, such as video telephony and high-speed data. In 2004 and 2005, we have pursued a strategy of gradual improvements to network coverage, using existing GSM sites where possible in order to minimize the need to install costly new sites.

UMTS 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.

**TV Cabo's Cable Television Authorizations.** Under the new regulatory framework set out in Law No. 5/2004, of February 10, 2004, the provision of cable television networks and services is subject only to a general authorization regime, which depends on the compliance with the rules provided for in the law and regulations. That is, the new framework does not require specific authorizations or licenses from ANACOM.

Currently, TV Cabo and its subsidiaries Cabo TV Açoreana and Cabo TV Madeirense, hold nine cable television authorizations to provide cable television services in 125 counties in continental Portugal and the Madeira and Azores Islands. All of these authorizations expire in May 2009 and will not be renewed, allowing the new regulatory framework to take effect. Currently, certain other operators are also authorized to provide cable television services in Portugal. See "*Competition Competition Facing PT Multimédia's Pay TV and Broadband Internet Business*". All these authorizations permit the construction of cable distribution centers and 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 charges for the provision of cable television services are not subject to regulation.

Under Portuguese law, advertising on TV Cabo's channels is generally restricted on the same terms as on 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.

## **Brazil**

**General.** Vivo's mobile business, the services it provides and the prices it charges 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 telecommunications 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. The government authority is also 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, in September 2004 and in March 2006. In July 2006, the Bill & Keep regime was discontinued. The current rule is "full billing", pursuant to which the SMP operator pays the entire call termination fee of the other mobile network. The partial "Bill and Keep" rule is still used between the SMP and SME (trunking) networks.

Under these new licenses:

services are to be provided using the 1,800 MHz frequency;

each operator may optionally provide domestic and international long-distance services in its licensed area;

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, can bid for band C, band D and band E licenses. However, fixed-line operators, their controlling shareholders and affiliated cellular providers can only bid for band D and band E licenses;

a cellular operator, or its respective controlling shareholders, may not have geographical overlap between licenses; and

current band A and band B cellular service providers can 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, Vivo's operating subsidiaries 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.

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.

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.

*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 providers. The terms and conditions of the interconnection agreements are freely negotiated between parties, subject to price caps and other rules established by ANATEL. 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. If the parties cannot agree on the terms and conditions of interconnection, ANATEL may determine the terms and conditions by arbitration. 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.

In 2005, ANATEL further standardized interconnection regulations to facilitate negotiation of interconnection agreements between wireline operators and mobile operators, referred to as the *Sistema de Telefonia Fixa Comutada* (Fixed Telephony Interconnection System, or STFC).

*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.

Vivo's 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).

*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.

**Internet and Related Services.** In Brazil, Internet service providers, or ISPs, are deemed to be suppliers of value-added services and are not considered telecommunications service providers. ANATEL's Resolution 190 requires cable operators to act as carriers of third-party Internet service providers. The Brazilian House of Representatives is considering a law that would penalize Internet service providers for knowingly providing services that allow illegal goods or services to be sold on the Internet and would impose confidentiality requirements on Internet service providers regarding nonpublic information transmitted or stored on their networks. This would affect Vivo indirectly because mobile phones are used extensively for Internet traffic.

**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 4A UNRESOLVED STAFF COMMENTS**

We received a comment from the staff of the Securities and Exchange Commission (the "Staff") in connection with our Annual Report on Form 20-F for the year ended December 31, 2005 asking whether our equity investee Universe Online S.A. ("UOL") was significant under Rule 3-09 of Regulation S-X for such year. We have concluded that our interest in UOL represented a significant portion of our net income from continued operations before change in accounting principles under U.S. GAAP for purposes of Rule 3-09 of Regulation S-X for the year ended December 31, 2005. Consequently, we have included in Item 18 to this Annual Report (1) audited financial statements for UOL for the years ended December 31, 2005 and 2006 and (2) a descriptive disclosure of the differences between U.S. GAAP and Brazilian Generally Accepted Accounting Principles (BGAAP) applicable to UOL. We understand that the related Staff comment will be resolved upon the inclusion of such financial statements in this Annual Report.

#### **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 International Financial Reporting Standards, or IFRS, as adopted by the European Commission for use in the European Union. IFRS differs in significant respects from U.S. GAAP. For a discussion of the principal differences between IFRS and U.S. GAAP, as they relate to us, see "*U.S. GAAP Reconciliation and Recent Accounting Pronouncements*" below and Notes 47, 48 and 49 to our audited consolidated financial statements.

**Overview**

***Our Business 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 and the manner in which our management views and manages our operations. Portugal Telecom's businesses consist of the following:

Wireline Business	<p>Offering the following wireline services:</p> <p style="padding-left: 40px;">Retail services, including fixed line telecommunications service and Internet services to residential customers;</p> <p style="padding-left: 40px;">Wholesale services; and</p> <p style="padding-left: 40px;">Data and corporate services, including data communications, leased lines, outsourcing and net solutions, and Internet business-to-business.</p>
Domestic Mobile Business	<p>Offering mobile services, such as voice, data and Internet-related services, through TMN.</p>
Multimedia Business	<p>Offering multimedia and Internet-related services for the residential market through PT Multimédia and its subsidiaries, including:</p> <p style="padding-left: 40px;">Cable and satellite television through TV Cabo;</p> <p style="padding-left: 40px;">Broadband Internet access through cable modems provided by TV Cabo;</p> <p style="padding-left: 40px;">TV programming activities through PT Conteúdos and its subsidiaries and affiliates;</p> <p style="padding-left: 40px;">Cinema distribution, negotiation of cinema rights for all film exhibition windows and distribution of DVDs, videos, and videogames through Lusomundo Audiovisuais; and</p> <p style="padding-left: 40px;">Cinema exhibition through Lusomundo Cinemas.</p>
Brazilian Mobile Business	<p>Offering mobile services in Brazil, such as voice, data and Internet-related services, through Vivo.</p>
Other	<p>International investments other than Vivo, instrumental companies and the Portugal Telecom, SGPS S.A. holding company. Our international investments other than Vivo mainly include:</p> <p style="padding-left: 40px;">Mobitel, providing call center services in Brazil, which we fully consolidate in our audited consolidated financial statements;</p> <p style="padding-left: 40px;">Cabo Verde Telecom, providing fixed and mobile telecommunications services in the Cabo Verde Islands, which we fully consolidate in our audited consolidated financial statements;</p> <p style="padding-left: 40px;">MTC, providing mobile telecommunications services in Namibia, in which we acquired a 34% stake in September 2006 and which we fully consolidated in our audited consolidated financial statements for the last four months of 2006;</p>

Medi Telecom, providing mobile telecommunications services in Morocco, which we account for using the equity method;

Unitel, providing mobile telecommunications services in Angola, which we account for using the equity method; and

CTM, providing fixed and mobile telecommunications services in Macao, which we account for using the equity method.

#### ***Consolidation Treatment of Vivo and Sport TV***

***Vivo.*** We provide mobile telecommunications services in Brazil through Vivo Participações S.A., or Vivo. We hold our participation in Vivo through our 50% interest in Brasilcel N.V., a joint venture with Telefónica. Following a series of reorganizations described in "Item 4 Information on the Company Our Businesses Brazilian Mobile Business", Vivo Participações S.A. has one wholly owned subsidiary, Vivo S.A. As of December 31, 2006, Brasilcel and its subsidiaries held 88.85% of the common shares of Vivo Participações, 47.76% of its preferred shares and 62.77% of its total share capital.

We proportionally consolidate the financial results of Vivo in our consolidated financial results for the years ended December 31, 2004, 2005 and 2006.

***Sport TV.*** We acquired an additional 16.6% stake in Sport TV in a purchase completed in April 2004, increasing our ownership in that company to 50%. We proportionally consolidate the financial results of Sport TV in our consolidated financial results for the years ended December 31, 2004, 2005 and 2006.

#### ***Business Drivers and Measures***

The businesses of each of our segments are affected by a number of significant industry trends. In operating our businesses and monitoring their performance, we also pay attention to a number of operational and other factors. We summarize some of these trends and factors for each of our business segments below.

##### ***Wireline Business***

***Traffic Trends.*** Since 2002, we have experienced a continuing decrease in traffic on our fixed line network, primarily as a result of the trend among consumers to use mobile phones rather than fixed line service and increasing competition from mobile operators, other fixed line operators and, more recently, cable and VoIP providers. This decrease in traffic has negatively affected both our retail and wholesale revenues. We have also experienced strong increases in customers of our ADSL broadband Internet services, as well as a corresponding decrease in dial-up Internet use. See "Item 4 Information on the Company Our Businesses Wireline Business Fixed Line Network" and "Traffic".

***Decreasing Fixed Line Calling Prices and Greater Focus on Pricing Plans.*** Retail calling prices, particularly for regional, national and international calls, have been decreasing steadily in recent years, which has negatively affected our retail revenues. One of our strategies in response to this trend has been to aggressively market a variety of pricing plans to promote customer loyalty in our competitive market. Our pricing plans tend to increase our revenues from fixed charges but sometimes decrease our traffic revenues, particularly with respect to the growing percentage of pricing plans that offer calls at a flat rate. In our wholesale business, the decrease in regulated fixed-to-mobile interconnection charges has also affected our revenues because our wholesale wireline unit records revenue from international incoming calls through our network that terminate on the networks of mobile operators, although the impact on our results of operations

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relating to wholesale services has not been significant. Decreases in transit traffic (calls that use our network but neither originate nor terminate on our network) also have affected our wholesale revenues. See "Item 4 Information on the Company Our Businesses Wireline Business Retail Fixed Line Telephone Services" and " Wholesale Prices".

*Workforce Reductions and Post Retirement Obligations.* We expect to continue to use workforce reductions to decrease our labor costs and increase our productivity over time. In 2006, we reduced our workforce in Portugal by 792 employees, incurring expenses of €229.2 million to do so. Workforce reductions in our fixed line business will continue to be a significant feature of our cost management in 2007. In addition, we have substantial unfunded liabilities for unfunded pension and healthcare benefits during those periods. In 2005, we established an autonomous fund, to which we contributed €300 million in 2005 and €302 million in 2006 to finance our post retirement healthcare obligations, and we also made contributions to our pension funds. We expect that contributions to these funds will continue to represent significant outflows in the coming years. In the second half of 2006, we made changes to the health care plan of our wireline business in order to maintain its long-term sustainability, which resulted in a reduction in healthcare obligations of €146 million, of which €127 million were recorded as a prior years' service gain. In addition, in December 2006, our subsidiary PT Comunicações and the Portuguese national health care system (SNS) agreed to terminate the protocol entered into in 2004 related to the health care plan, which resulted in a reduction of liabilities of €220.4 million recorded in the income statement under the caption "curtailment costs, net." See " Post Retirement Benefits" below and Note 9.2 to our audited consolidated financial statements.

### **Domestic Mobile Business**

*Decreasing Interconnection Charges.* In 2005, ANACOM declared all mobile operators, including TMN, to have significant market power in call termination in the mobile networks market. As a result ANACOM imposed price controls on interconnection charges that caused both fixed-to-mobile and mobile-to-mobile interconnection rates to decrease by an average of 23.5% in 2005 and 18.5% in 2006. Both interconnection rates reached €0.11 per minute at the beginning of October 2006. These reductions have had a significant impact on TMN's revenues and results of operations. See "Item 4 Information on the Company Our Business Domestic Mobile Business Prices and Revenue Breakdown".

*Continuing Roll-Out of 3G Services.* One of the ways in which we respond to intense competition in the mobile networks market is by continuing to develop and bring to market innovative third generation (3G) services that increase revenues and customer loyalty. We list several of our recently launched services in "Item 4 Information on the Company Domestic Mobile Business Services". Remaining competitive requires continuing investments to build out our third generation network and develop new services, and our capital expenditures on our third generation network have increased in recent years.

### **Multimedia Business**

*Shift from Analog to Digital Service.* In order to remain competitive, PT Multimédia completed the shift of the premium content cable signal from analog to digital. Digitalization of cable television business both creates a platform for offering more value-added and competitive services, while facilitating our ability to restrict illegal access to our content. In addition, shutting down the analog signal for premium content improves cable network capacity by allowing, for example, further increases in broadband internet download speeds. PT Multimédia also expects to face increasing competition from other broadband providers and from new technologies, including IP television. See "Item 4 Information on the Company Our Businesses Multimedia Business TV Cabo Digitalization" and " Network".

*Effect of Macroeconomic Factors on Premium Services Provided.* PT Multimédia's revenues are sensitive to general macroeconomic conditions in Portugal, which result, for example, in higher disconnection levels on Pay TV and Internet services, thereby affecting PT Multimédia's customer base and its retention costs.

***Brazilian Mobile Business***

*Shift to Prepaid Services.* The Brazilian mobile market has been influenced in recent years by a shift to prepaid services. Prepaid services generate usage charges and interconnection charges but do not generate fixed monthly charges. Prepaid services have also attracted lower income customers to Vivo's services, and prepaid customers tend to make fewer outgoing calls than contract customers. Because of the importance of contract customers to Vivo's business, Vivo has undertaken initiatives to maintain and develop the contract customer base.

*Competition.* Vivo faces aggressive competition throughout its service regions, both from existing competitors and new entrants into the market. In the face of this competition, Vivo has generally pursued a strategic focus on profitability and selective customer growth, rather than a specific focus on gaining market share. Within its strategic focus, Vivo pursues a number of strategies to address these competitive pressures, often including discounts on handsets and accessories, loyalty programs (which have generally contributed to a reduction in revenues from monthly subscription charges in the short term) and marketing and promotional expenses (which increase selling expenses).

*Impact of Regulatory Matters.* The introduction of carrier pre-selection codes in 2003 has tended to decrease both the outgoing call revenues of Vivo and the interconnection charges it pays to other companies. At the same time, the partial "Bill & Keep" regime governing interconnection charges also introduced in 2003 tended to decrease the revenues received by Vivo from interconnection fees charged to other companies. Then in July 2006, ANATEL eliminated the partial "Bill & Keep" regime and established "full billing," under which the SMP operator pays the entire call termination fee of the other mobile network. The termination of the partial "Bill & Keep" regime had a positive impact on interconnection revenues in 2006. However, significant uncertainty remains regarding future regulation of interconnection charges and other matters by ANATEL. See "Item 4 Information on the Company Regulation Brazil".

All our business segments are subject to significant competition and operate in highly regulated environments. You should carefully review "Item 4 Information on the Company Competition" and "Regulation" for more information. In addition, you should be aware of the risks to which each of our businesses is subject. See "Item 3 Key Information Risk Factors".

***Transition to International Financial Reporting Standards***

Portugal Telecom applies IFRS as adopted by the European Union, and including all interpretations of the International Financial Reporting Interpretation Committee as of December 31, 2006. For Portugal Telecom, there are no differences between IFRS as adopted by the EU and IFRS as published by the International Accounting Standards Board. Portugal Telecom's consolidated financial statements prepared in accordance with IFRS include comparative financial statements for the years ended December 31, 2004, 2005 and 2006. IFRS requires that an entity develop accounting policies based on the standards and related interpretations effective at the reporting date of its first annual IFRS consolidated financial statements. These accounting policies must be applied as of the date of transition to IFRS (January 1, 2004) and throughout all periods presented in the first IFRS consolidated financial statements.

***Explanation of Exemptions Applied Under IFRS 1.*** In general, the carrying amounts of the assets and liabilities in the consolidated balance sheet under Portuguese GAAP for the year ended

December 31, 2003 must be recognized and measured retrospectively in the opening IFRS consolidated balance sheet as of January 1, 2004 on the basis of those standards under IFRS in force at December 31, 2005. IFRS 1 nevertheless provides exemptions from this principle in specific cases. The main exemptions applied by Portugal Telecom are explained below:

*Cumulative Translation Differences.* Under IAS 21, "The Effects of Changes in Foreign Exchange Rates", differences from the translation of financial statements prepared in a currency other than the presentation currency of the parent must be recognized as a separate component of equity. In line with the principle of retrospective application of IFRS, these differences would ordinarily be required to be determined retrospectively. However, under an exemption contained in IFRS 1, cumulative translation differences may be deemed to be zero as of January 1, 2004, the date of transition. In the case of subsequent disposal of the entity concerned, only translation differences that arose after the date of transition to IFRS are recognized in profit or loss. Portugal Telecom has applied this exemption. See Note 3(q) to our audited consolidated financial statements for a more detailed discussion of our accounting for cumulative translation differences.

*Revaluation as Deemed Cost.* Companies that have revalued their assets in accordance with the legislation in force at a particular date prior to first-time adoption of IFRS may establish the related value as deemed cost of the assets and may account for the assets from the date of the revaluation in accordance with IFRS effective at the date of preparation of the first IFRS financial statements. In prior years, Portuguese legislation allowed companies to perform a revaluation of their tangible assets in accordance with applicable official inflation rates. Portugal Telecom has applied the exemption under IFRS, and, accordingly, the revaluation of its tangible assets performed in accordance with Portuguese legislation prior to January 1, 2004 was included as the deemed cost of the assets for IFRS purposes. See Note 3(c) to our audited consolidated financial statements for a more detailed discussion of our accounting for tangible assets. The effect of the revaluation on our balance sheet was to increase our tangible assets and other investments by a total amount of approximately €157 million and €141 million at December 31, 2005 and 2006, respectively.

*Business Combinations.* IFRS 3, "Business Combinations", is not required to be applied retroactively to business combinations that took place before the date of transition to IFRS. Portugal Telecom has applied this exemption and has therefore recorded goodwill relating to business combinations prior to January 1, 2004 as it was recorded under Portuguese GAAP. Since January 1, 2004, goodwill has not been amortized and business combinations since that date have been recorded in accordance with IFRS 3. At the date of transition to IFRS, goodwill was tested for impairment (*i.e.*, a reduction in its recoverable amount to below its carrying amount) and was written down, if required. Historical cost and accumulated goodwill amortization were netted for the purpose of preparing the opening IFRS consolidated balance sheet. If we had not applied this exemption, we would have had to measure net assets acquired in acquisitions that took place prior to January 1, 2004 at fair value. If we had not applied the exemption, we expect that the net assets related to companies acquired prior to January 1, 2004 on our opening IFRS consolidated balance sheet could have been higher and our goodwill could have been lower.

***Critical Accounting Policies under International Financial Reporting Standards***

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with IFRS. 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.

***Property, plant and equipment, and intangible assets.*** Accounting for property, plant and equipment, and intangible assets involves the use of estimates for determining fair value at the acquisition date, in particular in the case of assets acquired in a business combination, and for determining the expected useful lives of those assets. The determination of the fair values of assets, as well as of the useful lives of the assets is based on management's judgment.

The determination of impairments of property, plant and equipment, and intangible assets involves the use of estimates that include, but are not limited to, the cause, timing and amount of the impairment. Impairment analysis is based on a large number of factors, such as changes in current competitive conditions, expectations of growth in the telecommunications industry, increased cost of capital, changes in the future availability of financing, technological obsolescence, discontinuance of services, current replacement costs, prices paid in comparable transactions and other changes in circumstances that indicate an impairment exists. The determination of recoverable amounts and fair values are typically based on discounted cash flow methodologies that incorporate reasonable market assumptions. The identification of impairment indicators, the estimation of future cash flows and the determination of fair values of assets (or groups of assets) require management to make significant judgments concerning the identification and validation of impairment indicators, expected cash flows, applicable discount rates, useful lives and residual values. At December 31, 2006, 2005 and 2004, Portugal Telecom concluded that the carrying value of these assets did not exceed their recoverable amounts.

Under U.S. GAAP, the recoverability of intangible assets subject to amortization is measured by comparing the sum of the future undiscounted cash flows derived from an asset (or a group of assets) to their carrying value. If the carrying value of the asset (or the group of assets) exceeds the sum of the future undiscounted cash flows, an impairment is considered to exist. If an impairment is considered to exist on the basis of undiscounted cash flows, the impairment charge is measured using an estimation of the assets' fair value. Reversal of previously recognized impairment losses is not permitted.

***Goodwill.*** Goodwill arising on consolidation represents the excess of the cost of acquisition over our interest in the fair value of the identifiable assets and liabilities of a subsidiary at the date of acquisition. The assets and liabilities acquired are measured provisionally at the date on which control is acquired, and the resulting value is reviewed in a maximum period of one year from the date of acquisition. Until the fair value of the assets and liabilities has been definitively determined, the difference between the cost of acquisition and the carrying amount of the company acquired is recognized provisionally as goodwill.

Goodwill acquired on or after January 1, 2004 is measured at acquisition cost, and goodwill acquired in previous periods is recognized at the carrying amount at December 31, 2003, in accordance with Portuguese GAAP. In both cases, since January 1, 2004, goodwill has not been amortized, and at the end of each reporting period, goodwill of each cash-generating unit is reviewed for impairment (*i.e.*, a reduction in its recoverable amount to below its carrying amount) and written down if necessary. The recoverability analysis of goodwill is performed systematically at the end of each year or whenever it is

considered necessary to perform such an analysis. The recoverable amount is the higher of the estimated selling price of the asset less the related selling costs and value in use. Value in use is taken to be the present value of the estimated future cash flows. In calculating the recoverable amount of goodwill, Portugal Telecom used the value in use approach for all cases, preparing the projections of future pre-tax cash flows on the basis of the budgets most recently approved by our board of directors. These budgets include the best available estimates of the income and costs of the cash-generating units using industry projections, past experience and future expectations. These projections cover the coming five years, and the flows for future years are estimated by applying reasonable growth rates that in no case are increasing or exceed the growth rates of prior years.

Under U.S. GAAP, effective January 1, 2002, we adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. The goodwill impairment test, which is based on fair value, is performed on a reporting unit level. Goodwill on equity method investments continues to be tested for impairment in accordance with Accounting Principles Board ("APB") Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* ("APB 18"). The fair value of the reporting units for which goodwill has been assigned was considered to be the best reasonably consistent measurement of fair value measurements that included both income and market approaches, as explained above. Goodwill in each operating segment will be tested for impairment at the year end.

In light of the fact that analyzing the impairment of our recorded goodwill requires a combination of various assumptions and variables, it is very difficult to analyze the sensitivity of the projections to changes in any isolated variable on its own, since a change in one variable may have an effect on one or more of the other variables used.

The goodwill impairment analysis that we conducted as of December 31, 2006 did not suggest that any such impairment was likely in a future period.

**Impairment tests.** The determination of the recoverable amount of a cash-generating unit (under IFRS) or the fair value of an asset group or a reporting unit (under U.S. GAAP) for impairment testing purposes involves the use of estimates by management. Methods used to determine these amounts include discounted cash flow methodologies and models based on quoted stock market prices. Key assumptions on which management has based its determination of fair value include ARPU (monthly average revenue per user), subscriber acquisition and retention costs, churn rates, capital expenditures and market share. These estimates can have a material impact on fair value under both IFRS and U.S. GAAP and the amount of any goodwill write-down.

**Accrued post retirement liability.** As of December 31, 2006, we recorded an accrued post retirement liability amounting to €1,673.5 million to cover our net unfunded obligations regarding pensions and post retirement healthcare benefits. 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. The key financial assumptions affecting post retirement benefit costs are based, in part, on actuarial valuations, including discount rates used to calculate the amount of the post retirement benefit obligations. The discount rate reflects the weighted average timing (approximately 25 years) of the estimated defined benefit payments. The discount rate premium is determined based on European corporate bonds with a high quality rating. The assumptions concerning the expected return on plan assets are determined on a uniform basis, considering long-term historical returns, asset allocation and future estimates of long-term investment returns. In the event that further changes in assumptions are required with respect to discount rates and expected returns on invested assets, the future amounts of our post retirement benefit costs may be materially affected.

**Provisions.** Provisions are recorded when, at the end of the period, we have an obligation to a third party that 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 and contractual in nature. It may also be derived from our practice or from public commitments having created a legitimate expectation for such third parties that we will assume certain responsibilities.

To estimate the expenditure that we are likely to bear to settle its obligation, our 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 obligations which are neither probable nor certain at the time of drawing up the financial statements, and probable obligations for which the cash outflow is not probable are not recorded. Information about them is presented in the notes to the consolidated 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 rendered. 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 recognized. 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.

Unbilled expenses related to telecommunications costs incurred during the period (which primarily consist of interconnection fees paid to other operators) 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.

**Allowance for doubtful accounts.** The allowance 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 allowances required is made after careful analysis of the evolution of accounts receivable balances, and, in specific cases, our analysis is also based on our knowledge of the financial situation of our customers. The required allowances may change in the future due to changes in economic conditions and our knowledge of specific issues. Future possible changes in recorded allowances would impact our results of operations in the period that such changes are recorded.

### Results of Operations

Our results reflect the changing patterns in our business described above in " *Overview*". The key changes over the course of 2005 and 2006 include:

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

decreasing wireline telephone service revenues and domestic mobile services;

a high level of workforce reduction program costs in 2005 and 2006, as we focus on increasing the efficiency of our wireline business, which in 2006 were partially offset by gains related to the termination of the protocol with the Portuguese national healthcare system; and

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a lower provision for income taxes recorded in 2006 following the recognition of tax credits and gains totaling €330 million, as explained below.

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, 2004, 2005 and 2006.

	Year Ended December 31,							
	2004			2005			2006	
	EUR Millions	% of Operating Revenues	% Increase of Item	EUR Millions	% of Operating Revenues	% Increase of Item	EUR Millions	% of Operating Revenues
<b>CONTINUED OPERATIONS</b>								
<b>Operating revenues:</b>								
<b>Wireline business</b>	<b>2,144.8</b>	<b>35.9%</b>	<b>(4.4)%</b>	<b>2,050.4</b>	<b>32.1%</b>	<b>(6.8)%</b>	<b>1,911.9</b>	<b>30.1%</b>
Retail	1,374.0	23.0%	(4.2)%	1,315.7	20.6%	(11.2)%	1,168.8	18.4%
Wholesale	360.0	6.0%	(8.9)%	328.1	5.1%	1.9%	334.4	5.3%
Data and corporate	225.6	3.8%	2.4%	231.0	3.6%	4.8%	242.1	3.8%
Directories	129.7	2.2%	(7.2)%	120.4	1.9%	(9.6)%	108.9	1.7%
Sales	35.5	0.6%	(4.8)%	33.8	0.5%	(5.0)%	32.1	0.5%
Other	20.0	0.3%	7.5%	21.5	0.3%	19.0%	25.6	0.4%
<b>Domestic mobile business</b>	<b>1,462.4</b>	<b>24.5%</b>	<b>(0.5)%</b>	<b>1,455.4</b>	<b>22.8%</b>	<b>(2.1)%</b>	<b>1,424.4</b>	<b>22.5%</b>
Services	1,307.1	21.9%	(0.1)%	1,306.2	20.5%	(1.3)%	1,289.0	20.3%
Sales	149.1	2.5%	4.6%	142.2	2.2%	(11.4)%	126.0	2.0%
Other	6.3	0.1%	11.1%	7.0	0.1%	33.8%	9.4	0.1%
<b>Multimedia business</b>	<b>597.9</b>	<b>10.0%</b>	<b>4.9%</b>	<b>627.4</b>	<b>9.8%</b>	<b>5.8%</b>	<b>663.8</b>	<b>10.5%</b>
Pay-TV and cable Internet	511.9	8.6%	7.6%	550.7	8.6%	6.9%	588.5	9.3%
Audiovisuals	85.2	1.4%	(11.2)%	75.7	1.2%	(0.6)%	75.3	1.2%
Other	0.8	0.0%	37.5%	1.1	0.0%	(96.1)%	0.0	0.0%
<b>Brazilian mobile business</b>	<b>1,599.1</b>	<b>26.8%</b>	<b>27.4%</b>	<b>2,036.9</b>	<b>31.9%</b>	<b>3.3%</b>	<b>2,104.8</b>	<b>33.2%</b>
Services	1,425.3	23.9%	21.9%	1,737.8	27.2%	3.0%	1,789.8	28.2%
Sales	136.6	2.3%	71.2%	233.8	3.7%	9.0%	254.8	4.0%
Other	37.3	0.6%	75.1%	65.3	1.0%	(7.8)%	60.2	0.9%
<b>Other businesses</b>	<b>163.2</b>	<b>2.7%</b>	<b>31.9%</b>	<b>215.2</b>	<b>3.4%</b>	<b>10.7%</b>	<b>238.1</b>	<b>3.8%</b>
Services	152.4	2.6%	36.0%	207.2	3.2%	5.7%	219.0	3.5%
Sales	3.7	0.1%	2.7%	3.8	0.1%	237.9%	12.8	0.2%
Other	7.1	0.1%	(39.4)%	4.3	0.1%	47.6%	6.3	0.1%
<b>Total operating revenues</b>	<b>5,967.4</b>	<b>100.0%</b>	<b>7.0%</b>	<b>6,385.4</b>	<b>100.0%</b>	<b>(0.7)%</b>	<b>6,343.0</b>	<b>100.0%</b>

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<b>Costs, expenses, losses and income:</b>								
Wages and salaries	631.8	10.6%	5.6%	667.3	10.5%	0.2%	668.4	10.5%
Post retirement benefits	58.8	1.0%	N.A.	(21.6)	(0.3)%	233.8%	(72.1)	(1.1)%
Direct costs	852.0	14.3%	3.4%	881.2	13.8%	3.1%	908.4	14.3%
Costs of products sold	595.8	10.0%	9.5%	652.3	10.2%	(8.6)%	596.5	9.4%
Support services	203.8	3.4%	13.0%	230.2	3.6%	(0.1)%	230.0	3.6%
Marketing and publicity	159.8	2.7%	15.4%	184.4	2.9%	(15.7)%	155.4	2.4%
Supplies and external services	810.5	13.6%	18.3%	958.6	15.0%	7.0%	1,025.5	16.2%
Indirect taxes	123.2	2.1%	34.7%	166.0	2.6%	6.8%	177.3	2.8%
Provisions and adjustments	168.8	2.8%	1.6%	171.5	2.7%	34.2%	230.2	3.6%
Depreciation and amortization	934.9	15.7%	19.9%	1,120.7	17.6%	8.0%	1,209.8	19.1%
Impairment losses(1)	28.0	0.5%	N.A.					
Curtailed costs, net	165.6	2.8%	89.8%	314.3	4.9%	(93.5)%	20.3	0.3%
Losses on disposals of fixed assets, net	9.2	0.2%	(87.2)%	1.2		N.A.	8.1	0.1%
Other costs	83.6	1.4%	(78.8)%	17.7	0.3%	N.A.	98.4	1.6%
<b>Income before financial results and taxes</b>	<b>1,141.6</b>	<b>19.1%</b>	<b>(8.7)%</b>	<b>1,041.8</b>	<b>16.3%</b>	<b>4.3%</b>	<b>1,086.8</b>	<b>17.1%</b>
Net interest expense	204.9	3.4%	25.7%	257.6	4.0%	(11.8)%	227.2	3.6%
Net foreign currency exchange losses (gains)	4.5	0.1%	N.A.	(41.3)	(0.6)%	(88.2)%	(4.9)	(0.1)%
Net losses (gains) on financial assets	(11.6)	(0.2)%	N.A.	8.8	0.1%	N.A.	(18.3)	(0.3)%
Equity in earnings of affiliated companies	(20.9)	(0.4)%	N.A.	(238.2)	(3.7)%	(44.9)%	(131.4)	(2.1)%
Net other financial expenses	55.6	0.9%	15.9%	64.5	1.0%	(18.9)%	52.3	0.8%
<b>Income before taxes</b>	<b>909.1</b>	<b>15.2%</b>	<b>9.0%</b>	<b>990.5</b>	<b>15.5%</b>	<b>(2.9)%</b>	<b>961.8</b>	<b>15.2%</b>
Income taxes	210.0	3.5%	53.9%	323.3	5.1%	(97.6)%	7.7	0.1%
	<b>699.1</b>	<b>11.7%</b>	<b>(4.6)%</b>	<b>667.2</b>	<b>10.4%</b>	<b>43.0%</b>	<b>954.1</b>	<b>15.0%</b>

**Net income  
from  
continued  
operations  
Discontinued  
operations:**

Net income from discontinued operations	26.1	0.4%	(16.6)%	21.7	0.3%			0.0%
<b>Net income</b>	<b>725.2</b>	<b>12.2%</b>	<b>(5.0)%</b>	<b>689.0</b>	<b>10.8%</b>	<b>38.5%</b>	<b>954.1</b>	<b>15.0%</b>
<b>Attributable to:</b>								
Minority interests(2)	102.0	1.7%	(65.7)%	35.0	0.5%	149.6%	87.4	1.4%
<b>Equity holders of the parent</b>	<b>623.2</b>	<b>10.4%</b>	<b>4.9%</b>	<b>654.0</b>	<b>10.2%</b>	<b>32.5%</b>	<b>866.8</b>	<b>13.7%</b>

(1) We recorded an impairment loss on the goodwill of the Audiovisuals unit of PT Multimédia in 2004, calculated as the difference between the carrying value and management's estimates of the recoverable amount based on the discounted cash flows from this business.

(2) In 2004, income applicable to minority interests primarily included 50% of the share of minority shareholders of Vivo's subsidiaries in their corresponding income (€37.8 million) and the share of

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minority shareholders in the income of PT Multimédia (€52.0 million) and Cabo Verde Telecom (€7.1 million). In 2005, income applicable to minority interest primarily included 50% of the share of minority shareholders of Vivo's subsidiaries in their income (negative €11.0 million) and the share of minority shareholders in the income of PT Multimédia (€33.9 million) and Cabo Verde Telecom (€8.2 million). In 2006, income applicable to minority interests primarily included 50% of the share of minority shareholders of Vivo's subsidiaries (prior to the elimination of those subsidiaries in Vivo's reorganizations in 2006) in their corresponding income (€558.4 million) and the share of minority shareholders in the income of PT Multimedia (€171.0 million), MTC (€62.6 million) and Cabo Verde Telecom (€37.6 million)

### *Year Ended December 31, 2006 Compared to Year Ended December 31, 2005*

#### *Operating Revenues*

Our operating revenues decreased to €6,343.0 million in 2006 from €6,385.4 million in 2005, a decrease of 0.7%, reflecting in part the decrease in interconnection tariffs (a negative impact at the wireline business and TMN of €22 million and €49 million, respectively), which was offset by a higher contribution from Vivo, due to the appreciation of the Real against the Euro during the period, and PT Multimédia. Although the contribution from Vivo increased 3.3% to €2,104.7 million in 2006 from €2,036.9 million in 2005, in local currency terms our proportion of Vivo's revenues decreased by 7.2% to R\$5,749.0 million in 2006 from R\$6,193.5 million in 2005. The reasons for these changes are explained in more detail below.

We present below the revenue information for each of our business segments. The revenue information for each segment in the tables below differs from the contribution to our consolidated revenues for each such segment in the table above because it is presented on a stand-alone basis and includes revenues from services rendered to other Portugal Telecom group companies.

**Wireline Business.** The table below sets forth the operating revenues from our wireline business in 2005 and 2006.

	<u>2005</u>	<u>2006</u>	<u>% Change</u>
(EUR Millions)			
<b>Wireline Operating Revenues (Stand-Alone)</b>			
Retail	1,318.8	1,173.5	(11.0)%
Wholesale	457.7	464.2	1.4%
Data and corporate	244.9	250.5	2.3%
Other wireline services	192.2	183.6	(4.5)%
	<u>2,213.6</u>	<u>2,071.8</u>	<u>(6.4)%</u>
<b>Total</b>	<b>2,213.6</b>	<b>2,071.8</b>	<b>(6.4)%</b>

**Retail.** Retail revenues decreased 11.0% to €1,173.5 million in 2006 from €1,318.8 million in 2005. This decrease occurred mainly due to lower traffic revenues and, to a lesser degree, fixed charges resulting from competition from fixed and mobile operators. The decrease in volume is due to the reduction in PSTN and ISDN lines to 3,317 thousand as of December 31, 2006 from 3,769 thousand as of December 31, 2005. Of those lines, 408 thousand lines were being used by customers of our wireline competitors through carrier pre-selection as of December 31, 2006, a decrease of 29.1% from 575 thousand lines as of December 31, 2005. In addition, a decrease in the regulated fixed-to-mobile interconnection tariffs had a negative impact of €21.6 million on retail traffic revenues in 2006. The decreases in fixed line traffic and prices in recent years are described further in "Item 4 Information on the Company Our Businesses Wireline Business Traffic" and "Retail". The number of pricing plans in use by our customers increased significantly to 2,827 thousand in 2006 from 1,795 thousand in

2005, contributing to an increase in revenues from fixed charges. However, the growing percentage of flat rate pricing plans contributed in part to the decrease in traffic revenues.

The decreases in traffic revenues and fixed charges were partially offset by a 13.0% increase in ADSL retail revenues to € 170.1 million in 2006 from €150.6 million in 2005. ADSL retail lines increased to 685 thousand lines as of December 31, 2006 from 585 thousand lines as of December 31, 2005 as increasing numbers of customers switched to ADSL service from dial-up Internet service.

**Wholesale.** Wholesale revenues increased by 1.4% to €464.2 million in 2006 from €457.7 million in 2005. This increase is primarily explained by the increase in leased lines due to the rollout of mobile 3G networks in Portugal, as well as the growth in unbundled local loop (ULL) and wholesale line rental (WLR) revenues. Domestic and international revenue per minute for calls terminated on our network, which are recorded as wholesale revenues, declined 7.8% and 21.0%, respectively, in 2006. Wholesale revenues also were affected by decrease in wholesale Internet traffic as reflecting the increasing switch to broadband from dial-up service described in "Item 4 Information on the Company Our Businesses Wireline Business Wholesale Traffic".

**Data and Corporate.** Data and corporate revenues increased by 2.3% to € 250.5 million in 2006 from €244.9 million in 2005, partly as a result of the growth in network management and outsourcing, partially offset by a decline in revenues from virtual private networks (VPN) and circuits. See "Item 4 Information on the Company Our Businesses Wireline Business Data and Corporate".

**Domestic Mobile Business.** The table below sets forth the operating revenues from our domestic mobile business in 2005 and 2006.

	<u>2005</u>	<u>2006</u>	<u>% Change</u>
(EUR Millions)			
<b>Domestic Mobile Operating Revenues (Stand-Alone)</b>			
Services rendered:			
Billing	1,116.3	1,117.0	0.1%
Interconnection	287.3	246.2	(14.3)%
Sales	146.3	129.7	(11.4)%
Other operating revenues	7.1	9.4	33.1%
	<u>          </u>	<u>          </u>	
<b>Total</b>	<b>1,557.1</b>	<b>1,502.4</b>	<b>(3.5)%</b>
	<u>          </u>	<u>          </u>	

Operating revenues from our domestic mobile business decreased by 3.5% to € 1,502.4 million in 2006 from €1,557.1 million in 2005, primarily as a result of the impact on service revenues of the mobile termination rate cuts (€49 million) and lower equipment sales. Customer growth in 2006 supported the performance of billing revenues, which remained stable at €1,117.0 million in 2006 (and increased 7.7% in the second half of 2006 compared to the first half of 2006). However, interconnection revenues continued to decline sharply due to the reduction in mobile termination rates over the past quarters. The reduction of the fixed-to-mobile and mobile-to-mobile interconnection rates at the beginning of each quarter of the year led to an average decline in 2006 of 18.5% and 18.6%, respectively, in interconnection rates to €0.11 per minute for both rates at the beginning of October 2006. Excluding the €49 million impact of lower mobile termination rates, service revenues would have increased by 0.6% in 2006. Revenues from sales of handsets decreased by 11.4% to € 129.7 million in 2006 from €146.3 million in 2005.

**Multimedia Business.** The table below sets forth the operating revenues from our multimedia business in 2005 and 2006.

	<u>2005</u>	<u>2006</u>	<u>% Change</u>
	(EUR Millions)		
<b>Multimedia Operating Revenues (Stand-Alone)</b>			
Pay TV and Cable Internet	553.0	591.1	6.9%
Audiovisuals	53.4	52.6	(1.5)%
Cinema	40.0	43.7	9.2%
Other and eliminations	(18.0)	(20.9)	16.1%
	<u>        </u>	<u>        </u>	
<b>Total</b>	<b>628.5</b>	<b>666.5</b>	<b>6.1%</b>
	<u>        </u>	<u>        </u>	

Operating revenues from our multimedia business increased by 6.1% to €666.5 million in 2006 from €628.5 million in 2005. This increase was primarily due to the growth in Pay TV and broadband Internet revenues. Average monthly revenue per customer in the Pay TV business increased by 5.7% to €29.1 in 2006 from €27.6 in 2005. Revenues from the audiovisuals business decreased by 1.5% in 2006 to €52.6 million from €53.4 million in 2005 with a reduction in video/DVD sales being partially offset by an increase in revenues from exhibition and transmission rights. Revenues from the cinema business increased by 9.2% to €40.0 million in connection with the growth in ticket sales.

**Brazilian Mobile Business.** The table below sets forth both our operating revenues from our Brazilian mobile business in 2005 and 2006 in Euros and the total operating revenues of the Brazilian mobile business (including the portion attributable to our joint venture partner) in Reais.

	<u>2005</u>	<u>2006</u>	<u>% Change</u>	<u>2005</u>	<u>2006</u>	<u>% Change</u>
	(EUR Millions)(1)			(R\$ Millions)(1)		
<b>Brazilian Mobile Operating Revenues (Stand-Alone)</b>						
Services rendered	1,737.8	1,789.8	3.0%	10,567.8	9,777.5	(7.5)%
Sales	233.8	254.8	8.9%	1,422.0	1,391.7	(2.1)%
Other operating revenues	65.3	60.2	(7.8)%	397.2	328.9	(17.2)%
	<u>        </u>	<u>        </u>		<u>        </u>	<u>        </u>	
<b>Total</b>	<b>2,036.9</b>	<b>2,104.7</b>	<b>3.3%</b>	<b>12,387.0</b>	<b>11,498.0</b>	<b>(7.2)%</b>
	<u>        </u>	<u>        </u>		<u>        </u>	<u>        </u>	

(1) Amounts presented in Euros correspond to the proportional consolidation of 50% of Vivo's operating revenues, while amounts presented in Reais correspond to 100% of Vivo's operating revenues.

Operating revenues from our Brazilian mobile business increased by 3.3% to € 2,104.7 million in 2006 from €2,036.9 million in 2005, primarily as a result of the impact of the appreciation of the Real against the Euro. In local currency terms, operating revenues decreased by 7.2% as a result of the decrease in service revenues, equipment sales and other operating revenues. Service revenues decreased by 7.5% in 2006, largely as a result of the challenging operating environment in Brazil. The average revenue per user per month in 2006 was R\$27.1 million, as compared to R\$28.7 million in 2005 primarily due to the decrease in incoming traffic, the migration of fixed-to-mobile to mobile-to-mobile traffic and traffic promotions. See "Item 4 Information on the Company Our Businesses Brazilian Mobile Business".

**Other Businesses.** Operating revenues from our other businesses contributed €238.2 million to our consolidated operating revenues in 2006, an increase of 10.7% from €215.2 million in 2005. This increase was primarily due to the full consolidation of MTC for the first time in 2006 following the acquisition of a 34% stake in this company in September 2006.

**Costs, Expenses, Losses and Income**

As explained in more detail below, our costs decreased in 2006 due to, among other factors, the reduction in net curtailment costs and in post retirement benefits expenses, which were partially offset by increases in depreciation and amortization and other costs, net. For more detail on these costs and expenses as they relate to each of our segments, see Note 7 to our audited consolidated financial statements.

**Wages and Salaries.** Wages and salaries, including employee benefits and social charges, increased by 0.2% to €668.4 million in 2006 from €667.3 million in 2005. On a constant currency basis, wages and salaries would have decreased by 2.6%, primarily as a result of the 5.1% decrease in the wireline business in connection with its workforce reduction program. These effects were partially offset by the 5.8% increase in local currency terms in wages and salaries of Mobitel, PT's call center business in Brazil, due to the increase in its average number of employees in 2006 by 1,310 employees compared to 2005.

**Post Retirement Benefits.** We recorded a €72.1 million gain from post retirement benefits in 2006, compared to a gain of €21.6 million in 2005, primarily as a result of (1) the increase in prior year service gains (from €137 million in 2005 to €151 million in 2006) and (2) an improvement in the return on assets resulting from contributions made to our pension funds in 2005 and 2006. In 2006, the prior year service gains of €151 million were primarily related to a reduction in healthcare benefits (€127 million) in connection with changes made to our healthcare plan in order to maintain its long-term sustainability and financing. In 2005, the prior year service gains of €137 million were primarily related to (1) a change in the retirement age in Portugal (€110 million) and (2) a change in the pension formula from 90% of the last salary to 90% of the average of the last three years of salaries (€27 million). This cost item does not include early termination costs related to our workforce reduction program, which are discussed under " *Workforce Reduction Program Costs*" below.

**Direct Costs.** Direct costs increased by 3.1% to €908.4 million in 2006 from €881.2 million in 2005. This increase was primarily due to an increase of 7.4% in programming costs at PT Multimédia to €149.9 million and an increase in other direct costs, primarily due to the growth in content expenses related to 3G services at TMN. Telecommunications costs, which are the main component of direct costs, increased by 0.2% to €562.6 million in 2006, with lower wireline traffic volumes and lower fixed-to-mobile and mobile-to-mobile interconnection rates in Portugal being more than offset by an increase in telecommunications costs at Vivo, mainly due to the end of the partial "Bill & Keep" interconnection regime.

**Costs of Products Sold.** The costs of products sold decreased by 8.5% to €596.5 million in 2006 from €652.3 million in 2005. This decrease was primarily due to lower handset prices at TMN and Vivo, notwithstanding the increase in commercial activity, partially offset by the effects of the appreciation of the Real against the Euro.

**Support Services.** Support services remained stable at €230.0 million in 2006, compared to €230.2 million in 2005. The impact of the appreciation of the Real against the Euro (€12.1 million) and the increase of support services at Vivo on a constant currency basis (€5.3 million) in connection with the growth in call center expenses related to an increase in commercial activity were offset by a reduction of these expenses in the wireline business.

**Marketing and Publicity.** Marketing and publicity costs decreased 15.7% to €155.4 million in 2006 from €184.4 million in 2005, due to a reduction across all businesses: Wireline (€2.7 million), TMN (€5.2 million), Vivo (€29.7 million) and PT Multimedia (€2.0 million). These effects were partially offset by the effects of the appreciation of the Real against the Euro (€6.6 million).

**Supplies and External Services.** Supplies and external services increased by 7.0% to €1,025.5 million in 2006 from €958.6 million in 2005, mainly as a result of the appreciation of the Real against the Euro (€36.2 million). On a constant currency basis, supplies and external services expenses would have increased by 3.2% in 2006 to €989.3 million, primarily as a result of the increase in commissions at TMN due to an increase in commercial activity.

**Indirect Taxes.** Indirect taxes increased 6.8% to €177.3 million in 2006 from €166.0 million in 2005, primarily due to the appreciation of the Real against the Euro during the period (€14.0 million).

**Provisions and Adjustments.** Provisions and adjustments increased 34.2% to €230.2 million in 2006 from €171.5 million in 2005. This increase was primarily related to the increases of €51 million and €18.7 million in the wireline business and Vivo, respectively. The increase in the wireline business is primarily related to the reversals in 2005 of (1) a provision for a receivable from Angola Telecom (€23.2 million) that was received in that period and (2) a provision to cover risks associated with the cancellation of certain onerous contracts (€30.0 million), each of which favorably affected the amounts recorded for 2005. The increase in Vivo is partly explained by the impact of the appreciation of the Real against the Euro (€17.0 million). The provisions and adjustments recorded at Vivo include provisions for accounts receivable (including doubtful receivables relating to the improper use of Vivo's network) and tax contingencies (including reversals of provisions upon receiving favorable tax judgments).

**Depreciation and Amortization.** Depreciation and amortization costs increased 8.0% to €1,209.8 million in 2006 from €1,120.7 million in 2005. This increase was primarily due to an increase in the contributions of Vivo (€51.7 million) and PT Multimédia (€17.1 million). The increase in Vivo's contribution is primarily related to the impact of the appreciation of the Real against the Euro (€51.4 million), while the increase in PT Multimedia's contribution is primarily related to the higher level of capital expenditures in 2005 and first half of 2006.

**Curtailement Costs.** Curtailment costs decreased to €20.3 million in 2006 from €314.3 million in 2005, which includes net gains related to the termination of the protocol with the Portuguese national healthcare system. Excluding this gain, curtailment costs would have amounted to €229.2 million, corresponding to a reduction in the workforce at our wireline business by 792 employees in 2006. See " *Liquidity and Capital Resources Post Retirement Benefits*" for a description of these reductions.

**Other Costs.** Other costs amounted to €98.4 million in 2006, compared to €17.7 million in 2005. This increase is primarily due to an adjustment to the realizable amount of certain CDMA network fixed assets at Vivo due to technological obsolescence (€50.9 million), the impact of the change in the estimated useful life of certain tangible assets at PT Multimedia (€5.7 million) and expenses incurred by Portugal Telecom and PT Multimedia totaling €37 million related to the tender offer launched on these companies in 2006.

#### **Financial Income and Expenses**

**Net Interest Expenses.** Net interest expenses decreased by 11.8% to €227.2 million in 2006 from €257.6 million in 2005, primarily as a result of the reduction of approximately 0.9% in the average cost of debt to 5.7% in 2006. Excluding net interest incurred by Vivo and the interest cost associated with the equity swaps for shares of PT Multimedia, the average cost of debt was 3.8% in 2006, as compared to 4.5% in 2005.

**Net Foreign Currency Exchange Losses (Gains).** We had net foreign currency gains of €4.9 million in 2006, compared to net foreign currency gains of €41.3 million in 2005. In 2006, this item primarily included foreign currency gains related to the effect of the appreciation of the Real against the U.S. dollar on Vivo's U.S. dollar debt not swapped to Reais, partially offset by foreign currency losses related to dividends receivable from Unitel (denominated in U.S. dollars) following the devaluation of

the U.S. dollar against the Euro in the period. Foreign currency gains recorded in 2005 are primarily related to Vivo's U.S. dollar debt not swapped to Reais and to the effect of the appreciation of the U.S. dollar against the Euro on intercompany loans granted by PT Finance to Vivo (denominated in U.S. dollars).

**Net Losses (Gains) on Financial Assets.** We recorded net gains on financial assets of €18.3 million in 2006, compared to net losses on financial assets of €8.8 million in 2005. This caption primarily includes the following gains and losses on certain derivative contracts: (1) equity swap contracts on PT Multimedia shares (gains of €10.2 million in 2006, compared to gains of €25.0 million in 2005); (2) gains recorded in 2006 related to the financial settlement of equity swaps for Portugal Telecom's own shares (€23.5 million); (3) Vivo's free-standing cross currency derivatives (net losses of €4 million in 2006, compared to net losses of €50.5 million in 2005), and (4) Portugal Telecom's free-standing cross currency derivatives (losses of €8.4 million in 2006, as compared to gains of €14.1 million in 2005).

**Equity in Earnings of Affiliated Companies.** Equity in earnings of affiliated companies amounted to €131.4 million in 2006, compared to €238.2 million in 2005. This item included mainly our shares in the earnings of Unitel in Angola (€82.5 million), Médi Télécom in Morocco (€45.6 million) and CTM in Macao (€14.8 million). The reduction in this caption of €106.9 million is primarily explained by the decrease in the gains related to UOL (from €175.4 million in 2005 to €6.2 million in 2006), which in 2005 included the gain and other effects of the disposal of a 16% stake in the initial public offering of this associated company in December 2006. This effect was partially offset by the increase in earnings of Unitel and Médi Télécom.

**Net Other Financial Expenses.** Net other financial expenses decreased 18.9% to €52.3 million in 2006 from €64.5 million in 2005 and include banking services expenses, commissions, financial discounts and other financing costs.

#### **Income Taxation**

Income taxes decreased to €7.7 million in 2006, compared to €323.3 million in 2005. The reduction in this caption is primarily related to the net effect of (1) a gain of €134.5 million recorded by Vivo following the completion of its corporate restructuring in the fourth quarter of 2006, (2) the recognition of a tax credit amounting to €53.3 million in 2006 following the liquidation of a subsidiary in Portugal, (3) a gain of €142.0 million recorded in 2006 in connection with the reduction of deferred tax liabilities resulting from the voluntary taxation of certain capital gains and (4) a loss of €16 million in adjustments of deferred taxes due to the reduction in the nominal tax rate from 27.5% to 26.5% in the beginning of 2007. Adjusting for these one-off effects in 2006, the provision for income taxes would have been €321.2 million in 2006, compared to €323.3 million in 2005, corresponding to an effective tax rate of 33% in 2006 and 2005.

#### **Net Income From Continued Operations**

For the reasons described above, net income from continuing operations increased 43.0% to €954.1 million in 2006 from €667.2 million in 2005.

#### **Discontinued Operations**

Discontinued operations reflect the results of companies that have been disposed of during the reportable periods and the after-tax gains obtained with the sale of these investments. Due to the announced disposals of Lusomundo Serviços (PT Multimédia's media business) and PrimeSys in 2005, these businesses were reported as discontinued operations in the consolidated income statement for 2005. The earnings of these companies were included in this caption until the effective date of the disposals, which were concluded on August 25, 2005 in the case of Lusomundo Serviços and on November 25, 2005 in the case of PrimeSys. In 2005, this line item includes a gain of €16.8 million from the sale of Lusomundo Serviços and a gain of €4.0 million from the sale of PrimeSys.

***Net Income (Before Minority Interests)***

Net income (before minority interests) increased by 38.5% to €954.1 million in 2006 from €688.9 million in 2005 for the reasons described above.

Net income from our wireline business increased by 50.0% to €489.1 million in 2006 from €326.1 million in 2005, primarily due to the gains obtained from the cancellation of the Protocol with the Portuguese national healthcare service, partially offset by the increase in provisions and by the reduction in net wireline revenues.

Net income from our domestic mobile business decreased 5.6% to €318.1 million in 2006 from €337.0 million in 2005, primarily due to the decrease in operating revenues net of direct costs and costs of products sold, and also due to the increase in depreciation and amortization.

Net income from continuing operations (before minority interests) of our multimedia business decreased by 25.1% to €74.1 million in 2006 from €99.0 million in 2005, primarily due to an increase in depreciation and amortization expenses, partially offset by an increase in operating revenues due to the growth in Pay TV and broadband Internet revenues

Net losses (before minority interests) from our Brazilian mobile business decreased to €(26.5) million in 2006 from €(134.0) million in 2005, primarily due to the income tax gain related to the completion of Vivo's corporate restructuring in the fourth quarter of 2006.

***Net Income Attributable to Minority Interests***

Net income attributable to minority interests in 2006 amounted to €87.4 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 (€33.5 million) and to the share of minority shareholders in the net income of PT Multimédia (€28.7 million), Cabo Verde Telecom (€10.2 million) and MTC (€8.9 million). In 2005, net income attributable to minority interests amounted to €35.0 million and related primarily to 50% of the minority interests attributable to the share of minority shareholders in the net income of Vivo subsidiaries (€11.0 million) and to the share of minority shareholders in the net income of PT Multimédia (€33.9 million) and Cabo Verde Telecom (€8.2 million).

***Net Income Attributable to Equity Holders of the Parent***

For the reasons described above, our net income attributable to equity holders of Portugal Telecom increased by 32.5% to €866.8 million in 2006 from €654.0 million in 2005.

Basic earnings per ordinary and A shares from total operations in 2006 increased to €0.78 in 2006 from €0.57 in 2005 on the basis of 1,128,856,500 shares issued at December 31, 2006 and 2005.

***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

***Operating Revenues***

Our operating revenues increased to €6,385.4 million in 2005 from €5,967.4 million in 2004, an increase of 7.0%, primarily reflecting the higher contribution from Vivo (which was primarily due to the appreciation of the Real during 2005) and, to a lesser extent PT Multimédia and other businesses. Although the contribution from Vivo increased 27.4% to €2,036.9 million in 2005 from €1,599.1 million in 2004, in local currency terms our proportion of Vivo's revenues increased by 6.5% to R\$6,193.5 million in 2005 from R\$5,814.0 million in 2004. The increase in revenues from the Vivo, PT Multimédia and other businesses more than offset a 4.4% decrease in contribution of our wireline business to €2,050.4 million in 2005 from €2,144.8 million in 2004 (primarily due to decreases in both retail and wholesale revenues) and a 0.5% decrease in contribution of our domestic mobile business to €

1,455.4 million in 2005 from €1,462.4 million in 2004. The reasons for these changes are explained in more detail below.

We present below the revenue information for each of our business segments. The revenue information for each segment in the tables below differs from the contribution to our consolidated revenues for each such segment in the table above because it is presented on a stand-alone basis and includes revenues from services rendered to other Portugal Telecom group companies.

**Wireline Business.** The table below sets forth the operating revenues from our wireline business in 2004 and 2005.

	2004	2005	%
	Change		
(EUR Millions)			
<b>Wireline Operating Revenues (Stand-Alone)</b>			
Retail	1,379.4	1,318.8	(4.4)%
Wholesale	476.4	457.7	(3.9)%
Data and corporate	242.0	244.9	1.2%
Other wireline services	207.3	192.2	(7.3)%
<b>Total</b>	<b>2,305.2</b>	<b>2,213.6</b>	<b>(4.0)%</b>

**Retail.** Retail revenues decreased 4.4% to €1,318.8 million in 2005 from €1,379.4 million in 2004. This decrease occurred primarily because of a decrease in traffic revenues due to (1) decreases in call volume as a result of the continuing trend among customers to use mobile services instead of fixed line services and competition from other wireline providers, and (2) the continuing downward trend in prices for domestic and international fixed line calling prices. The decrease in volume is illustrated by the decrease in PSTN and ISDN lines to 3,769 thousand as of December 31, 2005 from 3,948 thousand as of December 31, 2004. Of those lines, 575 thousand lines were being used by customers of our wireline competitors through carrier pre-selection as of December 31, 2005, an increase of 18.5% from 485 thousand lines as of December 31, 2004. In addition, a decrease in the regulated fixed-to-mobile interconnection tariffs had a negative impact of €23 million on retail traffic revenues in 2005. The decreases in fixed line traffic and prices in recent years are described further in "Item 4 Information on the Company Our Businesses Wireline Business Traffic" and "Retail". The number of pricing plans in use by our customers increased significantly to 1,795 thousand in 2005 from 947 thousand in 2004, contributing to an increase in revenues from fixed charges. However, the growing percentage of flat rate pricing plans contributed in part to the decrease in traffic revenues.

The decrease in traffic revenues was partially offset by a 50.8% increase in ADSL retail revenues to €150.6 million in 2005 from €99.9 million in 2004. ADSL retail lines increased to 585 thousand lines as of December 31, 2005 from 382 thousand lines as of December 31, 2004 as increasing numbers of customers switched to ADSL service from dial-up Internet service.

**Wholesale.** Wholesale revenues decreased by 3.9% to €457.7 million in 2005 from €476.4 million in 2004. This decrease is primarily explained by the decrease in traffic revenues due to the decrease in the price of international mobile interconnection and the decrease in transit traffic. Domestic and international revenue per minute for calls terminated on our network, which are recorded as wholesale revenues, declined 10.1% and 18.1%, respectively, in 2005. Wholesale revenues also were affected by decrease in wholesale Internet traffic as reflecting the increasing switch to broadband from dial-up service, as well as the other decreases in traffic described in "Item 4 Information on the Company Our Businesses Wireline Business Wholesale Traffic".

**Data and Corporate.** Data and corporate revenues increased by 1.2% to €244.9 million in 2005 from €242.0 million in 2004, primarily due to increases in revenues from network management and outsourcing, including online back-up security solutions and long-term outsourcing contracts. We also

introduced a series of pricing plans to stimulate use of our services by small and medium-sized businesses. Without giving effect to the one-time impact of the Euro 2004 soccer championship, data and corporate revenues would have increased at a higher rate for the reasons described above. See "Item 4 Information on the Company Our Businesses Wireline Business Data and Corporate".

**Domestic Mobile Business.** The table below sets forth the operating revenues from our domestic mobile business in 2004 and 2005.

	2004	2005	%
	(EUR Millions)	(EUR Millions)	Change
<b>Domestic Mobile Operating Revenues (Stand-Alone)</b>			
Services rendered:			
Billing	1,087.3	1,116.3	2.7%
Interconnection	359.0	287.3	(20.0)%
Sales	153.3	146.3	(4.5)%
Other operating revenues	6.7	7.1	5.4%
<b>Total</b>	<b>1,606.3</b>	<b>1,557.1</b>	<b>(3.1)%</b>

Operating revenues from our domestic mobile business decreased by 3.1% to €1,557.1 million in 2005 from €1,606.3 million in 2004, primarily as a result of the impact of lower interconnection rates (both fixed-to-mobile and mobile-to-mobile) set by ANACOM in 2005. Interconnection rates declined by an average of 23.5% in 2005 and contributed to €82 million of the decrease in revenues from interconnection. The increase in revenues from customer billing (due to growth in the number of postpaid customers and revenues from data) was not sufficient to offset the effect of lower interconnection revenues. Although the number of TMN's active mobile telephone cards increased 5.1% in 2005, many of the new additions were customers of our low-cost Uzo service, and revenues from customer billings therefore increased less than the number of active mobile phone cards. We estimate that TMN's revenues per active mobile telephone card decreased by 6.8% in 2005 to an average of approximately €22.8 per month, compared to €24.5 per month in 2004, and average revenue per minute decreased 7.3%, in each case primarily due to the decrease in interconnection rates. The effect of lower interconnection fees on average revenues per active mobile telephone card was partially offset by the increase in use of non-SMS data services, such as ring tones, screen savers, games and other downloads. Revenues from sales of handsets decreased 4.5% to €146.3 million in 2005 from €153.3 million in 2004.

**Multimedia Business.** The table below sets forth the operating revenues from our multimedia business in 2004 and 2005.

	2004	2005	%
	(EUR Millions)	(EUR Millions)	Change
<b>Multimedia Operating Revenues (Stand-Alone)</b>			
Pay TV and Cable Internet	513.3	553.0	7.7%
Audiovisuals	53.7	53.4	(0.5)%
Cinema Exhibition	41.8	40.0	(4.3)%
Other and eliminations	(10.0)	(18.0)	80.3%
<b>Total</b>	<b>598.8</b>	<b>628.5</b>	<b>5.0%</b>

Operating revenues from our multimedia business increased by 5.0% to €628.5 million in 2005 from €598.8 million in 2004. This increase was primarily due to growth in Pay TV and cable Internet revenues, which increased 7.7% in 2005, due to the continuing popularity of PT Multimédia's Pay TV and broadband internet offers, price increases in Pay TV and a steady increase in broadband

penetration of the Pay TV customer base. Average monthly revenue per customer in the Pay TV business increased by 8.5% to €27.6 in 2005 from €25.4 in 2004. Revenues from the audiovisuals business decreased 0.5% in 2005 to €53.4 million from €53.7 million in 2004 mainly due to fewer blockbuster movies in 2005. Revenues from the cinema business decreased by 4.3% in 2005 due to lower attendance rates in the cinema exhibition business stemming from the continuing effects of growth in the DVD market.

**Brazilian Mobile Business.** The table below sets forth both our operating revenues from our Brazilian mobile business in 2004 and 2005 in Euros and the total operating revenues of the Brazilian mobile business (including the portion attributable to our joint venture partner) in Reais.

	2004	2005	% Change	2004	2005	% Change
	(EUR Millions)(1)			(R\$ Millions)(1)		
<b>Brazilian Mobile Operating Revenues (Stand-Alone)</b>						
Services rendered	1,425.3	1,737.8	21.9%	10,364.2	10,567.8	2.0%
Sales	136.6	233.8	71.2%	993.0	1,422.0	43.2%
Other operating revenues	37.3	65.3	75.1%	270.9	397.2	46.6%
<b>Total</b>	<b>1,599.1</b>	<b>2,036.9</b>	<b>27.4%</b>	<b>11,628.1</b>	<b>12,387.1</b>	<b>6.5%</b>

(1) Amounts presented in Euros correspond to the proportional consolidation of 50% of Vivo's operating revenues, while amounts presented in Reais correspond to 100% of Vivo's operating revenues.

Operating revenues from our Brazilian mobile business increased 27.4% to €2,036.9 million in 2005 from €1,599.1 million in 2004, primarily due to appreciation of the Brazilian Real. In local currency terms, operating revenues increased 6.5%, primarily due to increased sales of handsets stemming from a higher proportion of high-end handsets sold and the increase in the price of entry-level handsets and, to a lesser degree, an increase in service revenues. In general, the increase in mobile usage charges due to an increase in the customer base (especially of prepaid customers) more than offset (1) a decrease in revenues from interconnection charges due to the effects of the trend toward mobile-to-mobile calls (which were subject to lower interconnection charges than fixed-to-mobile calls) and the effects of the partial "Bill & Keep" interconnection regime and (2) a decrease in monthly subscription charges, as the trend toward prepaid service in a highly competitive environment continued. The average revenue per user per month in 2005 was R\$28.7, as compared to R\$32.8 in 2004, primarily due to the increasing proportion of prepaid customers and the lower interconnection charges applicable to mobile-to-mobile calls. See "Item 4 Information on the Company Our Businesses Brazilian Mobile Business".

**Other Businesses.** Operating revenues from our other businesses contributed €215.2 million to our consolidated operating revenues in 2005, an increase of 32.5% from €162.4 million in 2004. This increase was primarily due to the increase in revenues recorded by Mobitel (a call center company in Brazil), PT Inovação (R&D consultancy) and PT Contact (call centers in Portugal). The increase in Mobitel's revenues, however, were significantly affected by the appreciation of the Real. The contribution of Mobitel's operating revenues to our consolidated operating revenues increased 60.2% to €51.7 million in 2005 from €32.3 million in 2004 but increased 34.0% in local currency terms to R\$157.3 million in 2005 from R\$117.4 million in 2004.

#### **Costs, Expenses, Losses and Income**

As explained in more detail below, our costs increased in 2005 due to, among other factors, the appreciation of the Real against the Euro and higher commercial activity across all businesses. For

more detail on these costs and expenses as they relate to each of our segments, see Note 7 to our audited consolidated financial statements.

**Wages and Salaries.** Wages and salaries, including employee benefits and social charges, increased 5.6% to €667.3 million in 2005 from €631.8 million in 2004. This increase was primarily due to the effect of the incorporation of 5,460 additional employees by Mobitel, although the effect on our consolidated financial statements was exacerbated by the appreciation of the Real. Wages and salaries at Mobitel increased 72.9% in local currency terms, but the contribution of Mobitel's wages and salaries to our consolidated wage and salaries increased 106.7% to €64.8 million in 2005 from €31.3 million in 2004. These increases in wage and salary expenses at Mobitel and at Vivo were partially offset by a 3.3% decrease in wages and salaries in our wireline business.

**Post Retirement Benefits.** We recorded a €21.6 million gain from post retirement benefits in 2005, compared to post retirement benefit expenses of €58.8 million in 2004, primarily due to changes made by the Portuguese government in the vested rights under our defined benefit plan, namely (1) the change in the retirement age in Portugal (which had a positive impact of approximately €110 million) and (2) changes in the method of calculating the pension of an employee upon retirement, which is now computed based on the average of the last three years of salary instead of the last salary (which had a positive impact of approximately €27 million). In 2004, our post retirement benefit expenses were partially offset by a prior years service gain in the amount of approximately €67 million related to a decrease in the percentage of the last salary prior to retirement (from 100% to 90%) used to calculate pensions. Our interest costs on our post retirement obligations increased to €229.1 million in 2005 from €212.9 million in 2004, but the expected return on the assets of the funds that cover a portion of our liabilities for post retirement benefit obligations increased to €139.0 million in 2005 from €111.1 million in 2004 due to our €300 million contribution to a new autonomous fund we established in 2005. Our interest costs net of our expected return on fund assets, therefore, decreased €12 million in 2005. See Note 9.2 to our audited consolidated financial statements. Excluding the effect of this extraordinary contribution, our net interest costs would have increased due to the increase in our post retirement benefit obligations as a result of further workforce reductions in our wireline business. This cost item does not include early termination costs related to our workforce reduction program, which are discussed under " *Workforce Reduction Program Costs*" below.

**Direct Costs.** Direct costs increased by 3.4% to €881.2 million in 2005 from €852.0 million in 2004. This increase was primarily due to a 1.5% increase in telecommunications costs, which are the main component of direct costs, to €562 million in 2005. These telecommunications costs include the interconnection fees we pay to other operators for calls terminated on their networks in our wireline and mobile businesses. Increases in telecommunications costs at Vivo, due in part to the appreciation of the Real against the Euro (which had an effect of approximately €37 million) were partially offset by lower telecommunications costs in our wireline and mobile businesses due to lower wireline traffic volumes and lower mobile-to-mobile interconnection rates affecting our domestic mobile business. In local currency, Vivo's telecommunications costs increased by 26.5% in 2005 as a result of higher traffic volumes. In our multimedia business, direct costs consist primarily of the costs of cable television programming. These programming costs increased 10.0% in 2005 to €140 million in 2005, primarily as a result of the launch of our Funtastic Life digital package in the Pay-TV business.

**Costs of Products Sold.** The costs of products sold increased by 9.5% to €652.3 million in 2005 from €595.8 million in 2004. This increase was primarily due to the appreciation of the Real against the Euro (which had an effect of approximately €70 million) and to increased sales of handsets by our domestic mobile business, partially offset by decreases in the costs of products sold in our wireline and multimedia businesses. In local currency, Vivo's costs of products sold decreased 7.1% to R\$2,557.1 due to the decrease in gross additions of customers.

**Marketing and Publicity.** Marketing and publicity costs increased 15.4% to €184.4 million in 2005 from €159.8 million in 2004. This increase was primarily due to a higher expenses for marketing and promotional activities in the highly competitive mobile service markets of Vivo and, to a lesser degree, TMN. The appreciation of the Real against the Euro exacerbated the effect of Vivo's higher spending on our consolidated marketing and publicity expenses. Vivo's marketing and publicity expenses increased 27.5% in local currency terms, but Vivo's contribution to our consolidated marketing and publicity expenses increased 52.5% to €87.0 million in 2005 from €57.1 million in 2004.

**Support Services.** Support services increased 12.9% to €230.2 million in 2005 from €203.8 million in 2004, primarily due to increases at Vivo and in our wireline business as a result of the outsourcing of certain additional functions and higher call center costs related to increased commercial activity. The appreciation of the Real against the Euro exacerbated the effect of Vivo's higher expenses on our consolidated support services expenses. Vivo's support services expenses increased 22.7% in local currency terms, but Vivo's contribution to our consolidated support services expenses increased 33.0% to €94.8 million in 2005 from €71.3 million in 2004.

**Maintenance and Repairs.** Maintenance and repairs increased 10.9% to €157.2 million in 2005 from €141.7 million in 2004 due to increases in maintenance expenses at Vivo and in our multimedia business, partially offset by decreases in such expenses in our wireline and domestic mobile businesses.

**Supplies and External Services.** Supplies and external services increased 18.2% to €760.4 million in 2005 from €643.5 million in 2004, primarily due to increases in sales commissions at TMN and Vivo due to increased commercial activity. The appreciation of the Real against the Euro exacerbated the effect of Vivo's higher expenses on our consolidated supplies and external services expenses. Vivo's expenses increased 19.5% in local currency terms, but Vivo's contribution to our consolidated supplies and external services expenses increased 41.3% to €267.5 million in 2005 from €189.3 million in 2004.

**Provisions for Doubtful Receivables, Inventories and Other.** Provisions for doubtful receivables, inventories and other increased 1.6% to €171.5 million in 2005 from €168.8 million in 2004. This increase was primarily due to an increase of €92.6 million in Vivo's contribution to this consolidated cost item, as a result of increases in provisions for doubtful receivables relating to certain calls not acknowledged by our customers and the impact of the appreciation of the Real against the Euro (which had an effect of approximately €24 million). This increase in provisions for doubtful receivables at Vivo was partially offset by a reduction in provisions in the wireline business, including the reversal of a provision for a receivable from Angola Telecom (€23 million) that was received in the period and the reduction of a provision recorded in 2004 to cover risks associated with the cancellation of certain contracts (€30 million). The reduction in the latter provision resulted from positive developments in the negotiations for the settlement of these contracts.

**Indirect Taxes.** Indirect taxes increased 34.7% to €166.0 million in 2005 from 123.2 million in 2004, primarily due to increased expenses at Vivo for FISTEL fees (Fundo de Fiscalização das Telecomunicações), a Brazilian federal tax applicable to telecommunications transmission equipment. Such expenses increased by €35 million, of which €18 million was related to the appreciation of the Real against the Euro.

**Depreciation and Amortization.** Depreciation and amortization costs increased by 19.9% to €1,120.7 million in 2005 from €934.9 million in 2004. This increase was primarily due to the increase of €165.3 million in the contribution of Vivo to our consolidated depreciation and amortization. This increase was primarily due to the impact of the Real's appreciation against the Euro (which had an effect of approximately €74 million) and to the allocation of goodwill generated in the tender offers for additional shares of the Vivo subsidiaries in October 2004 to an intangible asset (the telecommunications licenses held by these companies) that is being amortized over the remaining period of those licenses.

**Workforce Reduction Program Costs.** Workforce reduction program costs increased 89.8% to €314.3 million in 2005 from €165.6 million in 2004 in connection with the reduction of the workforce at our wireline business by 1,272 employees in 2005. See " *Liquidity and Capital Resources Post Retirement Benefits*" for a description of these reductions.

**Other Costs.** Other costs amounted to €18.8 million in 2005, compared to €92.8 million in 2004. This decrease is primarily due to the following costs recorded in 2004: (1) a provision of €26 million in the Pay TV business related to the dismantling of the analog network, (2) a provision amounting to €12 million for tax contingencies at PT Multimédia and (3) an expense of €10 million incurred in the wireline business for the settlement of a litigation case with DECO, the Portuguese consumer association, as described in greater detail in " *Item 8 Financial Information Legal Proceedings*".

### **Financial Income and Expenses**

**Net Interest Expenses.** Net interest expenses increased 25.7% to €257.6 million in 2005 from €204.9 million in 2004. In 2005, net interest expenses related to our debt excluding Brazil increased 30.0% to €156.0 million in 2005 as a result of the increase in average net debt in the period, in view of, among other things, contributions to fund pension and healthcare post retirement obligations and working capital requirements, and taking into account higher cash balances following financings in 2005, in part to repay the Eurobonds due in February 2006. In 2005, Vivo's contribution to our interest expenses increased 19.8% to €101.7 million in 2005 from €84.9 million in 2004 due primarily to the appreciation of the Real against the Euro during the period and higher CDI (a Brazilian interbank deposit interest rate) levels. In local currency, Vivo's interest expenses increased 0.2% during the period. Our net interest expenses in 2005 were equivalent to an average cost of debt, including debt in Brazil, of approximately 6.6%. Our net interest expenses for our Portuguese businesses represented an average cost of debt of approximately 4.7% in 2005.

**Net Foreign Currency Exchange Losses (Gains).** We had net foreign currency gains of €41.3 million in 2005, compared to net foreign currency losses of €4.5 million in 2004, primarily as a result of the evolution of the Real/Dollar and Euro/Dollar exchange rates over the period. The gains recorded in 2005 are mainly related to (1) the appreciation of the Real against the U.S. dollar, which led Vivo to record gains in connection with its U.S. dollar-denominated debt not swapped into Reais and (2) the depreciation of the Euro against the U.S. dollar, which generated gains in connection with the inter-company loans (denominated in U.S. dollars) granted to Vivo in previous years that were fully repaid by the end of 2005.

**Net Losses (Gains) on Financial Assets.** We recorded net losses on financial assets of €8.8 million in 2005, compared to net gains on financial assets of €11.6 million in 2004. This line item primarily includes gains and losses on derivative contracts, namely (1) equity swap contracts for PT Multimédia shares (which produced a net gain of €26 million in 2005, compared to €54 million in 2004), (2) foreign exchange derivatives of Vivo (which produced net losses of €50 million in 2005, compared to net losses of €34 million in 2004) and (3) foreign exchange derivatives of Portugal Telecom (which produced net gains of €14 million in 2005, compared to net losses of €12 million in 2004).

**Equity in Earnings of Affiliated Companies.** Equity in earnings of affiliated companies amounted to €238.2 million in 2005, compared to €20.9 million in 2004. This increase occurred primarily due to (1) the gain of €174 million related to the restructuring of Portugal Telecom's investment in UOL and the subsequent disposal of a portion of the investment (16%) following the initial public offering of that company in Brazil in December 2005, as described in more detail in Note 28 to our audited consolidated financial statements, and (2) an increase in the earnings of Unitel (from €17 million to €51 million), CTM (from €11 million to €16 million) and Médi Télécom (from €(6) million to €3 million).

**Net Other Financial Expenses.** Net other financial expenses increased 15.9% to €64.5 million in 2005 from €55.6 million in 2004 and include banking services expenses, commissions, financial discounts and other financing costs. The increase in 2005 is primarily due to operations in Brazil (including €3 million due to the appreciation of the Real against the Euro), namely in connection with the disposal of a portion of the investment in UOL and expenses relating to the corporate reorganization of Vivo that was completed in the first quarter of 2006.

**Income Taxation**

Income taxes increased 53.9% to €323.2 million in 2005 from €210.0 million in 2004. This increase was primarily due to the recognition in 2004 of a deferred tax asset of €104 million in connection with tax losses carried forward at PT Multimédia. Other than the effect of this deferred tax asset, our effective tax rate increased from 34.6% in 2004 to 36.5% in 2005, mainly as a result of the increase in net losses at certain Vivo subsidiaries during the period that did not generate corresponding tax credits that could be used to lower our income tax expenses for the period.

**Net Income From Continued Operations**

For the reasons described above, net income from continuing operations decreased 4.6% to €667.2 million in 2005 from €699.1 million in 2004.

**Discontinued Operations**

Discontinued operations reflect the results of companies that have been disposed of during the reportable periods, and the after-tax gains obtained with the sale of these investments. Due to the announced disposal of Lusomundo Serviços (PT Multimédia's media business) and PrimeSys in 2005, these businesses were reported as discontinued operations in the consolidated statement of income for the years 2004 and 2005 in accordance with IFRS. The earnings of these companies were included in discontinued operations until the effective date of the disposals, which were concluded on August 25, 2005 in the case of Lusomundo Serviços and on November 25, 2005 in the case of PrimeSys. In 2005, this line item includes a gain of €16.8 million from the sale of Lusomundo Serviços and a gain of €4.0 million from the sale of PrimeSys. In 2004, discontinued operations include the earnings of Lusomundo Serviços and PrimeSys for the full year, the earnings of Mascom until September 7, 2005 (the date of effective disposal of that company) and a gain of €23.4 million related to the sale of Mascom.

**Net Income (before minority interests)**

Net income (before minority interests) decreased 5.0% to €689.0 million in 2005 from €725.2 million in 2004 for the reasons described above.

Net income (before minority interests) from our wireline business increased 9.5% to €326.1 million in 2005 from €297.8 million in 2004, due to decreases in direct costs, post retirement benefit expenses, provisions for doubtful receivables and other factors, partially offset by the effects of lower operating revenues and a significant increase in workforce reduction program costs. Net income (before minority interests) from our domestic mobile business decreased 13.9% to €337.0 million in 2005 from €391.1 million in 2004 due to decreases in interconnection revenues, increases in the cost of products sold and supplies and external services, and other factors. Net losses (before minority interests) from our Brazilian mobile business increased to €(134.0) million in 2005 from €(8.5) million in 2004, where increases in expenses from depreciation and amortization, supplies and external services, provisions for doubtful receivables, direct costs and other expenses more than offset increases in operating revenues, in each case exacerbated by the effect of the appreciation of the Real against the Euro. Net income from continuing operations (before minority interests) of our multimedia business decreased 19.5% to €

99.4 million in 2005 from €123.4 million in 2004, primarily due to the absence in 2005 of deferred tax assets in the amount of €104 million recognized in 2004.

***Net Income Attributable to Minority Interests***

Net income attributable to minority interests in 2005 amounted to €35.0 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 (negative €11.0 million) and to the share of minority shareholders in the net income of PT Multimédia (€33.9 million) and Cabo Verde Telecom (€8.2 million). In 2004, net income attributable to minority interests amounted to €102.0 million and related primarily to 50% of the minority interests attributable to the share of minority shareholders in the net income of Vivo subsidiaries (€37.8 million), and to the share of minority shareholders in the net income of PT Multimédia (€52.0 million) and Cabo Verde Telecom (€7.1 million).

***Net Income Attributable to Equity Holders of the Parent***

For the reasons described above, our net income attributable to equity holders of Portugal Telecom increased by 4.9% to €654.0 million in 2005 from €623.2 million in 2004.

Basic earnings per ordinary and A share from total operations in 2005 increased to €0.58 in 2005 from €0.53 in 2004 on the basis of 1,128,856,500 shares issued at December 31, 2005 and 1,166,485,050 shares issued at December 31, 2004.

**Liquidity and Capital Resources**

***Overview***

Our principal capital requirements relate to:

funding our operations;

capital expenditures on our network infrastructure, information systems and other investments, as well as acquisitions of interests in other telecommunications companies (see " Capital Investment and Research and Development" and " Contractual Obligations and Off-Balance Sheet Arrangements" below);

repayments and refinancing of our indebtedness (see " Indebtedness" below);

dividend payments and purchases of Portugal Telecom shares; and

funding of post retirement benefits (see " Post Retirement Benefits" below).

Our principal sources of funding for these capital requirements are cash generated from our operations and equity and debt financing. Our cash and cash equivalents and short-term investments decreased 46.7% to €2,083.7 million as of December 31, 2006 from €3,911.8 million as of December 31, 2005. We believe that our cash balances, together with the cash that we expect to generate from our operations and available liquidity under our credit facilities and lines of credit, are currently sufficient to meet our present funding needs.

**Cash Flows**

The table below sets forth a breakdown of our cash flows for the years ended December 31, 2004, 2005 and 2006.

	<u>2004</u>	<u>2005</u>	<u>2006</u>
	(EUR Millions)		
Cash flow from operating activities	1,958.9	1,392.3	1,787.8
Cash flow from (used in) investing activities	185.5	(1,910.7)	1,147.8
Cash flow from (used in) financing activities	(1,958.2)	590.2	(2,992.7)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total</b>	186.2	71.7	(57.0)
	<u>          </u>	<u>          </u>	<u>          </u>

**Cash Flow From Operating Activities.** Cash flows from operating activities and used in operating activities include collections from clients, payments to suppliers, payments to personnel and other collections and payments of post retirement benefits activities. Our cash flows from operating activities result primarily from operations conducted by our subsidiaries and not by Portugal Telecom. 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 Brasilcel, the corporate entity that holds the joint venture's interests in Vivo. A proposal by the managing board of Brasilcel for the payment of dividends or other distributions requires the approval of Brasilcel's supervisory board and Brasilcel's shareholders. Because of the composition of Brasilcel's supervisory board and the 50% interest of each party in the joint venture, 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".

Net cash flow from operating activities increased by 28.4% to €1,787.8 million in 2006 from €1,392.3 million in 2005. This increase was primarily due to a €204.4 million increase in collections from customers, a €140.0 million reduction in payments to suppliers and a €138.0 million decrease in payments relating to post retirement benefits, mainly as result of a reduction in the contributions to our pension funds.

Net cash flow from operating activities decreased by 28.9% to €1,392.3 million in 2005 from €1,958.9 million in 2004. This decrease was primarily due to a €421.4 million increase in payments to suppliers, a €401.2 million increase in payments relating to post retirement benefits (including the €300.0 million contribution to the autonomous fund we created in 2005 to finance our healthcare benefit obligations) and other payments, which more than offset a €422.4 million increase in collections from customers.

**Cash Flow From (Used in) Investing Activities.** Cash flows from investing activities include proceeds of dispositions of investments in associated companies and property, plant and equipment, as well as interest and related income on investments. Cash flows used in investing activities primarily include investments in short-term financial applications, capital expenditures for telecommunications equipment and investments in other companies.

Net cash receipts from investing activities amounted to €1,147.8 million in 2006, compared to net cash payments of €1,910.7 million in 2005. The increase in net cash receipts in 2006 was primarily due to the increase in net cash receipts from short-term financial applications, mainly related to higher balances of short-term financial applications maintained by Portugal Telecom in 2006 as part of our centralized cash management strategy, including for purposes of repaying debt due in 2006. This effect was partially offset by a €384.9 million decrease in cash receipts from disposals of investments compared to 2005, as explained in the next paragraph.

Net cash used in investing activities increased to €1,910.7 million in 2005 from net cash receipts of €185.5 million in 2004. This increase was primarily due to (1) the increase in cash payments, net of cash receipts, from short-term financial applications, primarily as a result of the refinancings done in 2005, which were partially used in 2006 to repay a Eurobond maturing in February 2006 and (2) a €151.3 million increase in payments for investments in tangible assets reflecting an increase in capital expenditures on our network infrastructure and information systems. The increase in net cash used in investing activities was partially offset by the increase in cash receipts from dispositions of investments, including €173.8 million from the sale of Lusomundo Media, €101.8 million from the sale of PrimeSys and €85.6 million from the sale of an interest in UOL, and a decrease in payments relating to investments, especially a €222.5 million decrease in payments relating to Vivo due to the absence in 2005 of payments to finance the tender offers for additional shares of the Vivo subsidiaries completed in October 2004.

**Cash Flows From (Used In) Financing Activities.** Cash flows used in financing activities include borrowings and repayments of debt, payments of interest on debt and payments of dividends to shareholders. Cash flows from financing activities primarily consist of borrowings.

Net cash payments from financing activities amounted to €2,992.7 million in 2006, compared to net cash receipts of €590.2 million in 2005. In 2006, cash payments for the repayment of loans, net of cash receipts from loans obtained, amounted to €1,741.1 million and primarily included (1) €899.5 million related to the repayment of the notes issued by PT Finance in February 2001, (2) €460.0 million related to the partial repayment of the multicurrency credit facility entered into in 2003 and (3) €390.3 million related to the repayment of convertible bonds issued by PT Finance in December 2001. In 2005, cash receipts from loans obtained, net of cash payments from loans repaid, amounted to €1,951.0 million and primarily reflected (1) €2 billion in Eurobonds issued by PT Finance in 2005 and (2) €250 million related to two loans obtained from the European Investment Bank (EIB), partially offset by €585.0 million related to the repayment of the floating rate notes issued by PT Finance in December 2001.

Net cash receipts from financing activities amounted to €590.2 million in 2005, compared to net cash payments of €1,958.2 in 2004. In 2004, cash payments to repay loans, net of cash flows from loans obtained, amounted to €726.8 million and primarily reflected (1) repayments of the exchangeable bonds issued in June 1999 in the amount of €450.5 million and (2) the repayment of the PT/97 bond issued in 1997 in the amount of €124.7 million.

In 2005, dividend payments increased 49.9% to €445.4 million. In addition, acquisitions of our own shares decreased 31.3% to €340.5 million in 2005.

In 2006, dividends paid amounted to €581.5 million, compared to €445.4 million in 2005. In addition, there were no acquisitions of our own shares in 2006, compared to €340.5 million in acquisitions of shares in 2005.

### **Indebtedness**

Our total consolidated indebtedness decreased 23.0% to €5,840.3 million at the end of 2006, compared with €7,584.2 million at December 31, 2005, mainly due to (1) the repayment of the Eurobonds issued in February 2001, amounting to €899.5 million, (2) the repayment of the exchangeable bonds issued in December 2001, amounting to €390.3 million and (3) lower amounts drawn down under our standby facilities (€185 million at the end of 2006 compared to €575 million one year earlier). Our cash and cash equivalents decreased 10.4% to €548.5 million as of December 31, 2006 from €612.2 million as of December 31, 2005, and our short-term investments decreased 53.5% to €1,535.2 million as of December 31, 2006 from €3,299.6 million as of December 31, 2005, primarily due to the repayment of indebtedness.

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The composition of our indebtedness also changed in 2006, with medium- and long-term loans increasing from 68.1% to 76.5% of our total indebtedness mainly because of the repayments mentioned above.

In the table below, we have presented the composition of our consolidated indebtedness as of December 31, 2004, 2005 and 2006.

Debt	As of December 31,					
	2004		2005		2006	
	Euro millions	% of total indebtedness	Euro millions	% of total indebtedness	Euro millions	% of total indebtedness
<b>Short-term</b>	<b>1,622.4</b>	<b>29.4</b>	<b>2,415.6</b>	<b>31.9</b>	<b>1,372.7</b>	<b>23.5</b>
Exchangeable bond loans			390.3	5.1		
Bond loans	585.0	10.6	899.5	11.9		
Bank loans	480.4	8.7	407.8	5.4	406.9	7.0
Other loans	338.0	6.1	589.7	7.8	749.9	12.8
Liability for equity swaps on own shares	189.8	3.4	102.0	1.3	187.6	3.2
Financial leases	29.2	0.5	26.2	0.3	28.4	0.5
<b>Medium- and long-term</b>	<b>3,899.3</b>	<b>70.6</b>	<b>5,168.6</b>	<b>68.1</b>	<b>4,467.5</b>	<b>76.5</b>
Exchangeable bond loans	386.9	7.0				
Other bond loans	1,848.2	33.5	3,138.0	39.0	3,133.6	53.7
Bank loans	1,373.4	24.9	1,773.9	25.8	1,103.4	18.9
Other loans	90.6	1.6	31.2	0.4	0.3	0.0
Financial leases	200.2	3.6	225.5	3.0	230.2	3.9
<b>Total indebtedness</b>	<b>5,521.7</b>	<b>100.0</b>	<b>7,584.2</b>	<b>100.0</b>	<b>5,840.3</b>	<b>100.0</b>
Cash and cash equivalents	442.8	8.0	612.2	8.1	548.5	9.4
Short-term investments	1,505.8	27.3	3,299.6	43.5	1,535.2	26.3
	<b>3,573.2</b>	<b>64.7</b>	<b>3,672.5</b>	<b>48.4</b>	<b>3,756.6</b>	<b>64.3</b>

**Maturity.** Of the total indebtedness outstanding as at December 31, 2006, €1,372.7 million is due before the end of December 2007. The remaining €4,467.5 million is medium- and long-term debt. The average maturity of our debt is 7.4 years.

**Interest Rates.** As at December 31, 2006, 62.3% of our total indebtedness was at fixed rates, primarily as a result of the fixed-rate bonds issued in 1999 and 2005.

**Credit Ratings.** Our credit ratings are currently as follows:

Rating Agency	Credit Rating	Last Update	Outlook
Moody's	Baa2	March 5, 2007	Stable
Standard & Poor's	BBB-	March 16, 2007	Stable
Fitch Ratings	BBB	March 5, 2007	Negative

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Immediately after the announcement by Sonae on February 6, 2006 of the tender offer for Portugal Telecom, Standard & Poor's placed our credit rating on CreditWatch with negative implications, while Moody's placed our credit rating on review for possible downgrade, in each case due to the possible increased leverage that would result from the transaction. Following the presentation by our board of directors of an alternative shareholders' remuneration plan which would increase our indebtedness, Standard & Poor's and Moody's downgraded our ratings to BBB+ and Baa1, respectively, on March 8, 2006. On August 3, 2006, Standard & Poor's and Moody's downgraded our ratings to BBB- and Baa2, respectively, following the announcement of a further step-up in the shareholder remuneration plan. After the failure of the tender offer, the rating agencies confirmed our credit ratings as BBB- (Standard & Poor's) and Baa2 (Moody's), both with stable outlook.

We have four loans from the European Investment Bank (EIB) totaling €365 million as of December 31, 2006 that contained a provision under which the EIB had the right to require us to provide a guarantee acceptable to EIB in the event our ratings were downgraded to BBB/Baa2. In that circumstance, and after notice from the EIB, we would have 60 days to present an acceptable guarantee. If we failed to provide EIB the required guarantee, the EIB would have the right to accelerate the repayment of the loans. As a result of our ratings downgrade on August 3, 2006 to BBB- by S&P, to Baa2 by Moody's and to BBB by Fitch, we negotiated with EIB revised terms and conditions for these loans. The agreement with the EIB, signed on February 23, 2007, allows us to present the guarantee mentioned above only in the case of a downgrade from the current rating (BBB- by S&P, Baa2 by Moody's and BBB by Fitch). As part of this agreement, the spreads on these loans were increased by between 1 and 28 basis points, which will increase our interest expenses. See "*Item 3 Key Information Risk Factors Our Recent Ratings Downgrade and Any Future Downgrades May Impair Our Ability to Obtain Financing and May Significantly Increase Our Cost of Debt*".

***Debt Instruments and Repayment and Refinancing of Indebtedness.*** Set forth below is a brief description of certain of our debt instruments. See Note 34 to our audited consolidated financial statements for more information.

**Global Medium Term Note Program.** We have established a global medium term note program providing for the issuance of bonds. 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. During 2002 and 2003, we repurchased a portion of these bonds, which we cancelled in 2004. As of December 31, 2006, the outstanding amount of the bonds maturing in 2009 was €880 million. In February 2001, we issued another €1 billion in notes under the program at a fixed interest rate of 5.75%. These bonds were repaid at maturity in February 2006.

On March 24, 2005, we issued €1 billion in bonds under our global medium term note programme 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 same 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 same program at a fixed interest rate of 4.5% per annum, maturing in 2025.

In November 2006, we increased the size of the program to €7.5 billion.

**Multi-Currency Revolving Credit Facilities.** 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 the former Vivo entities Telesp Celular and Global Telecom. In January 2003, we cancelled this syndicated loan, and in February 2003, we entered into a bilateral multi-currency revolving credit facility that amounted to €500 million, maturing in 2005. In 2004 and 2005, we renegotiated the

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terms of this facility. The spread over Euribor was reduced and the maturity was extended so that 50% of the loan is payable in 2009 and the remainder in 2010.

In 2004, we entered into three bilateral multi-currency revolving credit facilities totaling €400 million: one in June 2004 amounting to €150 million and with a maturity of four years; the second in October 2004 amounting to €100 million and with a maturity of three years; and a third in October 2004 amounting to €150 million and with a maturity of three years and six months. In 2005, the maturities of the June 2004 €150 million multi-currency credit facility and the €100 million multi-currency credit facility were extended for two additional years.

As of December 31, 2006, we had borrowed a total of €185 million under these four bilateral credit facilities described above.

**EIB Loans.** We have several amortizable loans from the European Investment Bank (EIB) in the aggregate amount of €699.0 million as of December 31, 2006. These include (1) loans in the aggregate amount of €239.2 million, bearing an average fixed interest rate of 3.80% per annum and maturing on various dates from 2007 to 2013; (2) loans in the aggregate amount of €100.3 million, bearing fixed interest rates revisable on pre-agreed dates, with an average rate of 4.49% per annum as of December 31, 2006, and maturing on various dates from 2007 to 2013; (3) loans in the aggregate amount of €319.2 million whose floating interest rates have been swapped for fixed rate obligations at an average interest rate of 3.71% and maturing on various dates from 2007 to 2014 and (4) loan in the aggregate amount of US\$53.1 million (equivalent to €40.3 million using the Euro/U.S. dollar exchange rate at year-end), maturing in annual installments of US\$10.6 million, whose U.S. dollar principal and floating U.S. dollar interest rate have been swapped for Euro principal and floating Euro interest rate obligation at a spread of 0.05% over the Euro interbank offered rate, generating exchange losses of €9.5 million as of December 31, 2006 (also part of our indebtedness). See "*Item 11 Quantitative and Qualitative Disclosures About Market Risk*" for more information.

**Commercial Paper.** We have in place domestic commercial paper programs totaling €875 million, under which, as of December 31, 2006, there was indebtedness of €749.4 million outstanding.

**Vivo Indebtedness.** Our indebtedness includes bank loans in the Euro equivalent of €240.8 million as of December 31, 2006 (using the Euro/Real exchange rate at year-end), representing 50% of the outstanding indebtedness of Vivo under various bank loans, since we proportionally consolidate the assets and liabilities of Vivo. Our indebtedness also includes 50% of bonds issued by former Vivo subsidiary Telesp Cellular Participações S.A. (TCP) on August 1, 2003 in the principal amount of R\$500 million with a maturity of five years and an interest rate of 104.4% of the CDI rate per annum and 50% of bonds issued by TCP on May 1, 2005 in the principal amount of R\$1 billion with a maturity of ten years and an interest rate ranging between 103.3% and 104.2% of the CDI rate per annum. Our indebtedness also includes a Euro equivalent of €27.9 million in indebtedness of the Vivo subsidiaries to BNDES, the Brazilian development bank, representing 50% of the outstanding indebtedness under those facilities at the Euro/Real exchange rate at year-end.

**Covenants.** Our debt instruments contain certain covenants, as well as customary default and cross-acceleration provisions. As of the date hereof, the main covenants are as follows:

**Change in control.** Credit facilities amounting to €900 million and some loans obtained from EIB totaling €686 million as at December 31, 2006, give the lenders the right to demand repayment of the loans in the case of any change in control of Portugal Telecom.

**Credit rating.** Certain of our loan agreements with the EIB in the amount of €365 million as at December 31, 2006 stated that we may be asked to present a guarantee acceptable by the EIB if, at any time, the long-term credit rating assigned by the rating agencies to Portugal Telecom

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was reduced to BBB/Baa2 or less. As a result of our downgrade on August 3, 2006 to BBB- by S&P, to Baa2 by Moody's and to BBB by Fitch, the Company negotiated with EIB revised terms and conditions for these loans. The agreement with the EIB, signed on February 23, 2007, allows us to present the guarantee only in the case of a downgrade from the current rating (BBB- by S&P, Baa2 by Moody's and BBB by Fitch). See " *Credit Ratings*" above.

**Control and limitations on disposals of subsidiaries.** The credit facility amounting to €500 million requires us to, 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.

**Disposals of Assets.** Our €100 million multi-currency credit facility and certain of our EIB loans in the amount of €680 million as of December 31, 2006 contain restrictions regarding the disposal of assets by Portugal Telecom. Following the agreement signed with EIB on February 23, 2007 mentioned above, EIB waived its rights related to this covenant solely with respect to PT Multimedia's spin-off (subject to approval by the shareholders of Portugal Telecom, which has been obtained).

**Financial Ratios.** The €500 million multi-currency credit facility and the October 2004 €150 million credit facility agreement state that the consolidated ratio of Net Debt/EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the agreement) may not be higher than 3.5. The €100 million credit facility agreement states that Portugal Telecom's consolidated ratio of Net Debt/EBITDA may not be higher than 4.0. In addition, the terms (spread) of the €500 million credit facility and the June 2004 €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, 2006, this ratio stood at 1.55.

**Negative Pledge.** Our global medium term note program and credit facilities totaling €900 million include certain restrictions on the granting of pledges of 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. See "*Item 3 Key Information Risk Factors Our Recent Ratings Downgrade and Any Future Downgrades May Impair Our Ability to Obtain Financing and May Significantly Increase Our Cost of Debt*".

We discuss our exposure to interest rate and exchange rate risk, as well as our use of derivative instruments, in "*Item 11 Quantitative and Qualitative Disclosures About Market Risk*".

**Post Retirement Benefits**

The following table shows the amount of our liabilities for post retirement benefits recorded on our balance sheets at December 31, 2004, 2005 and 2006:

	As of December 31,		
	2004	2005	2006
(EUR millions)			
Gross projected pension benefit obligations(1)	3,592.4	4,238.8	4,071.5
Pensions	2,733.6	3,274.1	3,073.8
Salaries	858.8	964.7	997.7
Pension fund assets at fair value	1,972.6	2,200.2	2,263.9
<b>Unfunded pension liabilities</b>	<b>1,619.8</b>	<b>2,038.7</b>	<b>1,807.6</b>
Gross projected healthcare benefit obligations	701.8	912.8	491.1
Healthcare fund assets at fair value		315.6	644.2
Prior years' service gains(2)			19.1
<b>Unfunded healthcare liabilities/(surplus)</b>	<b>701.8</b>	<b>597.2</b>	<b>(134.1)</b>
<b>Total unfunded liability for post retirement benefits(3)</b>	<b>2,321.6</b>	<b>2,635.9</b>	<b>1,673.5</b>

(1) Including salaries for pre-retired and suspended employees.

(2) This caption refers to the component of the prior years' service gain resulting from changes in the healthcare plan related to those benefits that are not yet vested. This amount will be recognized in earnings during the estimated period in which those benefits will be earned by employees (18 years).

(3) As at December 31, 2006, this caption includes an accrued post retirement liability of €1,807.6 million related to pension benefits and a non-current asset of €134.1 million related to the surplus of healthcare benefit obligations. This asset is expected to be realized through the reduction of future contributions to the healthcare funds.

As of December 31, 2006, the projected benefit obligations, or PBO, of our post retirement benefits, including pension and healthcare obligations amounted to €4,563 million (€3,074 million for pensions, €491 million for healthcare benefits and €998 million for salaries for pre-retired and suspended employees). The projected benefit obligations were computed based on a 4.75% discount rate for pension and healthcare benefits and 4.25% for obligations related to the payment of salaries to pre-retired and suspended employees and assuming a 2.25% annual salary increase. Our post retirement benefit (pension and healthcare) plans, which are closed to new participants, cover approximately 33,200 employees (27% still in service) in the case of pensions and approximately 28,700 employees (30% still in service) in the case of healthcare obligations.

According to the rules of the Instituto de Seguros de Portugal, or ISP, the Portuguese insurance regulator, the liability related to retire employees under the pension plans have to be fully funded. Our pension obligations for retired employees, computed based on ISP rules, are fully funded. Funding of pension funds for pre-retired employees and employees still in service can be completed up to the retirement age under current rules. The estimated average working life of employees still in service is 15 years.

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In Portugal, there is no legislation covering the establishment of funds to cover post retirement healthcare benefit obligations and salaries for pre-retired and suspended employees. Portugal Telecom will be required to pay for these benefits only when the healthcare services are rendered to retired employees and a corresponding claim is charged to the company or when the salaries are paid to

pre-retired and suspended employees, as the case may be. Accordingly, there is no requirement to fund these benefit obligations at present. However, Portugal Telecom has set up a fund managed by our subsidiary PT Prestações Mandatária de Aquisições e Gestão de Bens, S.A., or PT Prestações, to finance its healthcare post retirement liabilities. In 2005 and 2006, Portugal Telecom contributed €300 million and €302 million, respectively, to this fund, which is being managed in accordance with the same guidelines as its pension funds.

The asset allocation of our pension and healthcare benefit funds as of December 31, 2006 was 45% equity, 34% bonds, 9% real estate and 12% cash and others. The effective performance of the funds in 2006 was 6.8%. As of December 31, 2006, the market value of the funds amounted to €2,908.1 million and, as a result, the unfunded liability related to PT's post retirement benefits amounted to €1,673.5 million. In 2006, the unfunded obligations decreased by €962.4 million. The table below shows the evolution of our unfunded obligations during 2006.

	2005	2006
	(EUR Millions)	
Unfunded obligations (initial balance)	2,321.6	2,635.9
Post retirement benefit expenses/(gains)	(21.6)	(72.1)
Workforce program reduction costs	314.3	208.9
Contributions and payments	(699.8)	(561.9)
Termination of the protocol with the Portuguese national healthcare service		(220.4)
Net actuarial losses/(gains)(1)	730.3	(319.4)
Disposals and acquisitions	(8.8)	2.5
	<u>2,635.9</u>	<u>1,673.5</u>
Unfunded obligations (final balance)	2,635.9	1,673.5

(1)

During 2006, this amount primarily relates to the net effect of the following changes in actuarial assumptions: (i) the increase in the discount rate from 4.5% to 4.75% for pension and healthcare liabilities and from 3.5% to 4.25% for salary liabilities, (ii) the reduction in the long-term health care cost trend rate from 3% to 2.75%, (iii) the reduction in the salary growth rate from 3.0% to 2.25%, (iv) the reduction in the pension growth rate and inflation rate from 2.0% to 1.75%, and (v) the adjustment in mortality tables (PA (90), from less three years to less four years). In 2005 this amount related primarily to changes in actuarial assumptions corresponding to the reduction in the discount rate from 5.75% to 4.5% for pension and healthcare liabilities and from 4.0% to 3.5% for salary liabilities.

The market value of the pension funds amounted to €2,908 million at December 31, 2006, an increase of €392 million from 2005, resulting primarily from the €302 million extraordinary contribution to PT Prestações and the strong performance of the pension funds (actual returns of 6.8% in 2006 through a diversified portfolio including 45% in equities). See Notes 9.1 and 9.2 to our audited consolidated financial statements.

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The table below sets forth the components of our net post retirement benefit expense (gains) in 2004, 2005 and 2006.

	Year Ended December 31,		
	2004	2005	2006
	(EUR Millions)		
Service cost	23.5	24.8	28.7
Interest cost	212.9	229.1	217.5
Expected return on assets	(111.1)	(139.0)	(167.7)
Prior years service gains(1)	(66.5)	(136.6)	(150.6)
	58.8	(21.6)	(72.1)
Post retirement benefit expense (gains)	58.8	(21.6)	(72.1)

(1)

In 2006, prior year service gains are primarily related to the reduction in healthcare benefits (€127 million) in connection with the changes made to our healthcare plan in order to maintain its long-term sustainability and financing. In 2005, this caption includes (i) €110 million related with the change in the retirement age for pensioners and (ii) €27 million related with the change in the pension formula from 90% of the last salary to 90% of the average of the last three years of salaries. In 2004, the prior years service gain was related to the change in the pension formula from 100% to 90% of the last salary.

In 2006, curtailment costs amounted to €20 million, which include net gains related to the termination of the protocol with the Portuguese national healthcare system. Excluding this gain, curtailment costs would have amounted to €229 million corresponding to the reduction of 792 employees and primarily included the net present value of salaries to be paid to pre-retired and suspended employees up to retirement age and the net present value of future service costs for early retired and pre-retired employees. We had workforce reduction program costs of €314.3 million in 2005, reflecting the reduction of 1,272 employees. See Notes 9.5 and 9.6 to our audited consolidated financial statements.

The table below sets forth the components of our cash flows associated with post retirement benefits in 2004, 2005 and 2006.

	Year Ended December 31,		
	2004	2005	2006
	(EUR Millions)		
Contributions to the funds	125.7	197.8	59.9
Salary payments (pre-retired and suspended employees)	143.1	167.7	165.5
Regular healthcare payments	29.8	34.3	34.2
Extraordinary contribution for post retirement healthcare benefits		300.0	302.3
	298.6	699.8	561.9
Payments related to post retirement benefits	298.6	699.8	561.9

### Equity

Our total equity excluding minority interests amounted to €2,255 million at December 31, 2006, compared to €1,828 million at December 31, 2005 and €1,687 million at December 31, 2004.

The increase in total equity excluding minority interests in 2006 was primarily related to the net income for the period (€867 million) and to the net actuarial gains recorded in the period (€219 million, net of tax). These effects were partially offset by dividends paid (€526 million), acquisition of treasury shares through equity swaps (€86 million) and the effect of currency translation



adjustments (€80 million), primarily due to the depreciation of the Real against the Euro in 2006 (€77 million).

The increase in total equity excluding minority interests in 2005 primarily reflected the effects of the increase resulting from the net income for the period (€654 million) and of currency translation adjustments, primarily due to the appreciation of the Real against the Euro in 2005, partially offset by net actuarial losses recorded in the period (€531 million, net of tax), dividends paid (€395 million) and the acquisition of treasury shares (€253 million).

Our total equity excluding minority interests as a percentage of total assets increased from 11.0% at the end of 2005 and to 15.9% at the end of 2006. Our gearing ratio, calculated as the ratio of net debt to total equity plus net debt, was 58.7% and 54.7% as of the end of 2005 and 2006, 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. When we adopted IFRS, an exemption under IFRS 1 permitted us to deem cumulative translation differences to be zero at the date of transition to IFRS (January 1, 2004). Cumulative foreign currency translation adjustments recorded in shareholders' equity were €16.2 million in 2004, €701.0 million in 2005 and €79.9 million in 2006. As a result of the adoption of IFRS and the exemption under IFRS 1, translation differences that arose after the date of transition to IFRS will be recognized in profits and losses upon the disposal of the related investment. See " *Overview Transition to International Financial Reporting Standards Explanation of Exemptions Applied Under IFRS 1*" and Note 3(q) to our audited consolidated financial statements.

### 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, 2006:

	Payments due by period in millions of Euros				
	Total	Less than 1 year	1 3 years	4 5 years	More than 5 years
<b>Contractual obligations:</b>					
Indebtedness	5,840.3	1,372.7	1,544.8	451.2	2,471.6
Interest on indebtedness(1)	1,596.9	303.1	428.1	264.8	600.8
Unfunded post retirement benefits(2)	1,654.4	157.6	292.9	248.6	955.3
Operating lease obligations	624.5	158.9	164.4	115.5	185.7
Unconditional purchase obligations	159.3	159.3			
<b>Total contractual cash obligations</b>	<b>9,875.3</b>	<b>2,151.6</b>	<b>2,430.2</b>	<b>4,080.1</b>	<b>4,213.4</b>

- (1) Interest on indebtedness is based on our assumptions regarding interest rates on our floating rate debt. Our actual interest obligations could vary significantly from these amounts depending on market interest rates.
- (2) Out net accrued liability for post retirement benefits amounted to €1,673.5 million as of December 31, 2006, which differs from the unfunded post retirement obligations due to prior year service gains generated in 2006, amounting to €19.1 million, which are being deferred over a period of 18 years.

Our operating leases relate to the contractual rental agreements entered into by our businesses, including obligations related to leased lines, the rental of buildings and cinema viewing rooms by our multimedia business. 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). We have also entered into certain agreements related to the acquisition of content for our multimedia business. We believe that our operating cash flow will be sufficient to fulfill all of our unconditional purchase commitments.

As described in "Item 4 Information on the Company Regulation Portugal Summary of Our Concession and Existing Licenses Our Mobile Service Licenses", TMN holds a license to offer UMTS service. Under the purchase agreement for the UMTS license, we committed to make contributions of €532 million to the development of the information society in Portugal during the period through the maturity of the license (2015). On May 2007, pursuant to an agreement between TMN and the Portuguese State, and based on contributions already made, the outstanding commitments were valued at €355 million. These contributions will mainly include the sale of subsidized equipment, the offer of our services at reduced prices and investments in the UMTS network. As a result, we expect that the actual cash payments to meet these commitments will be significantly less than the total commitment amount.

#### **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, 2006, we had given the following guarantees to third parties:

	Guarantees by period in millions of Euros				
	Total	Less than 1 year	1 3 years	3 5 years	More than 5 years
Bank guarantees and other guarantees given to Tax Authorities	41.1	41.1			
Bank guarantees given to Portuguese courts for outstanding litigation	2.3	2.3			
Bank guarantees given to other entities:					
By TMN to ANACOM	22.6	22.6			
By PT Comunicações	8.1	8.1			
By PT Multimédia and subsidiaries	8.3	8.3			
Other bank guarantees	4.1	4.1			
	43.2	43.2			
Comfort letters and other bank guarantees	39.8	39.8			

As of December 31, 2006, bank guarantees given on behalf of TMN include a guarantee presented in connection to cross-border lease transactions contracted by TMN (Note 33 to our audited consolidated financial statements) and guarantees presented to ANACOM related to TMN's obligations under the UMTS licenses acquired in December 2000. Bank guarantees given on behalf of PT Comunicações were given to municipal authorities and are primarily related to the repayment of taxes and other fees in connection with Portugal Telecom's use of public rights-of-way. Bank guarantees given on behalf of PT Multimedia include guarantees presented to the "Alta Autoridade para a Comunicação Social" (the Portuguese medial regulator) in connection with licenses for the broadcasting of television shows.

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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, which we have proportionally consolidated in our balance sheet in the amount of €31.5 million, 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, Médi Télécom 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 had an average term of 8 years and served 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. Médi Télécom restructured the loans in July 2004, extending the maturity to 2012. Under the provisions of the contracts, Médi Télécom is required to attain certain financial performance levels. The major shareholders of Médi Télécom (Portugal Telecom, through PT Móveis (32.18%), Telefónica Intercontinental S.A. (32.18%) and Banque Marocaine du Commerce Exterior (17.59%)) signed a Shareholders Support Deed according to the terms of which they committed to make future capital contributions to Médi Télécom (in the form of capital or shareholders' loans), if necessary, to cover possible shortfalls in the agreed financial targets. Under this agreement, these parties are committed to make contributions (capital subscription or loans) proportional to their stakes in the company up to a total of €168 million, of which €50 million are related to the repayment of debt. The obligation to contribute these funds terminates as soon as Médi Télécom reaches a Net/EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the applicable documentation) ratio of less than 2.0. As at December 31, 2006, following the renegotiation of the Shareholders Support Deed, the maximum liability to Portugal Telecom amounts to €54 million, which is proportional to its stake in Médi Télécom.

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, 2006, Portugal Telecom has already granted loans to Sportinveste Multimédia amounting to €30 million.

At December 31, 2006, we had assumed commitments in the ordinary course of business for the purchase of basic equipment and components, amounting to approximately €116 million and €43 million, respectively.

At December 31, 2006, guarantees given by third parties on behalf of the Company in connection with bank loans, as described in Note 34 to our audited consolidated financial statements, were as follows:

	<b>Amount</b>
	<b>(EUR Millions)</b>
Guarantees in favor of European Investment Bank	161.2
Guarantee from the Portuguese State to Kreditanstalt Für Wiederaufbau	6.2

At December 31, 2006, Portugal Telecom had bank loan deposits amounting to €28.0 million whose use was restricted in connection with the cross-border lease transactions described in Note 33 to our audited consolidated financial statements. At the same date, Vivo had tangible assets and financial applications given as guarantees for legal actions amounting to €19.2 million and €8.1 million, respectively.

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Finally, as part of cross-leasing transactions (Qualified Technological Equipment transactions, or "QTE leases") with different third parties, Portugal Telecom has leased out and then leased back certain telecommunications equipment. The cross-flow of lease payments and Portugal Telecom's remuneration were prepaid at the outset of the contracts and, for this reason, are not shown as future lease payments in the table under "Contractual Obligations and Commercial Commitments" above. 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 €673.7 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. We have recorded these QTE leases on our balance sheet in accordance with IFRS. See Notes 3(1)(ix), 29 and 39 to our audited consolidated financial statements for more information on our accounting for these transactions.

### Capital Investment and Research and Development

**Capital Investments and Financial Investments** During the year ended December 31, 2006, we made capital expenditures and financial investments totaling €1,140.3 million.

The table below sets out our total capital investments for 2004, 2005 and 2006, including the proportional consolidation of Vivo, in millions of Euros:

	Year Ended December 31,		
	2004	2005	2006
	(EUR Millions)		
Capital expenditures	761.2	943.2	1,000.5
Financial investments	278.5	18.2	139.8
	1,039.7	961.4	1,140.3

**Capital Expenditures.** During 2006, we made capital expenditures totaling €1,000.5 million, primarily relating to our mobile businesses in Brazil and Portugal and to the wireline business. The table below sets forth our capital expenditures on tangible and intangible assets, excluding goodwill, for 2004, 2005 and 2006, including the proportional consolidation of Vivo, in millions of Euro:

	Year Ended December 31,		
	2004	2005	2006
	(EUR Millions)		
Wireline	206.8	233.1	238.5
Domestic Mobile	154.9	170.2	188.6
Multimedia	73.2	119.9	132.8
Brazilian Mobile	264.1	361.0	386.8
Other	62.2	59.0	53.8
	761.2	943.2	1,000.5

Capital expenditures reached €1,000.5 million in 2006, equivalent to 15.8% of total operating revenues, as a result of (1) strong investment at the wireline business in broadband coverage and customer bandwidth, as well as outsourcing contracts to the corporate segment; (2) capital expenditures at TMN in connection with the continuing investment in network capacity and 3G/3.5G services; (3) Vivo's investment in the implementation of the GSM/EDGE overlay, network coverage and quality, and the consolidation and rationalization of billing, customer relationship management and enterprise resource planning (ERP) information systems and (4) capital expenditures at PT Multimédia relating to the increase in homes passed, the restructuring of the architecture of the access network to provide fiber-to-the-hub in order to allow for greater bandwidth for customers, and investments related to the launch of voice services.

In 2007, we expect to make investments similar in nature (though amounts may vary) to those made in 2006. We generally fund our capital expenditures from our cash flow from operations and from debt financing. See "Item 4 Information on Our Company Businesses Brazilian Mobile Business Capital Expenditures," for additional information regarding Vivo's expected capital expenditures.

As of December 31, 2006, we had commitments in the ordinary course of business for the purchase of equipment in the amount of approximately €116 million and content in the amount of approximately €43 million.

**Financial Investments.** Investment in financial assets (including goodwill) amounted to €139.8 million in 2006, €18.2 million in 2005 and €278.5 million in 2004. In 2006, financial investments were primarily related to the acquisition of 34% of MTC (€109 million). In 2004, financial investments were mainly related to the acquisition of an additional interest in TCO, Tele Sudeste, Tele Leste and Celular CRT Participações (€231 million).

#### *Acquisitions and Divestitures of Companies*

**2006.** Set forth below are the primary changes that occurred during the year ended December 31, 2006 to our interests in the companies consolidated in our financial statements and in connection with purchases of our own shares.

##### *Acquisitions*

During 2006, Portugal Telecom acquired a 34% stake of Mobile Telecommunications Limited ("MTC"), a mobile operator in Namibia for €108.6 million. In connection with this transaction, Portugal Telecom entered into an agreement with the remaining shareholders of MTC under which Portugal Telecom has the power to set and control the financial and operating policies of this company.

##### *Other Transactions*

At the Annual General Meeting of April 21, 2006, shareholders approved a share capital increase of €338,656,950 and a subsequent share capital reduction of €1,072,413,675. The share capital increase was effected May 11, 2006 through the incorporation of capital issued premiums, legal reserves and reserves for treasury shares. The share capital reduction was effected on September 11, 2006 through the transfer of that amount to accumulated earnings. Following both these transactions, Portugal Telecom's fully subscribed and paid-in share capital as at December 31, 2006 amounted to €395,099,775 and is represented by 1,128,856,500 shares with a nominal value of thirty five euro each.

**2005.** Set forth below are the primary changes that occurred during the year ended December 31, 2005 to our interests in the companies consolidated in our financial statements and in connection with purchases of our own shares.

##### *Sales*

In August 2005, we sold Lusomundo Media for net proceeds of approximately €174 million.

In November 2005, we sold Primesys for R\$101.8 million.

In December 2005, we sold 35,000,000 shares of UOL (representing a 16% stake in the company) in UOL's initial public offering in Brazil and received net proceeds of R\$201.0 million. At the end of 2005, our participation in UOL was 29%.

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### *Share Buyback Program*

In December 2005, Portugal Telecom reduced its share capital from €1,166,485,050 to €1,128,856,500 through the cancellation of 37,628,550 treasury shares that were purchased during 2005. The number of treasury shares cancelled was equivalent to 3.0% of the initial share capital prior to the 7.0% cancellation in December 2004, thus completing the 10.0% share buyback announced in September 2003.

A new share buyback program was approved by the shareholders in April 2005, providing for the acquisition of up to 3.0% of our share capital. As of December 2005, we had contracted equity swaps for 13,240,000 shares with a notional amount of €102.0 million under this share buyback program, corresponding to 1.17% of our share capital.

**2004.** Set forth below are the primary changes that occurred during the year ended December 31, 2004 to our interests in the companies consolidated in our financial statements.

### *Acquisitions*

During 2004, PT Conteúdos acquired 250,000 shares of Sport TV, equivalent to 16.6% of its share capital, for €16.3 million. This acquisition increased PT Conteúdos' ownership of Sport TV to 50%, and the purchase price was allocated to an intangible asset consisting of the broadcasting rights held by Sport TV for the matches of the Portuguese football leagues for the 2004 to 2008 seasons.

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 Sudestecel Participações, S.A. for €20.6 million.

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, another former Vivo subsidiary. 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 Celular CRT. Vivo paid approximately R\$607 million and acquired an additional 4.2%, 22.7% and 15.8% of Tele Sudeste, Tele Leste and Celular CRT, 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, we disposed of Mascom Wireless for the amount of €45.6 million.

### *Other operations*

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In September 2003, we announced our intention to buy back 10.0% of our share capital by the end of 2004, subject to financial and market conditions. Pursuant to our share buyback program, we reduced our share capital in December 2004 by 7.0% through the cancellation of 87,799,950 treasury shares acquired during 2003 and 2004, at an average price of €7.87 per share. In

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addition to treasury shares repurchased directly by us, we entered into equity swap contracts to buy 21,551,006 shares during 2004. As described above, this share buyback program was completed in 2005.

### **Research and Development**

In 2004, 2005 and 2006, we invested approximately €10.6 million, €11.1 million and €4.0 million, respectively, in research and development. Our research and development programs focus 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 infrastructure 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.

### **U.S. GAAP Reconciliation and Recent Accounting Pronouncements**

#### **U.S. GAAP Reconciliation**

Our consolidated financial statements have been prepared in accordance with IFRS, which differs in certain significant respects from U.S. GAAP. Our net income from continuing operations (before minority interests) under IFRS was €699.1 million in 2004, €667.2 million in 2005 and €954.1 million in 2006, and our net income from continuing operations (after minority interests and before change in accounting principles) under U.S. GAAP was €485.7 million in 2004, €424.5 million in 2005 and €734.7 million in 2006. Our shareholders' equity as of December 31, 2004, 2005 and 2006 under IFRS was €2,254.2 million, €2,582.1 million and €3,106.0 million in 2006, respectively, and our shareholders' equity under U.S. GAAP as of those dates was €1,638.5 million, €1,819.4 million and €1,877.6 million in 2006, respectively. The principal differences between IFRS and U.S. GAAP with respect to our consolidated financial statements in 2004, 2005 and 2006 relate to:

the treatment of post retirement benefits, including the treatment of actuarial gains and losses, the recognition of prior years service gains, minimum liability adjustments under U.S. GAAP and treatment of the net transition obligation;

revaluations of fixed assets;

capitalization of interest;

treatment of goodwill;

recognition of revenue;

accounting for derivatives; and

U.S. GAAP adjustments relating to equity investees and discontinued operations.

See Note 47 to our audited consolidated financial statements for a complete description of these adjustments.

***New U.S. Accounting Pronouncements***

***Accounting for Certain Hybrid Financial Instruments: An Amendment of FASB Statements Nos. 133 and 140.*** In February 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments: an amendment of FASB Statements No. 133 and 140", which amends FASB Statements No. 133, "Accounting for Derivative Instruments and Hedging Activities", and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". This Statement resolves issues addressed in Statement 133 Implementation Issue No. D 1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets".

This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. We do not anticipate that the adoption of this new statement at the required effective date will have a significant effect in our results of operations, financial position or cash flows.

***Accounting for Servicing of Financial Assets.*** In March 2006 the FASB issued Statement No. 156 "Accounting for Servicing of Financial Assets: an amendment of FASB Statement No. 140." This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to choose a measurement method for each class of separately recognized servicing assets and servicing liabilities. An entity should adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year. We do not anticipate that the adoption of this new statement at the required effective date will have a significant effect in its results of operations, financial position or cash flows.

***Accounting for Uncertainty in Income Taxes.*** In June 2006, the FASB issued FASB Interpretation (FIN 48), "Accounting for Uncertainty in Income Taxes" an interpretation of FASB Statement No. 109". This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification and other matters.

FIN 48 is effective for fiscal years beginning after December 15, 2006. We are assessing the impact of the adoption of FIN 48.

**Fair Value Measurements.** In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements". This Statement defines fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that will result from the adoption of SFAS 157.

**Employers' Accounting for Defined Pension and Other Postretirement Plans.** In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Pension and Other Postretirement Plans an amendment of FASB Statement No. 87, 88, 106 and 132 (R)". This Statement requires the recognition of the funded status of a benefit plan in the statement of financial position. It also requires the recognition as a component of other comprehensive income (OCI), net of tax, of the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to Statement 87 or 106. The Statement also has new provisions regarding the measurement date as well as certain disclosure requirements. The Statement was effective at fiscal year end 2006, and the we adopted the statement at that time, as explained in Note 47 to our audited consolidated financial statements.

**Fair Value Option for Financial Assets and Financial Liabilities.** In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". SFAS No. 159 permits measurement of recognized financial assets and liabilities at fair value with some exceptions. Changes in the fair value of items for which the fair value option is elected should be recognized in income or loss. The election to measure eligible items at fair value is irrevocable and can only be made at defined election dates or events, generally on an instrument by instrument basis. Items for which the fair value option is elected should be separately presented or be parenthetically disclosed in the statement of financial position. SFAS No. 159 also requires significant new disclosures that apply for interim and annual financial statements. SFAS No. 159 will be effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted, if certain conditions are met. We are currently determining the policy of adoption as well as the resulting effect of SFAS No. 159 on or consolidated financial statements.

**Considering the Effects of Prior Year Misstatements.** In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements". SAB 108 expresses the SEC's view regarding the process of quantifying financial statement misstatements. The bulletin was effective as of the year beginning January 1, 2006. The implementation of this bulletin had no impact on our consolidated financial statements and disclosures.

**Gross Versus Net Presentation of Taxes Collected from Customers.** In June 2006, the Emerging Issues Task Force, or EITF, reached a consensus on Issue No. 06-03, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That Is, Gross versus Net Presentation)". EITF 06-03 relates to any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction. EITF 06-03 states that the presentation of the taxes, either on a gross or net basis, is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies", if those amounts are significant. EITF 06-03 should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006 (January 1, 2007 for us). We are currently evaluating the impact of this standard on our consolidated financial statements and disclosures.

**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 Reals as of December 31, 2005 and 2006.

Consolidated Assets	As of December 31,			
	2005		2006	
	EUR millions	% of total assets	EUR millions	% of total assets
Euro	11,072	66.6%	9,032	63.7%
Brazilian Real	5,424	32.6%	4,867	34.3%
Other	133	0.8%	272	1.9%
	16,629	100.0%	14,171	100%

**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, 2005 and 2006. The amounts presented take into account the derivative agreements we have entered into. For further information, see Note 34 to our audited consolidated financial statements included in this report.

Indebtedness	As of December 31,			
	2005		2006	
	EUR millions	% of total indebtedness	EUR millions	% of total indebtedness
Euro	6,511	85.9%	5,009	85.8%
Brazilian Real	927	12.2%	802	13.7%
U.S. dollar	136	1.8%	21	0.4%
Other currencies	10	0.1%	8	0.1%
	7,584	100.0%	5,840	100.0%

**Exposure to Exchange Rate Risk.** Our Brazilian Real-denominated debt enables us to hedge to a certain extent against exchange rate risk relating to our Brazilian Real-denominated assets. We do not generally use other hedging instruments to hedge our foreign currency-denominated assets. As of December 31, 2006, Vivo's consolidated debt (the great majority of which is either Brazilian Real-denominated or has been swapped into Brazilian Reals) represented 13.7% of our total consolidated indebtedness.

For more detailed information as at December 31, 2006 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, 2006, our 50% interest in Vivo's net assets amounted to €2,551.8 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 Operating and Financial Review and Prospects". In the last three years, the Real has stabilized and even appreciated against the Euro and the U.S. Dollar. By the end of 2006, the exchange rate between the Euro and the Real was R\$2.8118 = €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, 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 Risks Related to Our Brazilian Mobile Business 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 rules governing the composition of the Board of Directors were changed at the General Meeting of Shareholders held on June 22, 2007. Under the new rules, the Board of Directors is composed of any odd or even 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. 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.

The articles of association also provide for an audit committee composed of three members of the board of directors. The responsibilities of the audit committee are described below under " *Board Practices*".

#### *Board of Directors and the Executive Committee*

Portugal Telecom's Board of Directors currently consists of twenty-three directors. The Executive Committee is currently composed of seven directors. 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.

The term of office of the members of the Board of Directors listed below expires on December 31, 2008.

The following directors are also members of the Executive Committee:

*Henrique Manuel Fusco Granadeiro.* First elected 2003. Term expires 31st December, 2008. Aged 63. Chief Executive Officer and Chairman of the Board of Directors of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of PT Centro Corporativo S.A., since March 2006; Chairman of the Board of Directors of PT Portugal, SGPS S.A., since March 2006; Chairman of the Board of Directors of PT Rede Fixa, SGPS S.A., since April 2006; Member of the Strategic Council of Banco Finantia since 2001; Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimédia, SGPS, S.A. since 2001; Member of the Board of Directors of Fundação Eugénio de Almeida since 1992; Chief Executive Officer of Lusomundo Media, SGPS S.A. from 2002 until 2004; Chief Executive Officer of Diário de Notícias from 2002 until 2004; Chief Executive Officer of Jornal de Notícias from 2002 until 2004; Chief Executive Officer of TSF from 2002 until 2004; Chief Executive Officer of Jornal do Fundão from 2002 until 2004; Chief Executive Officer of Açoreana Ocidental from 2002 until 2004; Chief Executive Officer of DN da Madeira from 2002 until 2004; Chairman of the Board of Directors of Aleluia Cerâmica Comercio e Indústria S.A. from 2001 until 2004; Member of the Board of Directors of Parfil SGPS S.A. from 2001 until 2004; Chairman of the Board of Directors of Margrimar Mármore e Granitos S.A from 1999 until 2005; Chairman of Marmetal Mármore e Materiais de Construção S.A. from 1999 until 2005; Member of the Board of Directors of Controljornal SGPS S.A. from 1990 until 2001; Member of the Board of Directors of Sojornal Sociedade Jomalística 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 Electrica 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.

*Zeinal Abedin Mahomed Bava.* First elected 2000. Term expires December 31, 2008. Age 41. Vice President of the Executive Committee of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of TV Cabo Portugal, S.A. since March 2004; 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 Centro Corporativo S.A., since March 2006; Member of the Board of Directors of PT Portugal, SGPS S.A. since March 2006; Member of the Board of Directors of PT Rede Fixa, SGPS S.A. since March 2006; Chief Executive Officer of TMN Telecomunicações Múveis Nacionais, S.A. since December 2005, 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 Brasilcel, N.V. since December 2002; Vice-Chairman of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimédia, SGPS, S.A. since November 2002; Executive Vice-Chairman of the Board of Directors of PT Comunicações, S.A. from January 2004 until December 2005; Member of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas S.A. from June 2003 until 2006; Member of the Board of Directors of PT Compras Serviços de Consultoria e Negociação S.A. from May 2003 until 2005; Member of the Board of Directors of Fundação Portugal Telecom from March 2003 until December 2004; Member of the Board of Directors of Portugal Telecom Brasil, S.A. from July 2002 until March 2004; Member of the Board of Directors of BEST-Banco Electrónico de Serviço Total, S.A. from May 2001 until October 2004; Member of the

Board of Directors of Telesp Celular Participações S.A. from April 2001 until December 2003; Member of the Board of Directors of Tele Sudeste Participações, S.A. from 2003 until 2005; Member of the Board of Directors of CRT Celular Participações, S.A. from 2003 until 2005; Member of the Board of Directors of Tele Leste Participações, S.A. from 2003 until 2005; Member of the Board of Directors of Tele Centro Oeste Celular Participações, S.A. from 2003 until 2005; Vice-Chairman of the Board of Directors of PT Ventures, SGPS, S.A. (formerly Portugal Telecom Internacional, SGPS, S.A.) from 2000 until 2002; Executive 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.

*Rodrigo Jorge de Araújo Costa.* First elected 2005. Term expires 31st December, 2008. Aged 47. Vice President of the Executive Committee of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of PT Comunicações S.A. since March 2006; Member of the Board of Directors of PT Centro Corporativo S.A., since March 2006; Member of the Board of Directors of PT Portugal, SGPS S.A., since March 2006; Member of the Board of Directors of PT Rede Fixa, SGPS S.A., since April 2006; Chairman of the Board of Directors of PT.com Comunicações Interactivas, S.A. April 2006; Chairman of the Board of Directors of PT Prime Soluções Empresariais de Telecomunicações e Sistemas S.A. April 2006; Chairman of the Board of Directors of PT Sistemas de Informação, S.A. since May 2006; Chairman of the Board of Directors of PT Corporate Soluções Empresariais de Telecomunicações e Sistemas, S.A. since May 2006; Chairman of the Board of Directors of Portugal Telecom Informação S.A. since June 2006; Member of the High Council for Foreign Investment since 2004; Advisor of the Government Technology Plan since 2005; Corporate Vice President of Microsoft Corporation's OEM Division from 2002 until 2005; General Manager of Microsoft Corporation (Portugal) from 1990 until 2001; General Manager of Microsoft Brazil from 2001 until 2002; Vice President of the Portuguese-American Chamber of Commerce from 1996 until 2001.

*Luís Miguel da Fonseca Pacheco de Melo.* First elected 2006. Term expires 31st December, 2008. Aged: 41. Chief Financial Officer and Executive Director of Portugal Telecom, SGPS S.A. since April 2006; Member of the Board of Directors of Previsão Sociedade Gestora de Fundos de Pensões, S.A. since 2006; Chairman of the Board of Directors of Cabo TV Açoreana S.A. since 2004; Member of the Board of Directors of Cabo TV Madeirense S.A. since 2003; Member of the Board of Directors of PT PRO Serviços Administrativos e de Gestão Partilhados, S.A. since 2003; Executive Director of PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS S.A. from June 2002 until 2006; Member of the Board of Directors of TV Cabo Portugal S.A. from 2002 until 2006; Member of the Board of Directors of Lusomundo Audiovisuais S.A. from 2002 until 2006; Member of the Board of Directors of Lusomundo Cinemas S.A. from 2002 until 2006; Member of the Board of Directors of PT Conteúdos S.A. from 2002 until 2006; Member of the Board of Directors of PT Televisão por Cabo SGPS, S.A. from 2002 until 2006; Member of the Board of Directors of Sport TV from June 2002 until November 2005; Manager of Lusomundo España S.L. from 2002 until 2006; Executive Director of BES Investment, a subsidiary of Banco Espírito Santo Group, one of our major shareholders, from 1998 to 2002; Director of UBS Limited from 1995 to 1998.

*João Pedro Amadeu Baptista.* First elected 2006. Term expires 31st December, 2008. Aged 49. Member of the Executive Committee of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of PT Ventures, SGPS, S.A. (formerly Portugal Telecom Internacional, SGPS, S.A.) since 2006; Chairman of the Board of Directors of PT Móveis Serviços de Telecomunicações, SGPS S.A. since 2006; Chairman of the Board of Directors of PT Acessos de Internet WI-FI, S.A.; Vice-Chairman of Vivo Participações since 2006; Vice-Chairman of the Board of Directors of Brasilcel, N.V. since 2006; Member of the Board of Directors of Unitel, SARL since 2006; Member of the Audit Committee of the Victoria and Albert Museum in London since 2005; Lead Partner of Booz Allen Hamilton from 2005 to 2006; Global Head of the Technology, Information and Entertainment Industry Group at Marsh & McLennan Companies Inc. from 2004 to 2005; Global Head of the Technology,

Information and Entertainment Group and Co-Leader for the United Kingdom of Mercer Management Consulting from 2000 until 2005; Member of the Executive Committee of Mercer Management Consulting from 1997 until 2005.

*António Aleixo Caludino Caria.* First elected 2006. Term expires 31st December 2008. Aged 55. Member of the Executive Committee of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of PT Compras Serviços de Consultoria e Negociação, S.A. since 2006; Chairman of the Board of Directors of PT Contact Telemarketing e Serviços de Informação, S.A., since 2006; Member of the Board of Directors of Cabo TV Açoreana since 2003; Member of the Board of Directors of TV Cabo Portugal from 2000 until 2006; Managing Director of the Board of TV Cabo Lisboa from 2000 until 2002; CEO of TV Cabo Tejo from 1998 until 2000; Member of the Council of Fundação CulturSintra from 1998 until 2006; Member of the Board of Directors of INESC from 1997 until 2006; Member of the Council of AERSET, Associação Empresarial da Região de Setúbal, from 1996 until 1998; CEO of TV Cabo Sado from 1996 until 1997; Member of the Executive Committee of Portugal Telecom, SGPS S.A. from 1995 until 1996; Regional Managing Director of Portugal Telecom from 1990 until 1995; Manager of Customer Premise Equipment from 1987 until 1990; Manager of National Network Switching Planning from 1983 until 1987.

*Rui Pedro Oliveira Barroso Soares.* First elected 2006. Term expires 31st December 2008. Aged 34. Member of the Executive Committee of Portugal Telecom, SGPS S.A. since April 2006; Chairman of the Board of Directors of Portugal Telecom Imobiliária, S.A. since 2006; Vice-President of AIP Associação Industrial Portuguesa since 2006; Member of the Executive Committee of PT Compras Serviços de Consultoria e Negociação, SA from 2005 to 2006; Consultant to PT Multimédia's Board for Business Intelligence, Quality of Service, Security and Real Estate Management from 2001 to 2004; In the Banque Nationale de Paris/Paribas Executive in Business Intelligence on market and competition analysis; Consultant to the Socialist Group in the European Parliament from 1998 to 2000.

The following directors are not members of the Executive Committee:

*Joaquim Anibal Brito Freixial de Goes.* First elected 2000. Term expires 31st December, 2008. Aged 40. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimédia, 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; 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 ESDATA, Espírito Santo Data, SGPS, S.A. 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 1991 until 1993; Consultant to Roland Berger & Partner from 1989 until 1991.

*Jorge Humberto Correia Tomé.* First elected 2002. Term expires 31st December, 2008. Aged 52. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Chief Executive Officer of Caixa Banco de Investimento, S.A. since 2001; 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 Directors of SULPEDIP, S.A. (currently PME Investimentos, S.A.) from 1989 until 1994; Junior Manager and Principal Manager of Capital Market Division of Banco Pinto & Sotto Mayor, S.A. from 1986 until 1989; Senior Auditor with Coopers & Lybrand from 1980 until 1983; Junior

Economist in IAPMEI (Institute for Small and Medium Companies and Investment) from 1979 until 1980.

*Fernando Abril-Martorell.* First elected 2001. Term expires 31st December, 2008. Aged 44. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Chief Executive Officer of Credit Suisse Spain since 2005; Member of the Board of Directors of Telecomunicações de São Paulo Telesp from 2001 until 2003; Chief Operating Officer of Telefónica S.A. from 2000 until 2003; Chief Executive Officer of Telefónica Publicidad e Informação from 1999 until 2000; Chief Financial Officer of Telefónica, S.A. from 1997 until 1999; Director-General of Corporate Finance of Telefónica Publicidad e Informação from 1997 until 1999; Head of Treasury Department of JP Morgan from 1987 until 1997.

*Antonio Pedro de Carvalho Viana Baptista.* First elected 2000. Term expires 31st December, 2008. Aged 49. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Chairman of the Board of Directors and Chief Executive Officer of Telefónica de España, S.A.U.; Chairman of the Board of Directors and Chief Executive Officer of Telefónica Móviles España, S.A.U.; Member of the Board of Directors and of the Executive Committee of Telefónica, S.A., holding of Telefónica Group since 2006; Member of the Board of Directors of O2 PLC, and Telefónica Latinoamérica since 2006. 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. from 2003 until 2006; Member of the Board of Directors of Telefónica de Argentina, S.A. from 2003 until 2006; Chairman of the Board of Directors and Chief Executive Officer of Telefónica Moviles S.A. from 2002 until 2006; Member of the Board of Directors of Telefónica International, S.A. from 1998 until 2002; Member of the Board of Directors of Latinoamérica, from 1998 until 2002; Member of the Board of Directors of Telesp, S.A. from 2001 until 2006; Member of the Board of Directors of BPI from 1991 until 1996; Principal partner of McKinsey & Company from 1985 until 1991 (Madrid/Lisbon office).

*João Manuel de Mello Franco.* First elected 1997. Term expires 31st December, 2008. Aged 60. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; President of Audit Committee of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of José de Mello Participações, SGPS, S.A. since 2000; Vice-Chairman of the Board of Directors of Jose de Mello Imobiliária from 2001 until 2004; Chairman of the Board of Directors of José de Mello Residências e Serviços from 2001 until 2004; Chairman of the Board of Directors of Imópolis (SGFII) from 2001 until 2004; Chairman of the Board of Directors of Engimais from 2001 until 2004; Member of the Board of Directors of International Shipowners Reinsurance Cofrom 1998 until 2005; Member of the Superior Board of Portugal Telecom, SGPS S.A. 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 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 Stephen McGowan.* First elected 2003. Term expires 31st December, 2008. Aged 60. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Ambassador of the United States to Portugal from 1997 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.

*Tomaz de Mello Paes de Vasconcellos.* First elected 2003. Term expires 31st December, 2008. Aged 49. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Audit Committee of Portugal Telecom, SGPS S.A. since 2003; 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 1987 until 1988.

*Franquelim Fernando Garcia Alves.* First elected 2006. Term expires 31st December, 2008. Aged 52. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of Cinveste Group; Chairman and Chief Executive Officer of IGCP Instituto de Gestão do Crédito Público from 2004 until 2006; State Secretary Deputy of Economy Minister from 2003 until 2004; Chairman of the Board of Directors of SIMAB Sociedade Instaladora de Mercados Abastecedores, S.A. since 2002 until 2003; Chief Financial Officer of Lusomundo Group from 2000 until 2002; Member of the Board of Directors of Lusomundo, SGPS S.A., Lusomundo Net, Diário de Notícias, Lusomundo Media, SGPS S.A. and Lusomundo Audiovisuais, SGPS S.A., from 2000 until 2002; Member of the Board of Directors of PT Multimédia Serviços de Telecomunicações e Multimédia, SGPS, S.A. from 2000 until 2002; Member of the Board of Directors and Chief Financial Officer of Lusomundo, during 1992; Director of Research and Corporate Finance of Socifa & Beta, during 1991; Director of Banco Português do Atlântico, during 1987; Partner of Ernst & Young Portugal, during 1971.

*Fernando Henrique Viana Soares Carneiro.* First elected 2006. Term expires 31st December, 2008. Aged 57. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Economic Council Member at Portuguese Embassy on London since 2003; Consultant from 2002 until 2003; Chairman of the Board of Directors of Somincor Sociedade Mineira de Neves-Corvo, S.A. and of EDM, Empresa de Desenvolvimento Mineiro, S.A., from 1998 until 2002; Member of the Board of Directors of BERD, Banco Europeu de Reconstrução e Desenvolvimento, from 1993 until 1998; Member of the Board of Directors of Banco Mundial Group; Economic Council Member at Portuguese Embassy on Washington DC, before 1988; Director of SEDES and of DECO, before 1988.

*Nuno Rocha dos Santos de Almeida e Vasconcellos.* First elected 2006. Term expires 31st December, 2008. Aged 42. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of several companies; Member of the Remuneration Committee of a bank and Director of the Automóvel Clube de Portugal; devotes his full time running his personal businesses, in Portugal and abroad, through Ongoing Strategy Investments, SGPS, S.A.; In 1995 launched the Portuguese branch of the multinational Heidrick & Struggles; Senior Partner and Managing Partner of Heidrick & Struggles until 2006; Senior Manager of Strategy and Change Management at Andersen Consulting (currently Accenture), from 1987 until 1995; Simultaneously engaged on non-executive responsibilities, at family owned companies; Manager and shareholder of Sociedade do Rosário, SGPS, S.A. from 1987 until 1995.

*Luís Filipe Rolim de Azevedo Coutinho.* First elected 2006. Term expires 31st December, 2008. Aged 46. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of Statutory Audit Board of Fundação EDP, since 2005; Member of Board of Directors and member of Audit Committee of EDP Energias de Portugal S.A., since May, 2003; Consultant of Abrantina Group, since 1992; Director of AMEC Associação Música Educação e Cultura, from 2003 until 2005; Consultant at Câmara Municipal de Lisboa from 2002 until 2003; Member of the Board of Directors of Valora Serviços de Apoio à Emissão Monetária, S.A. from 1999 until 2002; Consultant of Banco de Portugal from 1998 until 1999 and from 1995 until 1996; Consultant of Fundação Calouste Gulbenkian from 1996 until 2000; Consultant of Finance State Secretary during 1994; Consultant of V.I/B.T.A Group from 1990 until 1993; Consultant of I.P.E. from 1989 until 1990.

*Amílcar Carlos Ferreira de Morais Pires.* First elected 2006. Term expires 31st December, 2008. Aged 45. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of Banco Espírito Santo, S.A.; Member of the Board of Directors of Companhia de Seguros Tranquilidade-Vida, S.A.; Member of the Board of Directors of Banco Espírito Santo de Investimento, S.A.; Chairman of the Board of Directors of Banco Espírito Santo (International) Limited; Member of the Board of Directors of ESAF Espírito Santo Activos Financeiros, SGPS, S.A.; Member of the Board of Directors of Espírito Santo PLC (Dublin); Member of the Board of Directors of Banco Espírito Santo Oriente, S.A.; Member of the Board of Directors of Espírito Santo Overseas Limited; Member of the Board of Directors of BES Finance Limited; Member of the Board of Directors of MTS Portugal Sociedade Gestora do Mercado Especial de Dívida Pública SGMR, S.A.; Member of Disciplinary Comité of ISMA (International Securities Markets Association); Member of the Board of Directors of Soginpar, Sociedade de Gestão de Fundos de Investimento Mobiliário, S.A. from 1991 until 1992; Member of the Board of Directors of ESER, from 1992 until 1995.

*Armando António Martins Vara.* First elected 2006. Term expires 31st December, 2008. Aged 52. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of Caixa Geral de Depósitos; Chairman of the Board of Directors of IMOCAIXA, S.A.; Chairman of the Board of Directors of SOGRUPO, GI (ACE CGD Group); Member of the Board of Directors of Caixa Participações, SGPS; Minister of the Youth and the Sport of the XIV Constitutional Government from September 2000 until December 2000; Deputy Minister of the Prime Minister of XIV Constitutional Government from October 1999 until September 2000; Deputy Secretary of State of the Minister of the Internal Administration of XIII Constitutional Government from 1997 until 1999; Secretary of State of the Internal Administration of XIII Constitutional Government from 1995 until 1997; Member of the House of Representatives in the IV, V, VI e VII Legislatures; Vice President of the Legislative Committees of Social Equipment and Youth; Member of the Parliamentary Assembly of Council of Europe from 1987 until 1991; Member of the Parliamentary Assembly of UEO from 1989 until 1991; Member of the National Secretaryship and the Permanent Commission of the Socialist Party (PS) from 1992 until 2002; Chairman of the Board of Directors of Foundation Jose? Fontana, from 1992 until 1996; Member of Câmara Municipal da Amadora; Member of the Direction of the Institute of the Democratic Press; Member of Instituto Luso-Árabe de Cooperação.

*Francisco Teixeira Pereira Soares.* First elected 2006. Term expires 31st December, 2008. Aged 57. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; President of the Environment Commission of CEEP, Brussels, since 2000; Consultant of Civil House of the President of the Republic from 2005 until 2006; Chief Executive Officer of API Capital, Sociedade de Capital de Risco, S.A., from January 2003 until October 2004; Chairman of the Board of Directors of API Capital, Sociedade de Capital de Risco, S.A., from May until December 2004; Member of the Board of Directors of NAER Novo Aeroporto, S.A. from 2002 until 2004; Member of the Board of Directors and Chief Executive Officer of I.P.E. Tecnologias de Informação, SGPS S.A. from 2000 until 2001; Member of the Board of Directors and Member of Executive Committee of I.P.E. Investimentos e Participações Empresariais, S.A. from 1996 until 2000; Chairman of the Board of Directors of I.P.E. Capital Sociedade de Capital de Risco, S.A. from 1996 until 2000; Member of the Direction of AMBELIS Agência para a Modernização Económica de Lisboa, S.A., from 1994 until 1996; Consultant at several companies and Consultant at NBIA (National Business Incubation Association, USA), RBN (European Business Network, Brussels), from 1994 until 1996; Chairman of the Board of Directors of AITEC Tecnologias de Informação, S.A. from 1987 until 1994; Member of the Direction from 1987 until 1993 and Member of General Council during 1994 of UNINOVA, Instituto de Novas Tecnologias; Member of the Direction of ICTM, Instituto de Ciência e Tecnologia de Materiais from 1987 until 1992; Consultant of the Board of Directors of I.P.E, S.A. from 1987 until 1992; Consultant of IPE, Investimentos e Participações Empresariais, S.A. from 1984 until 1986; Main Assessor of Ministry of the Industry from 1982 until 1986; Director of Ministry of Industry from 1977 until 1981; Chief of

Cabinet of the Minister of the Industry and Technology during 1975; Superior technician of the Ministry of the Industry from 1972 until 1977.

*José Guilherme Xavier de Bastos.* First elected 2007. Term expires 31st December, 2008. Aged 68. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Audit Committee of Portugal Telecom SGPS S.A since June 2007; Member of the Centre of Studies of the Chamber of Chartered Accountants since 2003; Member of the Portuguese Privatizations Monitoring Board since December 1988; Lecturer at the Faculty of Law of the University of Coimbra until 2005; Lecturer at the Faculty of Economics of the University of Coimbra until 2004; Appointed as Member of the Board for the Development of the Portuguese Tax Reform in 1994; Member of the Committee drafting Portuguese legislation that implemented the European Directives on the VAT transitional period in the internal market in 1993; Member of the VAT Administration Service in 1992; Member of the Portuguese Tax Reform Board from 1984 until 1988; Appointed as President of the Portuguese VAT Commission in May 1980.

*Rafael Luís Mora Funes.* First elected 2007. Term expires 31st December, 2008. Aged 41. Member of the Board of Directors of Portugal Telecom, SGPS S.A.; Member of the Board of Directors of Ongoing Strategy Investments, SGPS, S.A.; Member of the Remuneration Committee of Impresa Group; Member of the Sustainability and Governance Committee of Millennium BCP Group; Member of the Remuneration Committee of Banco Privado Português; Member of the Supervisory Board of the Business School of INDEG-ISCTE; Director of the Automóvel Clube de Portugal; In 1995 launched with Nuno Rocha dos Santos de Almeida e Vasconcellos the Portuguese branch of the multinational Heidrick & Struggles; Managing Partner of the Portuguese branch of Heidrick & Struggles since 1995.

#### **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. Age 58. Member of the Board of Directors of Portugal Telecom Investimentos Internacionais Consultoria Internacional S.A. since 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 to 2003; Member of the Board of Directors of Banco Espírito Santo do Oriente from 1996 to 2005; 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 from 1996 to 2005; 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) from 1996 to 2004; Assistant Senior Manager of the Board of Directors of Marconi responsible for the Company's Communication Office from 1995 to 1999; Secretary of State of Portuguese Communities from 1992 to 1995; Chief of Staff of Minister of the "Quality of Life" from 1981 to 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 to 1982.

*Francisco José Meira Silva Nunes.* Chief Accounting Officer and Manager of the Financial Reporting and Consolidation Department of Portugal Telecom. Appointed 2003. Age 43. Member of the Board of Directors of Previsão Sociedade Gestora de Fundos de Pensões, S.A. since 2003; Member of the Board of Directors of PT PRO, S.A. since 2003 and Member of its Executive Committee since 2004; Member of the Board of Directors of PT Compras Serviços de Consultoria e

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Negociação, S.A. since 2003; Partner of Audit and Business Advisory Services of Andersen from 1999 to 2002; Manager of Audit and Business Advisory Services of Andersen from 1992 to 1999.

*Carlos Manuel Mendes Fidalgo Moreira da Cruz.* Manager of the Financing and Treasury Department of Portugal Telecom. Appointed 2001. Age 40. 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 to 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 to 1996; Assistant Lecturer of Firm Valuation from 1994 to 1997 at IESF; Analyst of the Mergers and Acquisitions Department of BPI from 1990 to 1994.

*Nuno Bernardo Ramires Leiria Fialho Prego.* Manager of the Investor Relations Department of Portugal Telecom. Appointed 2004. Age 34. Head of Equity Research and Telecoms Analyst at BCP Investimento from 2001 to 2004; Portfolio Manager of BPI Fundos from 1999 until 2000; Deputy Director in the Research Department of Banco Finantia from 1996 to 1999.

*Nuno Miguel da Silva Anjos Machado.* Manager of the Planning and Control Department of Portugal Telecom. Appointed 2006. Age 32. Vice President in the Investment Banking Division of Goldman Sachs International from 1999 to 2004; Research Analysts at Deutsche Morgan Grenfell from 1997 to 1999.

*António Manuel Robalo de Almeida.* Coordinator of Regulatory Affairs of Portugal Telecom. Appointed 2005. Age 51. Manager of Regulatory Department of Portugal Telecom, SGPS S.A. from 2002 to 2005; Manager of Economic and Regulatory Coordination of PT Comunicações, S.A. since 2000; Manager of Regulation Department of Portugal Telecom, SGPS S.A. from 1997 to 2000; Member of the Board of Main Road/Optimus during 1997; Director of New Telecommunications Business of Sonae Group from 1996 to 1997; Member of the Board of Directors of ICP Instituto das Comunicações de Portugal from 1989 to 1996; Director of Planning and Development of CTT Correios e Telecomunicações de Portugal, S.A. from 1986 to 1988; Director of Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1985 to 1986; Deputy Director of Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1984 to 1985; Head of Training Department of CTT Correios e Telecomunicações de Portugal, S.A. from 1983 to 1984; Head of Human Resources Planning of CTT Correios e Telecomunicações de Portugal, S.A. from 1982 to 1983.

*Rita de Sampaio Nunes.* Manager of the Competition Department of Portugal Telecom. Appointed 2004. Age 43. Head of European Community Affairs of ICP-ANACOM Autoridade Nacional de Comunicações from 2003 to 2004; Member of the Regulatory Department of Portugal Telecom, SGPS S.A. from 2000 to 2003; Member of the Regulatory Department of Portugal Telecom, SGPS S.A. from 1998 to 1999; Seconded National Expert in the European Commission DG Enterprise and DG Information Society from 1995 to 1998; Internal Legal Adviser of the Board of Directors of CN Comunicações Nacionais, SGPS, S.A. from 1993 to 1995.

*Miguel Dias Amaro.* Manager of the Internal Audit Department of Portugal Telecom. Appointed 2004. Age 40. 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 2000 to 2002; Assistant to the Secretary of State for Treasury and Finance from 1999 to 2000; Equity Analyst (Retail and Pulp and Paper sectors) in Espírito Santo Research from 1997 to 1999 (Lisbon office); Head of Sales for Roca Cerâmica e Comércio S.A. from 1994 to 1996; Sales Delegate for Roca Cerâmica e Comércio S.A. from 1991 to 1994.

*Abilio Cesário Lopes Martins.* Manager of the Communication Department of Portugal Telecom. Appointed 2003. Age 35. Head of Corporate Communication of Portugal Telecom from 2002 to 2003; Media Relations Advisor for Portugal Telecom's Chief Executive Officer and Head of Corporate Communication for PT Brasil from 2000 to 2002.

*Luís Filipe Nunes Cabral Moura.* Manager of the Human Resources Department of Portugal Telecom. Appointed 2000. Age 49. Manager of Human Resources Department of Portugal Telecom, SGPS S.A. from 1998 to 2000; Manager of Banking Supervision Department of Monetary Authority of Macao from 1995 to 1998; Manager of Financial and Human Resources Department of Monetary Authority of Macao from 1993 to 1995; Manager of Human Resources Division of Monetary Authority of Macao from 1991 to 1993; Manager of Macao's Government Land Department from 1990 to 1991; Manager of Macao's Government Projects Analysis Department from 1989 to 1990; Operations Research High School Assistant from 1986 to 1989; Economist of a Portuguese Group (SOTRIL) from 1985 to 1986; Economist of the Azores' Planning Department from 1983 to 1985; Adviser of Energy's Secretary of State from 1983 to 1984; Manager of Plan and Production of Moore Paragon in 1983.

*Rogério Miguel Antunes Campos Henriques,* Manager of the Business Development Department of Portugal Telecom. Appointed 2004. Age 34. Senior Project Manager of the Strategy and Business Development Department of Portugal Telecom, SGPS S.A. from 2003 to 2004; Manager and consultant of The Boston Consulting Group in Lisbon and Madrid from 1994 to 2002.

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. and PT Compras, S.A. are set forth below:

*Rodrigo Jorge de Araújo Costa.* Chief Executive Officer of PT Comunicações, S.A. and PT Sistemas de Informação S.A. See " *Board of Directors and the Executive Committee*".

*Zeinal Abedin Mahomed Bava.* Chief Executive Officer of TMN Telecomunicações Móveis Nacionais, S.A. and PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, S.A. See " *Board of Directors and the Executive Committee*".

*João Pedro Amadeu Baptista.* Chief Executive Officer of PT Investimentos Internacionais, S.A. See " *Board of Directors and the Executive Committee*".

*Roberto Oliveira de Lima.* Chief Executive Officer of Vivo. Appointed 2005. Age 56. Chief Executive Officer and Vice President for Regulatory Matters and Institutional Relations of Vivo Participações S.A., Tele Centro Oeste Celular Participações S.A., Telerj Celular S.A., Teles Celular S.A., Telebahia Celular S.A., Telergipe Celular S.A., Celular CRT S.A., Telesp Celular S.A., Global Telecom S.A., Telegoiás Celular S.A., Telemat Celular S.A., Telems Celular S.A., Teleacre Celular S.A., Teleron Celular S.A., Norte Brasil Telecom S.A. and TCO IP S.A. since 2005; director of Avista Participações Ltda., Tagilo Participações Ltda., Sudestecel Participações Ltda., TBS Celular Participações Ltda., Ptelecom Brasil Ltda. and Portelcom Participações Ltda., all affiliates of Vivo, since 2005; Chairman of the Board of Directors of Grupo Credicard from 1999 to 2005 and Chief Executive Officer of Banco Credicard S.A. from 2002 to 2005; prior to 1999, held executive positions at Accor Brasil S.A., Rhodia Rhone Poulenc S.A. and Saint Gobain S.A.

*Pedro Manuel Brandão Rodrigues.* Chief Executive Officer of PT Compras, S.A. Appointed 2006. Age 56. Member of Supervisory Board of Brasilcel NV since 2003; Member of the Board of Directors and of the Executive Committee of TMN Telecomunicações Móveis Nacionais, S.A. from 2006 to 2006; Member of the Board of Directors of PT Móveis, S.G.P.S., S.A. from 2000 to 2003; Member of the Board of Directors of Tele Sudeste Celular Participações S.A., Telesp Celular Participações S.A.; Member of the Board of Directors of Mediatecom from 2000 to 2004; Member of the Board of Directors of Mascom Wireless from 2002 to 2003; elected to the Portuguese Parliament for Lisbon in the General Election of March 2002 and a member of the Portuguese National Educational Council elected by Parliament from 2000 to 2005; member of the Board of Directors and of the Executive Committee of Banco Mello and Banco Mello de Investimentos from 1993 to 2000; appointed in 2002 a member of the Committee for the Definition of the Television Public Service; Chief Executive Officer of Promindústria SA from 1987 to 1993; Manager Product and Business Development of Alusuisse-Lonza in Zurich from 1980 to 1987.

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*Paulo Manuel Namorado Nordeste.* Chief Executive Officer of PT Inovação, S.A. Appointed 1999. Age 53. Infrastructure General Manager from 1998 to 1999; Deputy member of the Board of Directors of INESCTEL from 1995 to 1998; Portugal Telecom's representative in the Executive Commission of the Telecommunications Institute from 1993 to 1998; Chairman of the Shareholders General Meetings of Instituto Electrotécnico Português (IEP) from 1993 to 1998; Deputy Member of the Board of Directors of MEGASIS from 1993 to 1994; Development and Investigation Manager/CET from 1990 to 1998; National Deputy of the European Union RACE and ACTS program from 1990 to 1998; Scientific Employee at DGXIII-F of the European Union, RACE program, in Brussels from 1986 to 1990; Chief of the Traffic Engineering Division (CET) of Portugal Telecom, SGPS S.A. in Aveiro from 1976 to 1986.

*Miguel Nuno Piedade Moreira.* Chief Executive Officer of PT PRO, S.A. Appointed 2003. Age 47. Team Leader for Shared Services Initiative at Portugal Telecom, SGPS S.A. from 2002 to 2003; Senior Manager at PricewaterhouseCoopers Lisbon from 2000 to 2002; Senior Manager at PricewaterhouseCoopers Madrid from 1997 to 2000; Manager at Coopers & Lybrand Lisbon from 1992 to 1997; Consultant at Andersen Consulting Lisbon from 1988 to 1992; Industrial Engineer at General Motors from 1983 to 1988.

For information regarding arrangements with major shareholders pursuant to which certain persons referred to above were selected as members of our Board of Directors, see "*Item 7 Major Shareholders and Related Party Transactions Major Shareholders*".

### Compensation

In the year ended December 31, 2006, we paid aggregate compensation of €10.4 million to our directors (including members of our Executive Committee). Of the total amount of compensation paid to directors in 2006, €4.1 million was based on performance and the ability to reach certain pre-defined goals that contribute to the strategic goals of the Portugal Telecom group. In addition to the above-mentioned remuneration, board members are entitled to certain privileges to facilitate their ability to carry out their jobs.

In addition, pursuant to agreements with certain former members of the Board of Directors, in return for non-competition clauses, Portugal Telecom also paid compensation in an amount of €10.7 million, of which €9.7 million was paid to executive directors and the remaining amount was paid to non-executive directors.

In 2006 and 2005, fixed remuneration of key employees of the Portugal Telecom Group management amounted to €6.9 million and €9.3, million respectively, and variable remuneration amounted to €3.6 million and €5.6 million, respectively.

We have a Compensation Committee consisting of three members whose functions include: (1) to establish the compensation for members of our corporate bodies and (2) to follow up and evaluate the performance of our directors with reference to our business goals. Following our General Meeting of Shareholders held on June 22, 2007, the new members of the Compensation Committee are Álvaro João Duarte Pinto Correia, João de Mello Franco and Francisco Adelino Gusmão Esteves de Carvalho.

The Compensation Committee approves the model to be used to calculate variable compensation for each fiscal year and approves the value of the variable compensation to be paid to the Chairman of the Board of Directors and the members of the Board of Directors who are executive officers. The factors included in the variable compensation model for any given year may include performance measures such as consolidated revenues, adjusted EBITDA, adjusted EBITDA minus capital expenditures, net profits before workforce reduction program costs and the ratio of the Total Shareholder Return of Portugal Telecom compared to the Total Shareholder Return of the DJ Stoxx 600 Telecom index, where the "Total Shareholder Return" means the sum of the variation in the share

price plus the value of dividends per share. The members of our Compensation Committee are listed below under " *Board Practices*".

Four of our directors and executive officers also participate in the Portugal Telecom pension plan or related plans on the same basis as other employees or former employees who participate in the plan. One of those persons has begun to receive retirement benefits under the plan, and amounts were accrued in respect of retirement benefits for the other three members. The total amount accrued to provide benefits under the plan for these directors and officers as of December 31, 2006 was €7.8 million. For information on our post retirement benefit payments and obligations generally, see " *Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Post Retirement Benefits*".

The Chairman of our Board of Directors and certain members of our Executive Committee are parties to contracts that entitle them to receive the equivalent of between one and two years' salary (and, in some cases, variable compensation) if they are not reelected to those offices, the most recent of which was signed in April 2006 and provides for two years' salary. In return, those parties agree not to compete with the Company for a specified period following the time they cease to hold office with the Company. In addition, if the Company terminates any such person without cause, the person has the right to receive the salary (and, in some cases, variable compensation) that he would have received if he had completed his three-year term.

### **Board Practices**

At the General Meeting of Shareholders held on June 22, 2007, changes were made to Portugal Telecom's bylaws in order to adapt PT's corporate governance structure to the new legal framework established by Decree-Law 76-A/2006 of March 29, 2006, which amended the Portuguese Companies Code. At this meeting, the shareholders approved the adoption of the "Anglo-Saxon" model described in " *Item 10 Additional Information Corporate Governance*". Under this model, the audit committee acts as a supervisory board for the Company's activities. João Manuel de Mello Franco, Thomaz de Mello Paes de Vasconcellos and José Guilherme Xavier de Basto were elected as the new members of this audit committee to complete the 2006-2008 term of office.

In addition, the new corporate governance structure includes a registered accountant who is not one of the members of the audit committee, as required by Decree-Law 76-A/2006 dated March 29, 2006. At the above-mentioned General Meeting of Shareholders, P. Matos Silva, Garcia Jr., P. Caiado & Associados SROC, represented by Pedro João Reis de Matos Silva, was elected as the new effective registered accountant, and Ascensão, Gomes, Cruz & Associados SROC, represented by Mário João de Matos Gomes, was elected as the new substitute registered accountant.

As from the General Meeting of Shareholders held on June 22, 2007, Portugal Telecom is required by its articles of association and Portuguese law to maintain an audit committee consisting of three non-executive board members.

In addition to the authority established in Portuguese laws, the audit committee has specific authority granted by our articles of association, including, *inter alia*, powers: (i) to verify the accuracy of the financial statements and, in general, to supervise the quality and integrity of the financial information; (ii) to supervise the process of preparation and disclosure of financial information; (iii) to supervise the statutory audit and the auditing of our financial statements, as well as to supervise and evaluate the internal proceedings related to accounting and audit matters; (iv) direct and exclusive responsibility to appoint, hire, retain or dismiss and to establish the compensation of our independent auditors, as well as to supervise their qualifications and independence and to approve the audit services and/or non-audit services to be rendered by said independent auditors or associate persons; to supervise the quality, integrity and effectiveness of the risk management system, the internal control system, as well as the internal audit system; and (v) to receive the communications of irregularities,

claims and/or complains submitted by shareholders, employees of the Company or third parties, as well as to implement the proceedings for the receipt, retention and treatment of the above referred irregularities, claims and/or complaints whenever concerning accounting and auditing matters as well as related to internal controls as regards those subject matters. Under our articles of association, as approved in the aforementioned General Meeting, the independent auditors shall report to and be subject to the direct and exclusive oversight of the audit committee, which shall annually obtain and review an audit report with the independent auditors.

The audit committee shall schedule its meetings at least once every two months of each financial year at the time and place determined by its Chairman, without prejudice of additional meetings being convened by the Chairman or at request of the majority of its members. The audit committee shall not meet without the attendance of the majority of its members, provided that the Chairman may, in cases of recognized urgency or justified impossibility, permit such meeting without the attendance of such majority if it is assured by vote by correspondence or by proxy (provided however that each members does not act on behalf of more than one audit committee member).

The resolutions of the audit committee shall be adopted by the majority of votes cast and its Chairman has a casting vote. The resolutions adopted during the audit committee's meetings, as well as its members' voting statements shall be recorded in minutes prepared for such purpose, which shall be signed by all members of the audit committee participating in the meetings, all having the prerogative of summarizing their interventions to be mentioned in such minutes.

As required by the new rules set forth in the articles of association as from the General Meeting of Shareholders held on June 22, 2007, in our annual budget we establish the financial resources required for the audit committee to pay the compensation or funding of the independent auditor and of any advisors of the audit committee as well as to cover the expenses required for the audit committee to perform its powers and duties.

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.

At the General Meeting of Shareholders held on June 22, 2007, the following members of the Compensation Committee were elected: Álvaro João Duarte Pinto Correia, João de Mello Franco and Francisco Adelino Gusmão Esteves de Carvalho.

See " *Compensation*" above for information about contracts to which certain of our directors are party.

### Employees

We had a total of 12,666 employees in our domestic businesses on December 31, 2006, 13,101 on December 31, 2005 and 13,886 on December 31, 2004. 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 2004 through 2006. It does not include employees seconded to other entities, but does include temporary workers with fixed-term contracts.

	At December 31,		
	2004	2005	2006
Wireline	8,311	7,682	7,181
TMN	1,133	1,184	1,140
PT Multimédia	1,302	1,388	1,376
Vivo(1)	3,175	3,042	2,948
Other Businesses(2)	13,858	19,094	19,413
TOTAL(3)	27,780	32,389	32,058

(1) The number of employees corresponds to 50% of the employees of Vivo.

(2) The increases in 2004, 2005 and 2006 resulted primarily from employees working in call center operations in Brazil (Mobitel), which were outsourced externally in previous years. Mobitel had 15,107 employees at December 31, 2006, 15,232 employees at December 31, 2005, and 7,991 at the end of 2004.

(3) Of this total, we employed 13,886, 13,100 and 21,666, respectively, 2004, 2005 and 2006 in our domestic businesses and 13,894, 19,289 and 19,392, respectively, 2004, 2005 and 2006 in our international businesses.

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 792 employees in 2006. The total costs of these reductions during 2006 were approximately €229 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 22, 2007, our directors as a group directly owned 93,184 ordinary shares, representing around 0.01% of our share capital.

The following table provides the number of ordinary shares that may be deemed to be beneficially owned by our directors. The amounts below include amounts that are beneficially owned by shareholders of Portugal Telecom with which the director in question is affiliated. The directors below disclaim beneficial ownership of any shares they do not own directly.

Director	As of June 22, 2007	
	Ordinary shares	Percent of ordinary shares outstanding
Henrique Manuel Fusco Granadeiro	150	*
Zeinal Abedin Mahomed Bava(1)	63,236	*
Rodrigo Jorge de Araújo Costa		
Luís Miguel da Fonseca Pacheco de Melo	45	*
João Pedro Amadeu Baptista		
António Aleixo Claudino Caria	486	*
Rui Pedro Oliveria Barroso Soares	50	*
Joaquim Aníbal Brito Freixial de Goes(2)	87,736,614	7.77%
Jorge Humberto Correia Tomé(3)	57,740,600	5.11%
Fernando Abril-Martorell		
António Viana Baptista(1)(4)	112,484,651	9.96%
João Manuel de Mello Franco(1)	13,308	0.001%
Gerald S. McGowan		
Thomaz de Mello Paes de Vasconcellos		
Franquelim Fernando Garcia Alves(5)	7,000,000	0.6%
Fernando Henrique Viana Soares Carneiro		
Nuno Rocha dos Santos de Almeida e Vasconcellos(6)	60,404,969	5.35%
Luís Felipe Rolim de Azevedo Coutinho		
Amílcar Carlos Ferreria de Moraes Pires(7)	87,736,323	7.77%
Armando António Martins Vara(8)	57,740,600	5.11%
Francisco Teixeira Pereira Soares		
Rafael Luis Mora Funes(1)(9)	60,405,470	5.35%
José Guilherme Xavier de Basto		

\* Less than 0.01%.

(1) Joint ownership with spouse.

(2) Includes (1) 2,437 shares held directly by Mr. Joaquim Aníbal Brito Freixial de Goes and (2) 87,734,177 shares held by Banco Espírito Santo and its affiliates that may be deemed to be beneficially owned by Mr. Freixial de Goes. Mr. Freixial de Goes is a member of the Executive Committee of the Board of Directors of Banco Espírito Santo. Mr. Freixial de Goes disclaims beneficial ownership of the shares held by Banco Espírito Santo and its affiliates.

(3) Mr. Jorge Humberto Correia Tomé is the Chief Executive Officer of Caixa Banco de Investimento, a 99.7%-owned subsidiary of Caixa Geral de Depósitos, which holds 57,740,600 shares, or approximately 5.11% of the outstanding shares, of the Company.

(4)

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Includes (1) 10,825 shares held directly by Mr. António Pedro de Carvalho Viana Baptista and his spouse and (2) 112,473,826 shares held by Telefónica, S.A. that may be deemed to be beneficially

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owned by Mr. Viana Baptista. Mr. Viana Baptista is a member of the Executive Committee of the Board of Directors of Telefónica, S.A. Mr. Viana Baptista disclaims beneficial ownership of the shares held by Telefónica, S.A.

- (5) These shares are owned by Cinveste, SGPS, S.A., for which Mr. Franquelim Garcia Alves acts as a director and an executive officer, and may be deemed to be beneficially owned by Mr. Garcia Alves. Mr. Garcia Alves disclaims beneficial ownership of the shares held by Cinveste, SGPS, S.A.
- (6) Ongoing Strategy Investments - SGPS, S.A., for which Mr. Nuno de Almeida e Vasconcellos acts as a Chairman of the Board of Directors and which is 99.99% owned by members of his family, and Insight Strategic Investments - SGPS, S.A., a company 99.99%-owned by Ongoing Strategy Investments - SGPS, S.A., collectively hold a total of 60,404,969 shares, equivalent to 5.35% of the outstanding shares of the Company.
- (7) Includes (1) 2,146 shares held directly by Mr. Amílcar Carlos Fereira de Morais Pires and (2) 87,734,177 shares held by Banco Espírito Santo and its affiliates that may be deemed to be beneficially owned by Mr. Morais Pires. Mr. Morais Pires is the Chief Financial Officer and a member of the Executive Committee of the Board of Directors of Banco Espírito Santo. Mr. Morais Pires disclaims beneficial ownership of the shares held by Banco Espírito Santo and its affiliates.
- (8) Shares held by Caixa Geral de Depósitos, which may be deemed to be beneficially owned by Mr. Armando António Martins Vara. Mr. Vara is a member of the Executive Committee of the Board of Directors of Caixa Geral de Depósitos. Mr. Vara disclaims beneficial ownership of the shares held by Caixa Geral de Depósitos.
- (9) Includes (1) 501 shares held directly by the spouse of Mr. Rafael Luis Mora Funes and (2) 60,404,969 shares held by ongoing strategy Investments SGPS, S.A., for which Mr. Rafael Luis Mora Funes acts as a member of the Board of Directors. Mr. Rafael Luis Mora Funes disclaims beneficial ownership of the shares held by Ongoing Strategy Investments SGPS, S.A.

None of our other executive officers holds more than one percent of our ordinary shares.

In 2005, our executive officers and those of our directors who are employees of Portugal Telecom were given the chance, like all eligible employees of Portugal Telecom, to acquire 40 shares of Portugal Telecom, subject to the same terms and conditions applicable to all employees. Eligible employees who could prove that they had kept the shares similarly allotted to them in 2003 and 2004 had the right to acquire a premium of five additional shares for each such year. During 2006, the Company did not adopt any share allotment plans or share call options, nor did any such plans remain in force regarding directors or Portugal Telecom employees.

**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 June 22, 2007(1)	Percent of Class
Telefónica	112,473,826 ordinary shares	9.96%
Banco Espírito Santo Group	87,734,177 ordinary shares	7.77%
Brandes Investments Partners L.P.(2)	47,460,332 ordinary shares	4.20%
	36,188,923 ADSs	3.21%
Ongoing Strategy Investments, SGPS, S.A.	60,404,969 ordinary shares	5.35%
Caixa Geral de Depósitos Group	57,740,600 ordinary shares	5.11%
Telefónos de Mexico, S.A. de C.V. (Telmex)	38,460,000 ordinary shares	3.41%
Paulson & Co. Inc.	26,385,303 ordinary shares	2.34%
Merrill Lynch International	24,804,526 ordinary shares	2.20%
Fidelity Group	23,592,185 ordinary shares	2.09%
Grupo Barclays	23,216,664 ordinary shares	2.06%
Capital Group Companies	22,996,339 ordinary shares	2.04%
Visabeira Group	22,667,473 ordinary shares	2.01%
Controlinveste	22,600,000 ordinary shares	2.00%

(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 Direcção-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 1.88% 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 these transactions, Telefónica acquired an additional 10,629,271 of our shares, and Telefónica's ownership interest increased further as a result of our share capital reduction on December 28, 2004. As of June 2007, Telefónica holds 112,473,826 of Portugal Telecom's ordinary shares, representing 9.96% of our share capital. António Pedro de Carvalho Viana Baptista, an executive officer of Telefónica, is a non-executive member of the Board of Directors of Portugal Telecom. Telefónica is our joint venture partner in Vivo. See "*Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Telefónica*".

As of June 2007, Banco Espírito Santo Group, or BES, held, directly and indirectly, 7.77% of our issued voting ordinary shares. Joaquim Aníbal Freixial de Goes, member of the Board of Directors of BES, is a non-executive member of our Board of Directors, and Amílcar Carlos Ferreira de Moraes Pires, a member of the Board of Directors of BES, is a non-executive member of our Board of Directors.

As of June 2007, Caixa Geral de Depósitos Group, or Caixa, held, directly and indirectly, 5.11% of our issued voting ordinary shares. Armando António Martins Vara, a member of the Board of Directors of Caixa, is a non-executive member of our Board of Directors, and 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.

As of June 2007, Ongoing Strategy Investments SGPS, S.A. ("Ongoing") held, directly or indirectly, 5.35% of our issued voting shares. Nuno de Almeida e Vasconcellos is the Chairman of Ongoing and is a non-executive member of our Board of Directors. Mr. Rafael Luis Moura Funes is a member of the Board of Directors of Ongoing and is also a non-executive member of our Board of Directors.

The Board of Directors of Portugal Telecom is generally elected at a General Meeting of Shareholders from a slate proposed by certain of our major shareholders in accordance with Portuguese law and practice. The proposal for the members of the board elected in 2006 was submitted by BES and Caixa, and the proposal for the members elected in June 2007 was submitted by BES, Caixa and Ongoing.

Since the filing of our annual report on Form 20-F for the year ended December 31, 2005, the following major shareholders listed in the table above purchased all the shares attributed to them in that table: Ongoing Strategy Investments, SGPS, S.A., Teléfonos de Mexico, S.A. de C.V. (Telmex), Paulson & Co. Inc., Merrill Lynch International, Grupo Barclays, Visabeira Group and Controlinveste. Cinveste, SGPS, S.A. and Telexpress Investments Limited, which held 29,080,000 and 23,000,000 of our shares, respectively, as of the filing of the annual report on Form 20-F for the year ended December 31, 2005, have sold all or a portion of their shares and now each hold less than 2% of our shares.

As of June 21, 2007, approximately 23% of our issued share capital was held of record in the form of ordinary shares by approximately 150 U.S. residents. As of June 21, 2007, approximately 4.3% of our issued share capital was held in the form of ADSs by 95 holders of record, including The Depository 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 44 to our audited consolidated financial statements.

Some of Portugal Telecom's major shareholders are financial institutions with whom agreements are entered into in the normal course of business. The terms of such agreements are substantially identical to those usually entered into between independent entities in comparable transactions. Activities carried out within the framework of these agreements are mainly in respect of telecommunications services provided by the Portugal Telecom Group and financial and consultancy and insurance services provided by such financial institutions. From time to time, BES, Caixa, Merrill Lynch International and Grupo Barclays 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" initiative, which provides, among other things, for an executive officer of BES to serve as a non-executive member of our Board of Directors. See *"Item 4 Information on the Company Our Businesses Strategic Alliances Alliance with Banco Espírito Santo and Caixa Geral de Depósitos"*.

In addition, in 2004 Portugal Telecom entered into equity derivatives with Banco Espírito Santo which consisted of options that allowed the Company to have a right to receive €16.6 million and also allowed Portugal Telecom to acquire shares representing 5% of PT Multimédia's share capital. These options matured on December 31, 2005 and could not be exercised by either of the parties as the strike prices established in the respective contracts were not met. The payment of the option price previously mentioned was subject to the condition of payment to Banco Espírito Santo under similar options it had contracted with third parties (to obtain the financial hedging of its position on the call and put options entered into with our company). During 2005, Portugal Telecom received 50% of the option price described above, in the amount of €8.3 million. In June 2006, Banco Espírito Santo informed Portugal Telecom that the remaining 50%, totaling €8.3 million had not been paid because the conditions to payment had not been met. Consequently, this contract was terminated.

We entered into a strategic partnership with Telefónica, whereby Portugal Telecom may acquire up to 1.5% of the share capital in Telefónica and Telefónica may acquire up to 10% of the share capital in Portugal Telecom.

As of June 2007, Controlinveste Comunicações, SGPS, S.A. ("Controlinveste") held 2% of our issued voting ordinary shares. Controlinveste is part of the Olivedesportos group, which also includes the company PPTV, which holds 50% of Sport TV. We buy advertising space in the ordinary course of business at sporting events from a company controlled by the Olivedesportos group.

Also, in the ordinary course of business, Visabeira Group renders services to us, mainly related to the construction of our wireline network and client installation.

### 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 were 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 in the past that this statute confirmed 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 in March 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.

Law 5/2004 of February 10, 2004 established 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. This regime was implemented in 2005 but does not affect the lawsuit described above pursuant to the former statute.

#### ***Claims by a Consumer Protection Association***

A Portuguese consumer protection association, known as DECO, brought two claims against PT Comunicações in January 1998 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, similar to 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. DECO 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 were 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.

In March 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, and it did so in late 2004.

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. 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. 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.

In May 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 in January 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. In October 2000, the Portuguese Supreme Judicial Court confirmed the injunction ordered by the Lisbon Appeals Court. We had, however, introduced new prices in January 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 2000 and the confirmation of the injunction in October 2000 had no practical effect, therefore, on our price structure.

The Lisbon Civil Court, in December 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 in January 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. In October 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 and to reduce the risk of significant charges, 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. In addition, under the settlement, we opened a period in 2004 during which individuals could seek reimbursement of call set-up charges they had paid in 1999.

Although we believe that the settlement reached with DECO and the related reimbursement of call set-up charges 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 (to which the reimbursement period was not available, based on legal opinions questioning the validity of reimbursements to such customers) will not bring claims for compensation in the future. The amount of any potential liability in connection with such claims would depend on 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. Given the time elapsed since the 2003 court ruling and the absence of current claims by companies, we believe the risk of significant expenditures pursuant to such claims to be low.

### ***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 related to (i) PT Comunicações for alleged abuse of dominant position in the access to

telecommunications ducts; (ii) PT.com (this complaint was formerly against Telepac, which merged with PT.com in December 2004) and TV Cabo regarding alleged anti-competitive practices in the broadband Internet market; (iii) TV Cabo and Sport TV by TV TEL, a cable TV company operating in the Oporto area, for alleged refusal to supply advertising space; and (iv) PT Comunicações for alleged anti-competitive practices in the public wireline telephone market and for granting discriminatory discounts on leased lines. 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 should be dismissed due to the nature of the alleged abuses and the novelty of the relevant competition laws. However, if we are found to be in violation of applicable laws and regulations in these or other regulatory inquiries and investigations, we could become subject to penalties, fines, damages or other sanctions. 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"*.

In September 2005, the Portuguese competition authority also brought allegations against PT Multimédia and TV Cabo for practices allegedly in violation of Article 4 of Law 18/2003 (the Portuguese Competition Law) following the execution in 2000 of a partnership agreement among PTM, TV Cabo and SIC-Sociedade Independente de Comunicação, S.A. (SIC) in connection with SIC's acquisition of Lisboa TV Informação e Multimédia, S.A. PT Multimédia and TV Cabo contested the allegations by the Portuguese competition authority. However, in August 2006, the Portuguese competition authority imposed a fine of €2.5 million on PT Multimédia. PT Multimédia and TV Cabo appealed to the Commerce Court of Lisbon on September 8, 2006. This appeal suspended the decision of the Portuguese competition authority.

On June 8, 2005, Portugal Telecom was informed through the press that Sonaecom 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. Sonaecom requested that the European Commission require us to separate our cable television and fixed line telecommunications operations a so-called "structural remedy". However, on February 2, 2006, the Commission responded that the complaint should be addressed by the Portuguese Autoridade da Concorrência. To our knowledge, proceedings before the European Commission related to this complaint are now closed. We have not received further information about whether Sonaecom intends to pursue this matter with the Autoridade da Concorrência. After the Commission's response, Sonaecom and its parent Sonae, SGPS, S.A. announced an unsolicited tender offer for all the outstanding ordinary shares of Portugal Telecom. This tender offer has lapsed, as described in "Recent Developments" above.

Sonaecom has also submitted a complaint to the European Commission alleging illegal "state aid" in connection with the Portuguese government's 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. Sonaecom is claiming that the purchase price for the basic network was below market value, thereby adversely affecting the Portuguese State. Sonaecom 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. Sonaecom claims this discrimination against new operators represents a case of illegal "state aid" which harmed

both new operators and the municipalities. We have not received information from the European Commission or the Portuguese authorities regarding this complaint.

In April 2006, the European Commission sent to the Portuguese government a formal request to abandon the special rights it holds as the sole owner of our A shares. The European Commission believes that the special powers granted to the Portuguese government through the sole ownership of our A shares act as a disincentive for investment by other EU member states in a manner that violates European Community Treaty rules. Should the Portuguese authorities not take satisfactory steps to remedy the alleged infringement of EU law, the European Commission may decide to refer the case to the European Court of Justice.

#### ***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.

In March, 2004, TVTEL Grande Porto Comunicações, S.A., or TVTEL, a telecommunications company based in Oporto, filed a claim against PT Comunicações in the Lisbon Judicial Court. TVTEL alleged that PT Comunicações, since 2001, has unlawfully restricted and/or refused access to the telecommunication ducts of PT Comunicações in Oporto, thereby undermining and delaying the installation and development of TVTEL's telecommunications network. TVTEL alleges that PT Comunicações intended to favor both itself and CATVP TV Cabo Portugal, S.A, a PT Group company and a direct competitor of TVTEL.

TVTEL is claiming an amount of approximately €15 million from PT for damages and losses allegedly caused and yet to be sustained by that company as a result of the delay in the installation of its telecommunications network in Oporto. In addition, TVTEL has demanded that PT Comunicações be required to give full access to its ducts in Oporto. PT Comunicações submitted its defense to these claims in June 2004, stating that (1) TVTEL did not have a general right to install its network in PT Comunicações's ducts, (2) all of TVTEL's requests were lawfully and timely responded to by PT Comunicações according to its general infrastructure management policy and (3) TVTEL's claims for damages and losses were not factually sustainable. The preliminary hearing in this proceeding has been completed and we expect that a date for a trial will be set in the near future.

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, 2006, our provisions to cover probable losses in all legal proceedings (including tax and labor matters) totaled €96.0 million. In addition, we estimate that our potential liability in civil, labor and other proceedings in which a loss is considered possible (but not probable) in accordance with International Accounting Standard No. 37 was €573.7 million as of December 31, 2006.

## **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. At the Annual General Shareholders' Meeting on April 27, 2007, our shareholders approved the distribution of gross dividends in the amount of €0.475 per share with respect to the fiscal year ended December 31, 2006.

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 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.

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.

According to the new rules established by article 96 of the Portuguese Securities Code (as amended by the Decree-Law no 8/2007, of January 17, 2007), for one month from the publication of the registration of a share capital reduction, Portugal Telecom will not be able to distribute assets to its shareholders. Given that the recording of the share capital increase in the commercial registry was published on May 22, 2007, Portugal Telecom will be free to distribute its assets beginning June 22, 2007.

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. The share issuance premium is the amount corresponding to the subscription price paid for a share over the par value of the share. 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, 2003, 2004, 2005 and 2006 and proposed to be paid for the year ended December 31, 2007. U.S. dollar amounts have been calculated using the exchange rate in effect on the date on which each dividend was paid.

The ADS depository converts Euros into U.S. dollars and pays the net proceeds to ADS holders.

Fiscal Year	Number of shares considered	Payment Date	Dividends per share	
			€	US\$
2003	1,254,285,000	April 30, 2004	0.22	0.26
2004	1,166,485,050	May 27, 2005	0.35	0.43
2005	1,128,856,500	May 19, 2006	0.475	0.60
2006	1,128,856,500	May 18, 2009	0.475	0.64

The general rate of withholding income tax on dividends in Portugal is currently 20% for both Portuguese residents and non-residents. See "Item 10 Additional Information Taxation Dividends".

### Significant Changes

#### *Sonae Tender Offer*

On February 6, 2006, Sonae, SGPS, S.A. and Sonaecom SGPS, S.A., or Sonaecom, announced an unsolicited tender offer for all the outstanding ordinary shares (including ordinary shares represented by American Depositary Shares) and of Portugal Telecom at an initial price of €9.50 in cash per share. The offer was made by Sonaecom and Sonaecom, B.V., both subsidiaries of Sonae, SGPS, S.A., a Portuguese conglomerate engaged in the distribution business, shopping center development, media and telecommunications services, information technology services and other businesses. We refer to Sonae, SGPS, S.A., Sonaecom and Sonaecom, B.V. collectively as "Sonae". Sonae also offered €5,000 in cash

for each €5,000 in principal amount of outstanding convertible bonds issued by Portugal Telecom pursuant to resolutions of a general meeting of its shareholders on February 5, 2001 and of its board of directors on November 29, 2001.

Concurrently with its announcement of the tender offer for ordinary shares and convertible bonds of Portugal Telecom, Sonae announced a tender offer for all the outstanding ordinary shares of Portugal Telecom's subsidiary PT MULTIMÉDIA Serviços de Telecomunicações e Multimédia, SGPS, S.A., or PT Multimédia, for €9.03 per share.

On February 15, 2007, Sonae increased its offer consideration to €10.50. At the extraordinary meeting of shareholders of PT held on March 2, 2007, the removal of the voting limitation in the bylaws of PT, one of the conditions of the Sonae offer, was rejected by the majority of the votes cast and the Sonae offer lapsed.

### ***Ratings***

On March 5, 2007, after Sonae offer had lapsed, Moody's concluded the review for possible downgrade of Portugal Telecom and confirmed the Baa2 credit rating with stable outlook. On March 16, 2007, Standard and Poor's removed the credit rating of Portugal Telecom from CreditWatch with negative implications and confirmed the BBB- rating with stable outlook. See "*Item 3 Key Information Risk Factors Our Recent Ratings Downgrade Required Us to Seek a Waiver from Some of Our Lenders and Could Affect Our Ability to Obtain Future Financing*" and "*Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Indebtedness Credit Ratings*".

## 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 regulated market Eurolist by Euronext Lisbon and the high and low sales closing prices for our ADSs on the New York Stock Exchange for the years ended December 31, 2002, 2003 and 2004 and for each quarter of 2005 and 2006. Our ordinary shares are quoted in Euros. Our ADSs are quoted in U.S. dollars.

Calendar Period	Eurolist by Euronext Lisbon Closing Price Per Ordinary Share		NYSE Closing Price Per ADS	
	High	Low	High	Low
	€		US\$	
2002	9.40	4.55	8.44	4.62
2003	8.00	5.56	10.02	6.06
2004	9.42	7.98	11.78	9.76
2005	9.73	7.38	12.51	8.80
First quarter	9.73	8.90	12.51	11.57
Second quarter	9.23	7.55	11.93	9.24
Third quarter	8.16	7.44	10.10	8.94
Fourth quarter	8.69	7.38	10.29	8.80
2006	10.29	8.09	13.04	9.82
First quarter	10.29	8.09	12.43	9.82
Second quarter	10.18	9.16	12.72	11.66
Third quarter	9.90	9.47	12.71	11.89
Fourth quarter	9.90	9.65	13.04	12.19

The table below sets forth the reported high and low quoted closing prices for the ordinary shares on the regulated market Eurolist by Euronext Lisbon 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	Eurolist by Euronext Lisbon Closing Price Per Ordinary Share		NYSE Closing Price Per ADS	
	High	Low	High	Low
	€		US\$	
October 2006	9.88	9.70	12.61	12.19
November 2006	9.81	9.69	12.83	12.40
December 2006	9.90	9.65	13.04	12.78
January 2007	10.29	9.80	13.31	12.86
February 2007	10.29	10.07	13.50	13.00
March 2007	10.13	9.60	13.57	12.48
April 2007	10.50	10.09	14.35	13.54
May 2007	10.50	9.92	14.25	13.50

## June 2007 (through June 21, 2007)

On June 21, 2007, the closing price of the ordinary shares on the regulated market Eurolist by Euronext Lisbon was €10.27 per ordinary share. On June 21, 2007, the last reported sale price of the ADSs on the New York Stock Exchange was US\$13.87 per ADS.

### **Markets**

Portugal Telecom's ordinary shares are listed on the regulated market Eurolist by Euronext Lisbon.

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's corporation number is 503 215 058.

#### ***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 complementary groups of companies or in European economic interest groups 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 a favorable opinion of the audit committee (See "*Item 10 New corporate governance model*"). 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 their compensation, which is determined by a compensation committee elected by the General Meeting. 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 regulated market Eurolist by Euronext Lisbon 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 the votes cast at a shareholders' meeting 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, 2006, Portugal Telecom's legal reserve was equal to approximately 20.9% of share capital. 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.

The Annual General Shareholders' Meeting on April 27, 2007 approved a reduction of Portugal Telecom's excess capital, preceded by a share capital increase through the incorporation of legal reserves. Upon the completion of these transactions, Portugal Telecom's share capital became equal to approximately 35% of its share capital prior to the transactions, and the legal reserve was reduced in accordance with the new share capital.

According to the new rules established by Article 96 of the Portuguese Securities Code (as amended by the Decree-Law no 8/2007 of January 17, 2007), for one month from the publication of the registration of a share capital reduction, Portugal Telecom will not be able to distribute assets to its shareholders. Given that the recording of the share capital increase in the commercial registry was published on May 22, 2007, Portugal Telecom will be free to distribute any assets beginning June 22, 2007.

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 with shares trading on a regulated market and under the supervision of the Portuguese Securities Exchange 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 categories of other similar reserves under Portuguese law include, 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 exceeding 40% of Portugal Telecom's distributable net income in any year may not be distributed if the holders of the A shares vote against the distribution. 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 audit committee (See "*Item 10 Corporate Governance New corporate governance model*") and the certification of the statutory auditor, may also authorize the payment of interim dividends.

#### ***Voting Rights of the Ordinary Shares and the A Shares***

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-three directors. The current board of directors was elected at the Annual General Shareholders' Meeting on April 21, 2006. 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, provided that such minority has voted against the proposal for the election of directors. 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, all rights attached to treasury stock are suspended, including voting rights. As a result, treasury stock is not counted for the purpose of calculating any minimum quorum nor for determining a majority of votes cast. The purchase by Portugal Telecom of its own shares generally must be approved by its shareholders in accordance with the articles of association and the Portuguese Companies Code. Under Portuguese law, a Portuguese company may not, except under certain limited circumstances (such as the repurchase of its own shares for the purpose of reducing the share capital), purchase more than 10% of its nominal share capital as treasury stock. At the General Meeting of Shareholders held on April 27, 2007, we approved a share buyback program with the purpose of reducing our share capital by up to 16.5%.

Under 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 the chairman of the audit committee and the statutory auditor (See "*Item 10 Corporate Governance New corporate governance model*"), as well as the members of the General Meeting board

authorization of a dividend exceeding 40% of Portugal Telecom's distributable net income per year;

capital increases and other amendments to the articles of association;

issuance of bonds and other securities;

authorization of a shareholder that performs an activity competing with Portugal Telecom to hold more than 10% of our ordinary shares;

amending Portugal Telecom's general objectives and key principles governing Portugal Telecom's policies; and

defining Portugal Telecom's investment policies, including the authorization for acquisitions and transfers of shareholdings.

Additionally, the election of one-third of the directors, including the chairman of the board of directors, must be resolved with the approval of the Portuguese State, as the holder of all the A shares.

In April 2006, the European Commission sent to the Portuguese government a formal request to abandon the special rights the Portuguese government holds as sole owner of our A shares. The European Commission believes that the special powers granted to the Portuguese government through sole ownership of our A shares act as a disincentive for investment by other EU member states in a manner that violates European Community Treaty rules. Should the Portuguese authorities not take satisfactory steps to remedy the alleged infringement of EU law, the European Commission may decide to refer the case to the European Court of Justice.

#### ***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 registered office or, when the registered office does not have satisfactory conditions for the meeting, at another location within the Portuguese territory. Shareholders' meetings are called by publication of a notice on the Ministry of Justice's website (<http://publicacoes.mj.pt>), the CMVM's website ([www.cmvm.pt](http://www.cmvm.pt)) and our website ([www.telecom.pt](http://www.telecom.pt)). 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 audit committee (See "Item 10 Corporate Governance New corporate governance model") 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 five business days in advance. Shareholders may appoint proxies in writing. No shareholder may be represented by more than one representative. Shareholders' meetings are 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 reaching, exceeding or holding less than 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 regulated market Eurolist by Euronext Lisbon and the CMVM within three calendar days.

Portugal Telecom's articles of association contain limitations on ownership, as well as 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 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 or of the supervisory body. The Bank of New York, as ADS depositary, and its nominees are excluded from this requirement.

If any such shareholder holds or controls ordinary shares exceeding 10% of Portugal Telecom's share capital, the shareholders may decide at a shareholders' meeting to require the cancellation of the ordinary shares held exceeding 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 form of transfer of the excess ordinary shares within 30 days. By making such request, such shareholder renounces, pending the conclusion of such sale or transfer, 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.

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***

The articles of association contain limitations on ownership, as well as enforcement mechanisms designed to prevent an unauthorized change in control of Portugal Telecom. 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 resolutions defining the general principles of the policy for investing in companies or deciding on acquisitions and alienations when, in accordance with these principles, the transactions are required to be authorized in advance by the general meeting. In addition, under 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. The articles of association also 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. Shareholders are required under the articles of association to provide information on shareholders' agreements.

### ***Changes in Capital***

With the approval of the audit committee (See "*Item 10 Corporate Governance New corporate governance model*"), the board of directors may increase the share capital of Portugal Telecom on one or more occasions, up to a maximum of €15,000,000, as approved at the General Meeting held on June 22, 2007. 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.

On April 27, 2007, the General Meeting of Shareholders approved the possible issue of convertible bonds which may be adopted by a resolution of the Board of Directors pursuant to the law and the articles of association and in accordance with the parameters set forth in that resolution of the General Meeting of Shareholders. Therefore, in order to ensure that the Board of Directors is able to perform all the share capital increases that may be necessary to guarantee the satisfaction of all requests for conversion into shares that may occur in respect of the convertible bonds that are permitted to be issued by the Company, the Board of Directors proposed that the General Meeting of Shareholders update the general authorization for the approval of share capital increases by the Board of Directors, as set forth in paragraph 3 of Article Fourth of the Articles of Association. This general authorization was approved at the General Meeting held on June 22, 2007, and the maximum amount of share capital increases was fixed at €15,000,000, as mentioned above.

## **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 Companies Code was subject to two major amendments during 2006 and 2007. A revision on March 29, 2006 mainly related to corporate governance matters. On January 17, 2007, a second revision covered issues such as share capital reductions and disclosure of financial information. The Portuguese Securities Code and related rules complement the corporate governance provisions set forth in the Portuguese Companies Code by, inter alia: (i) requiring immediate disclosure of material information as well as the disclosure of qualifying holdings and certain periodic information, including financial statements and an annual corporate governance report and (ii) by establishing criminal and administrative sanctions for the breach of the material information regime, in particular providing for a market abuse crime (covering insider trading or abuse and market manipulation).

In response to the heightened focus world-wide on corporate governance in recent years, CMVM amended its "Recommendations on Corporate Governance for Listed Companies" and the "Regulation on Corporate Governance for Listed Companies", or Regulation 7/2001, in 2003, 2005 and 2006. These recommendations govern matters involving shareholder powers, rights and meetings, management and the tasks of non-executive and independent board members, committees, internal control systems and disclosure, remuneration and equity compensation plans, and whistleblowing policies. Regulation 7/2001 governs mainly board independence criteria, the mandatory content of the annual corporate governance report and of a listed company's website, as well as disclosure on equity compensation plans and transactions executed by senior management. It is expected that during the second half of 2007, new amendments to the aforementioned recommendations and Regulation 7/2001 will be approved by CMVM.

The Portuguese Companies Code is legally binding on any company with a registered office in Portugal. The Companies Code establishes corporate governance standards with respect to 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 contributions in kind;

Dividends, which are subject to mandatory minimum distributions of 50%, except in limited circumstances, including if a lower percentage is set forth in the articles of association;

Shareholders' meetings, including minimum notice requirements, minority rights, voting by correspondence, and requirements that shareholders elect the chairman and other officials of the meeting, composed of independent members (in the case of major companies and issuers of securities traded on a regulated market, like Portugal Telecom), 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 the company's performance;

Shareholder rights to, in certain circumstances, request the judicial declaration of annulment or voiding of decisions made at a shareholders' meeting and the suspension of an illegal resolution, as well as to request the chairman of the board of the shareholders' meeting to suspend a meeting in progress;

Management and supervisory structure, including three models of corporate governance with certain particularities applicable to issuers of securities traded on a regulated market like Portugal Telecom, as follows:

the two-tier model, with a management body (the so-called executive management board) and a supervisory body (the so-called supervisory board, which shall have a chairman, who may not be the chairman of the executive management board, and a committee for financial matters);

the one-tier model, with the board of directors as a management body (which, by contrast to the management body in a two-tier model, may delegate day-to-day management to an executive committee, and its chairman may also be the chairman of the executive committee) and the statutory audit board as a supervisory body (which, following the March 2006 revision of the Portuguese Companies Code, no longer includes the statutory auditor) (which was the model used by Portugal Telecom until the June 22, 2007 General Meeting of Shareholders); and

the "Anglo-Saxon" model with certain alterations (also permitted following the aforementioned March 2006 revision), where the board of directors (the management body) includes an audit committee, which is a corporate body composed of non-executive directors with supervisory functions. In this model, the board may also delegate the day-to-day management to an executive committee, and its chairman may also be the chairman of the executive committee;

An audit function, which is conducted by a statutory auditor who is elected by shareholders following a proposal of the supervisory body and who is entitled to participate in board meetings; as mentioned above, after the March 2006 revision of the Portuguese Companies Code, the statutory auditing function (carried out by the statutory auditor) was separated from the supervision of management (carried out by the supervisory body);

Appointment of members of the management and supervisory bodies by a shareholders' meeting and appointment of the statutory auditor by a shareholders' meeting, as mentioned above, following a proposal of the supervisory body;

Strengthening of the supervisory functions (following the March 2006 revision of the Portuguese Companies Code) as to the supervisory body's membership (it being mandatory for the aforementioned committee for financial matters, the statutory board and the audit committee to be composed of a majority of independent members among whom there must be an expert, as defined in the law) and broadening the scope of the supervisory powers (by adding powers on matters such as whistleblowing systems, oversight of the work and independence of the statutory auditor and making proposals on the selection and confirmation, of the statutory auditor);

Conflicts of interest, which are highly regulated, including through 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;

Fiduciary duties of board members to shareholders and the company; and

Compensation of members of our board of directors, which is established by our general shareholders' meeting or by a compensation committee appointed by a shareholders' meeting.

### ***New Corporate Governance Model***

As mentioned above, in March 2006, the Portuguese corporate law was broadly amended with relevant implications for the models and principles of corporate governance, in particular those concerning issuers of securities traded on a regulated market. These amendments required companies to change their corporate governance and supervision by June 30, 2007. At the general meeting held on June 22, 2007, shareholders approved a proposal from the Board adopting a new corporate governance model and introducing the required amendments to the Articles of Association of Portugal Telecom. The decision to adopt the new Anglo-Saxon model took into account, *inter alia*, the fact that the company has securities traded on the NYSE, where this structure is mandatory for domestic companies, as well as the fact that Portugal Telecom already had an audit committee. Following the adoption of the Anglo-Saxon model Portugal Telecom's corporate bodies consist of the General Meeting, the Board of Directors, which includes an Audit Committee, and a Statutory Auditor.

Although Portugal Telecom has had an audit committee as an internal committee of the board since December 2003, until June 22, 2007, the statutory audit board was the corporate body responsible for supervision of the audit function and other supervisory functions. At the General Meeting held last June 22, 2007, Portugal Telecom replaced the statutory audit board with the audit committee, consisting of three directors, one of them being its Chairman, all elected by the general shareholders' meeting. Additionally, the Company has a statutory auditor elected by shareholders following a proposal of the audit committee responsible for the audit function.

The aforementioned proposal of the Board of Directors, approved at the general meeting held on June 22, 2007, also included other amendments to the Company's Articles of Association deemed necessary or convenient for compliance with the remaining amendments to the Portuguese Companies Code, with respect to matters that go beyond the corporate governance model, such as the rules governing voting by correspondence, the absence and surety of directors, and share capital reduction (this latter rule resulting from the amendments to the Portuguese Companies Code approved by Decree-Law no. 8/2007 on January 17, 2007).

***Summary of Significant Differences Between Portuguese Corporate Governance Practices and the New York Stock Exchange's 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 for 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 require all members of management or the board of directors of a Portuguese company to be independent. However, Portuguese law does provide that the majority of the members of the audit committee must be independent according to the criteria established in the Portuguese Securities Code and that all the members of the audit committee fulfill the legal requirements concerning incompatibilities and expertise. These principles are designed to strengthen the supervision of the audit function, to avoid conflicts of interest and to establish procedures and standards for related party transactions. Additionally, the Portuguese law imposes that the majority of the directors composing the audit committee shall be independent. For this purpose, members of the audit committee will be deemed independent if they are not associated with any specific interest groups in the company, nor are under any circumstances that might affect the neutrality of their analysis or decisions. In particular, Portuguese law will not deem independent any holder, or any person acting on behalf or for the account of, a holder of a qualifying holding equal or higher than 2% of the company's share capital, nor anyone being reelected for more than two terms whether subsequent or not.

In Portugal Telecom's case, the Chairman of our board of directors for the 2006-2008 term simultaneously serves as Chief Executive Officer.

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.

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The audit committee elected at the General Meeting of Shareholders on June 22, 2007 complies with the independence requirements under Portuguese law, and each member of the audit committee also meets the independence requirements under Rule 10A-3 under the U.S. Securities Exchange Act of 1934, as amended.

**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. The NYSE's detailed requirements for the content of audit committee charters do not apply to non-U.S. listed companies.

Portuguese law requires companies adopting a two-tier or an Anglo-Saxon corporate governance model (as described under "*Portuguese Legal Framework*" above) to have, respectively, a committee for financial matters within the supervisory body or an audit committee within the board of directors, in both cases satisfying the aforementioned requirements as to its minimum powers, independence and expertise. Moreover, in each model it is permitted under the Portuguese Companies Code to create a compensation committee, within the supervisory board in the two-tier model, or appointed by the general meeting, in the case of the one-tier or Anglo-Saxon models. Additionally, the CMVM recommends listed companies to create committees to evaluate corporate governance structures and practices. There is no requirement to create a nominating committee under Portuguese laws and regulations or under the CMVM's Recommendations on Corporate Governance for Listed Companies.

Portugal Telecom established an audit committee in December 2003, consisting of independent members of its Board of Directors. The audit committee's primary function was 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.

At the general meeting held on June 22, 2007, Portugal Telecom redesignated the audit committee as Portugal Telecom's supervisory corporate body (See "*Item 10 New corporate governance model*"). According to the articles of association, the members of the audit committee must comply with the requirements on incompatibilities, independence and expertise arising from the Portuguese law and regulations, as well as other relevant market rules, including those in force in the jurisdictions where Portugal Telecom's has securities admitted for trading. In addition to the authority granted under Portuguese laws, the audit committee has specific authority granted by our articles of association, including, *inter alia*, powers: (i) to verify the accuracy of the financial statements and, in general, to supervise the quality and integrity of the financial information; (ii) to supervise the process of preparation and disclosure of financial information; (iii) to supervise the statutory audit and the auditing of our financial statements, as well as to supervise and evaluate the internal proceedings related to accounting and audit matters; (iv) direct and exclusive responsibility to appoint, hire, retain or dismiss and to establish the compensation of our independent auditors, as well as to supervise their qualifications and independence and to approve the audit services and/or non-audit services to be rendered by our independent auditors or associated persons; (v) to supervise the quality, integrity and effectiveness of the risk management system, the internal control system, as well as the internal audit system; and (vi) to receive the communications of irregularities, claims and/or complaints submitted by shareholders, employees of the Company or third parties, as well as to implement procedures for the receipt, retention and treatment of irregularities, claims and/or complaints whenever concerning accounting and auditing matters, as well as related to internal controls as regards those subject matters. Under our articles of association, as approved in the aforementioned General Meeting, the independent auditors shall report to and be subject to the direct and exclusive oversight of the audit committee, which annually obtain and review an audit report from the independent auditors.

As a result, the audit committee monitors our compliance with legal provisions, regulations, recommendations and guidelines issued by the SEC, NYSE, CMVM, and the Euronext Lisbon and defines and implements policies to ensure our compliance with these laws, regulations, recommendations and guidelines.

João Manuel de Mello Franco, Thomaz de Mello Paes de Vasconcellos and José Guilherme Xavier de Basto were elected at the General Meeting of Shareholders held on June 22, 2007 as the new members of the audit committee to complete the 2006-2008 term of office.

Additionally, the new corporate governance structure includes a registered accountant who is not one of the members of the audit committee, as required by the Decree-Law 76-A/2006 of March 29, 2006, which amended the Portuguese Companies Code. The new registered accountant was appointed at the General Meeting of Shareholders held on June 22, 2007. P. Matos Silva, Garcia Jr., P. Caiado & Associados SROC, represented by Pedro João Reis de Matos Silva, was elected as the new effective registered accountant, and Ascensão, Gomes, Cruz & Associados SROC, represented by Mário João de Matos Gomes, was elected as the new substitute registered accountant.

Portugal Telecom created a corporate governance committee in July 2006. This committee is responsible for evaluating Portugal Telecom's corporate governance principles and advising the Board of Directors on corporate governance practices and rules of conduct, including advising the Board as to the company's corporate governance model and practices, considering namely our relationship with shareholders and the market, as well as advising on measures to prevent conflicts of interest and to ensure information transparency. This committee also has advisory responsibilities in regard to the qualifications of board members and to the board evaluation process. The corporate governance committee also monitors the content and the compliance with our Code of Ethics and other rules of conduct. The members of the governance committee are the following: João Manuel de Mello Franco (chairman), Joaquim Anibal Brito Freixial de Goes, Jorge Humberto Correia Tomé, Franquelim Fernando Garcia Alves and Francisco Teixeira Pereira Soares.

**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 therefor. This disclosure is included in our Corporate Governance Report, which is attached as an appendix to our Portuguese annual report and to the English translation of that 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's regulations or general conditions, as applicable, must be attached to the proposal.

## Material Contracts

### Wireline Pricing Convention

Prices in our wireline business are set pursuant to a pricing convention entered into with ANACOM and DGCC in December 2002 (the "Universal Service Convention"). A copy of this agreement is filed as an exhibit to this Annual Report on Form 20-F. Under the Universal Service Convention, any price increases must be approved by ANACOM. The Universal Service Convention specifically regulates fixed telephone services (excluding ISDN), public telephone services and information services using a system of gradual cost adjustments, price caps and maximum ratios. The price of public telephone services is regulated by the use of a maximum ratio in relation to subscriber prices. In addition, the Universal Service Convention includes provisions to make prices more accessible, such as a pricing plan for low-use customers, a discount for retired and fixed-income individuals and assistance for customers with special needs.

A new price basket for 2005, approved by ANACOM, came into effect on July 1, 2005 and complied with the price cap of CPI-2.75% for the average annual change. The average annual changes in the price of the main components of the basket were as follows: (1) line rental prices increased by 1.7%, (2) local call prices increased by 0.5%, (3) regional call prices decreased by 24.1% and (4) domestic long distance call prices decreased by 25.3%. The number of call types used in the price basket was reduced from three to two, namely local and domestic long distance, to simplify the tariff structure. In contrast to previous years, the price cap was applied only to the residential segment and not to the corporate segment. In 2006, there was no new tariff scheme for residential customers. The average annual changes in the price of the components of the basket were as follows: (1) line rental prices had no change, (2) local call prices decreased by 5.9% and (3) national call prices decreased by 15.9%. See "*Item 4 Information on the Company Our Businesses Wireline Business*".

### Indebtedness

On November 7, 2006, we entered into an Amended and Restated Programme Agreement, a Fifth Supplemental Trust Deed, and Amended and Restated Agency Agreement and other documents relating to our Global Medium Term Note Program, increasing the size of the program to €7.5 billion. The issuer under the program is Portugal Telecom International Finance B.V., and the program benefits from Keep Well Agreements from Portugal Telecom and PT Comunicações, S.A. Copies of these documents are filed as Exhibits 2.2, 2.3, 2.4, 2.5 and 2.6 to this Annual Report on Form 20-F. See "*Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources Indebtedness Debt Instruments and Repayment and Refinancing of Indebtedness*" for more information about our Global Medium Term Note Program, including information about bonds issued under the program.

### **PT Multimédia Share Buyback Program**

In 2004, PT Multimédia established a share buyback program, which included the issuance of put warrants for PT Multimédia shares. This program allowed shareholders who held 10 put warrants to sell one PT Multimédia share at a price of €21.50 per share in the case of physical settlement of the put warrants. Alternatively, shareholders could choose financial settlement of the put warrants and receive an amount in cash determined under the final terms and conditions approved by PT Multimédia. In March 2005, Portugal Telecom opted for the financial settlement of 90,304,850 (before the stock split by PT Multimédia in 2005) put warrants for PT Multimédia shares. Under the final terms and conditions that were later on approved by PT Multimédia's board of directors, Portugal Telecom received a unit value of €0.307 per put warrant.

### **Certain Dispositions**

In August 2005, PT Multimédia sold Lusomundo Serviços, SGPS, S.A., including 80.91% of Lusomundo Media, SGPS, S.A., to Controlinveste, SGPS, S.A. In connection with this transaction, Portugal Telecom previously sold to PT Multimédia the 5.94% shareholding it directly held in the share capital of Lusomundo Media, SGPS, S.A. PT Multimédia received net proceeds from Controlinveste, SGPS, S.A. in the amount of approximately €174 million, of which €10.1 million were paid to Portugal Telecom for the purchase of the 5.94% shareholding referred to above.

Also in August 2005, PT Brasil signed an agreement with Embratel for the sale of its 100% interest in PrimeSys, the Brazilian provider of telecommunications business solutions to large corporate clients. PT Brasil received €101.8 million in the transaction, which closed in November 2005.

### **Exchange Controls**

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 alternative minimum tax considerations or any aspect of state, local or non-U.S. tax laws (other than certain Portuguese tax laws).

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 depository and on the assumption that each obligation in the Amended and Restated Deposit Agreement, dated as of June 25, 1999, which governs Portugal Telecom's ADSs 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:

an individual 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 a resident of the U.S. for purposes of the Tax Treaty;

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 attributable.

For purposes of the Tax Treaty and for U.S. federal income and Portuguese tax purposes, a U.S. Holder of 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 20% for both Portuguese residents and non-residents.

Under the Tax Treaty, the rate of withholding tax on dividends distributed to U.S. Holders generally may not exceed 15%. In order to apply the reduced treaty rate, Portugal Telecom must have confirmation that each shareholder is entitled to the benefits of the Tax Treaty and must possess a specific form duly certified by the U.S. tax authorities, prior to the date the dividends are made available to shareholders. If this form is not available as of the relevant date, withholding tax should be levied at the 20% rate. The 5% excessive withholding can nevertheless be subsequently reimbursed by



the Portuguese tax authorities, pursuant to specific claims of individual shareholders within two years following the date the dividends are made available.

**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. 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 U.S. Holder, in the case of ordinary shares, or by The Bank of New York as depository, in the case of ADSs, 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 U.S. Holder or The Bank of New York as depository, as the case may be, receives the Euros. If the Euros are not converted 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 during which it is not protected from risk of loss 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.

For taxable years beginning before January 1, 2007, 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. For taxable years beginning on or after January 1, 2007, dividends distributed by Portugal Telecom with respect to ordinary shares or ADSs generally should constitute "passive category income" or, in the case of certain holders, "general category income" for U.S. foreign tax credit limitation purposes.

Foreign tax credits that were not used due to the foreign tax credit limitation may generally be carried back one year and forward ten 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, 2010 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 (i) the shares (or ADSs) are readily tradable on an established securities market in the United States or (ii) the non-U.S. corporation is eligible for the benefits of a comprehensive income tax treaty with the U.S. which the U.S. Treasury Department determines to be satisfactory for these purposes and which includes an exchange of information provision. 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). In addition, the U.S. Treasury Department has determined that the Tax Treaty meets these requirements, and we believe we are eligible for the benefits of the Tax Treaty. Accordingly, unless we are treated as a "passive foreign investment company", the dividends that we pay in respect of our ordinary shares or 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.

Distributions in excess of Portugal Telecom's current or accumulated earnings and profits, as determined under U.S. federal income tax principles, 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. Consequently, such distributions in excess of Portugal Telecom's current and accumulated earnings and profits would generally not give rise to foreign source income and a U.S. Holder would generally not be able to use the foreign tax credit arising from any Portuguese withholding tax imposed on such distributions unless such credit can be applied (subject to applicable limitations) against U.S. federal income tax due on other foreign source income in the appropriate category for foreign tax credit purposes. However, we do not expect to keep earnings and profits in accordance with U.S. federal income tax principles. Therefore, U.S. Holders should expect that a distribution will generally be treated as a dividend (as discussed above).

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 ordinary shares or ADSs through taxable years beginning on or before December 31, 2010 is generally taxed at a maximum rate of 15% where the holder has a holding period of more than one year. 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 U.S. for foreign tax credit limitation purposes.

Deposits and withdrawals of ordinary shares by U.S. Holders in exchange for ADSs should not be subject to U.S. federal income tax.

***Passive Foreign Investment Company***

We do not believe that we are, for U.S. federal income tax purposes, a "passive foreign investment company," and we expect to operate in such a manner so as not to become a "passive foreign investment company." If, however, we are or become a "passive foreign investment company," U.S. Holders could be subject to additional U.S. federal income taxes on gain recognized with respect to the ordinary shares or ADSs and on certain distributions, plus an interest charge on certain taxes treated as having been deferred under the "passive foreign investment company" rules.

***Reportable Transactions***

Under applicable U.S. 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 advisors 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. Information Reporting and Back-up Withholding***

In general, U.S. information reporting will apply with respect to dividends paid on or proceeds of the sale or other disposition of an ordinary share or ADS that are paid to a U.S. Holder within the U.S. (and, in certain cases, outside the U.S.), unless the U.S. Holder is a corporation or otherwise establishes a basis for exemption. A back-up withholding tax may apply to such payments if the U.S. Holder fails to provide a taxpayer identification number or certification of other exempt status or fails to report in full dividend and interest income. Any amounts withheld under the back-up withholding rules will generally be allowed as a refund or a credit against a U.S. Holder's U.S. federal income tax liability, provided that the required information is furnished to the Internal Revenue Service.

**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 SEC may be inspected and copied by the public at the public reference facilities maintained by the SEC at Station Place, 100 F Street, N.E., Room 1580, Washington, D.C. 20549 and are also available on the website of the SEC 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 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 depository 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 consists of managing interest rate risk through a combination of fixed and floating rate debt instruments and derivatives. During 2006, the total notional amount of our interest rate swaps portfolio did not change significantly, as only small adjustments were made to our portfolio in result of partial amortization of some hedged amortizable loans.

As of December 31, 2006, approximately 62.3% of our total indebtedness carried fixed interest rates, compared to 66.6% at the end of 2005. The decrease in the proportion of our fixed rate debt is mainly due to the fact that most of the debt repaid in 2006, including eurobonds amounting to approximately €900 million and exchangeable bonds amounting to approximately €390 million, bore interest at fixed rates.

The floating rate component of our total indebtedness is mainly subject to fluctuations in the European Interbank Offered Rate (EURIBOR), CDI (Crédito Depositário Interbancário, a Brazilian interbank interest rate) and EIB rates. 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, the EIB's interest rates are generally competitive. EIB floating rates remained very close to EURIBOR flat rates during 2006.

### ***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 foreign currencies, including U.S. dollars

and Japanese Yen. Vivo's policy is to hedge against these currencies exchange risk so, as a result, most of the debt of Portugal Telecom's Brazilian subsidiaries was either Real-denominated or had been swapped into Reais, as of December 31, 2006. We remain exposed to exchange rate risk between Brazilian Reais and Euros with respect to 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, 2006, approximately 0.4% of our total indebtedness was denominated in U.S. dollars, compared with 1.8% at the end of 2005 (taking into consideration cross-currency swaps). Our total net exposure to the U.S. dollar, including our indebtedness, cash and certain free-standing derivatives, amounted to negative US\$232 million as of December 31, 2006.

### ***Equity Price Risk***

As of December 31, 2006, we faced equity price risk with regard to our shares in Telefónica and BES. See Note 31 to our audited consolidated financial statements. In June 2007, Portugal Telecom disposed of its interest in BES.

Pursuant to the 3% share buyback announced in 2005, we had entered into equity swaps for 20,640,000 of our own shares as of December 31, 2006. In view of the difference between the exercise price of those derivatives (ranging from €8.19 to €9.72 per share) and the market price of our shares, these equity swaps have been recorded as liabilities based on the present value of the amount to be paid at settlement. These instruments had maturities of up to five months as of December 31, 2006.

In order to increase our exposure to PT Multimédia, Portugal Telecom entered into equity swaps for 30,575,090 PT Multimédia shares with an exercise price of €9.02. In May 2007, these equity swaps were cash-settled, and Portugal Telecom received an amount of €85.7 million. See notes 41 and 46 to our audited financial statements.

The following tables provide information about our debt and derivative instruments as of December 31, 2006 that are sensitive to changes in interest rates and exchange rates. The tables present principal cash flows and average interest rates (unless otherwise stated) by expected maturity dates. The information concerning debt, namely average interest rates and fair value amounts, takes into account associated derivatives entered into with the purpose of hedging debt's interest rate and/or exchange rate risk. 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, 2006.

In addition, 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 IFRS as of December 31, 2004, 2005 and 2006.

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	2007	2008	2009	2010	2011	Thereafter	Total	Fair Value(1)
<b>Fixed Rate Debt</b>									
<b>EIB Fixed Rate Loans</b>									
EIB Loans (€)		47	45	36	36	32	43	239	233
Average Interest Rate		3.80%	3.81%	3.83%	3.85%	3.90%	4.05%	3.84%	
EIB Loans (€) with associated interest rate swaps		35	67	62	62	58	134	419	406
Average Interest Rate		4.02%	4.12%	4.12%	4.08%	4.02%	3.79%	4.03%	
<b>Total EIB Fixed Rate Loans</b>		<b>82</b>	<b>112</b>	<b>99</b>	<b>99</b>	<b>90</b>	<b>177</b>	<b>659</b>	<b>639</b>
<b>Non-EIB Fixed Rate Loans</b>									
Loans (€)		8	8	7	7	6	45	82	82
Average Interest Rate		4.50%	4.49%	4.48%	4.48%	4.47%	4.40%	4.48%	
Bonds (€)				878			1,989	2,867	2,642
Average Interest Rate		4.27%	4.27%	4.27%	4.12%	4.12%	1.88%	4.25%	
Loans (US\$)		0	0	0	0	0	0	1	1
Average Interest Rate		3.07%	0.75%	0.75%	0.75%	0.75%	0.35%	1.28%	
Loans (US\$) with associated €/US\$ swaps		1	1	1				3	3
Average Interest Rate		3.62%	3.62%	3.62%				3.62%	
Loans (BR\$)		0	0	0	20			21	23
Average Interest Rate		9.15%	9.27%	9.39%	9.45%			9.31%	
Loans (Other currencies)		1	2	2	2	2	0	8	8
<b>Total Non-EIB Fixed Rate Loans</b>		<b>10</b>	<b>11</b>	<b>888</b>	<b>29</b>	<b>8</b>	<b>2,035</b>	<b>2,981</b>	<b>2,758</b>
<b>Total Fixed Rate Debt</b>		<b>93</b>	<b>123</b>	<b>986</b>	<b>128</b>	<b>99</b>	<b>2,212</b>	<b>3,640</b>	<b>3,397</b>
<b>Floating Rate Debt</b>									
<b>EIB Floating Rate Loans</b>									
Loans (US\$) with associated €/US\$ swaps		10	10	10	10	10		50	49
Average Interest Rate ref. EIB rates		0.18%	0.18%	0.18%	0.18%	0.18%		0.18%	
<b>Total EIB Floating Rate Loans</b>		<b>10</b>	<b>10</b>	<b>10</b>	<b>10</b>	<b>10</b>	<b>0</b>	<b>50</b>	<b>49</b>
<b>Non-EIB Floating Rate Loans</b>									
Loans (€)		796	24	78	168	14	82	1,161	1,160
Average Spread ref. Euribor		0.34%	0.81%	0.81%	0.89%	1.76%	1.77%	0.65%	
Equity Swaps on Own Shares (€)		188						188	173
Average Spread ref. Euribor		0.22%						0.22%	
Loans (US\$)		11	10					21	21
Average Spread ref. USD Libor		1.54%	1.65%					1.58%	
Loans (US\$) with associated US\$/BR\$ swaps(2)		197	93	0	17			306	365
Average Spread ref. % of CDI		100.18%	102.27%	95.43%	95.43%			100.33%	

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	Notes	2007	2008	2009	2010	2011	Thereafter	Total	Fair Value(1)
Loans (JPY) with associated JPY/BR\$ swaps(2)		59	112					172	188
Average Spread ref. % of CDI		98.32%	100.95%					99.36%	
Bonds (BR\$)			89				178	267	276
Average Spread ref. % of CDI		104.15%	104.15%	104.02%	104.02%	104.02%	104.02%	104.06%	
Loans (BR\$)			2					2	4
Average Spread ref. % of CDI		100.00%	100.00%					100.00%	
Loans (BR\$)		17	3	3	3	2		29	29
Average Spread ref. TJLP		4.10%	4.60%	4.60%	4.60%	4.60%		4.34%	
Loans (BR\$)		3	1	1	1	0		5	5
Average Spread ref. UMBND		13.12%	13.23%	13.23%	13.23%	13.23%		13.18%	
<b>Total Non-EIB Floating Rate Loans</b>		<b>1,270</b>	<b>334</b>	<b>82</b>	<b>189</b>	<b>16</b>	<b>260</b>	<b>2,150</b>	<b>2,222</b>
<b>Total Floating Rate Debt</b>		<b>1,280</b>	<b>344</b>	<b>92</b>	<b>199</b>	<b>26</b>	<b>260</b>	<b>2,200</b>	<b>2,272</b>
<b>Total Debt</b>		<b>1,373</b>	<b>467</b>	<b>1,078</b>	<b>327</b>	<b>124</b>	<b>2,472</b>	<b>5,840</b>	<b>5,669</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	2007	2008	2009	2010	2011	Thereafter	Fair Value
<b>Fixed Rate Payer</b>								
Pay fixed Euro, receive floating Euro swaps		571	511	396	313	231	156	(2)
Average Rate Paid		4.34%	4.27%	4.24%	4.20%	4.14%	3.94%	
Average Spread Received ref. Euribor		0.07%	0.07%	0.08%	0.09%	0.09%	0.11%	
Pay fixed Euro, receive floating Euro forward starting swaps			57	68	52	36	20	(3)
Average Rate Paid			5.33%	5.35%	5.35%	5.36%	5.37%	
Average Spread Received ref. Euribor			0.00%	0.00%	0.00%	0.00%	0.00%	
Pay fixed Euro, receive floating U.S. dollar swaps		2	1	0				(0)
Average Rate Paid		3.62%	3.62%	3.62%				
Average Spread Received ref. US\$ Libor		0.40%	0.40%	0.40%				
Pay fixed U.S. dollar, receive floating U.S. dollar swaps		88	20					1
Average Rate Paid		5.17%	3.87%					
Average Spread Received ref. US\$ Libor		0.90%	0.00%					
Pay fixed Brazilian Real, receive floating Brazilian Real swaps		418	150					(1)
Average Rate Paid		14.13%	12.48%					
Average Spread Received ref. % of CDI		100.00%	100.00%					
<b>Floating Rate Payer</b>								
Pay floating Euro, receive floating U.S. dollar swaps		40	32	24	16	8		(10)
Average Spread Paid ref. Euribor		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%		
Pay floating Brazilian Real, receive fixed Brazilian Real swaps		20	20	20	20			1
Average Spread Paid ref. % CDI		107.00%	107.00%	107.00%	107.00%			
Average Rate Received -		9.45%	9.45%	9.45%	9.45%			
Pay floating Brazilian Real, receive fixed Euro swaps		1						(0)
Average Spread Paid ref. % CDI		100.00%						
Average Rate Received		3.83%						
Pay floating Brazilian Real, receive fixed U.S. dollar swaps		306	110	16	15	0		(70)
Average Spread Paid ref. % CDI		105.64%	102.67%	95.71%	95.56%	100.00%		
Average Rate Received		6.18%	6.30%	5.65%	5.64%	7.96%		
Pay floating Brazilian Real, receive fixed Japanese Yen swaps		160	107					(26)
Average Spread Paid ref. % CDI		105.22%	105.44%					
Average Rate Received		1.92%	1.76%					

(1)

All the amounts refer to the notional amounts of derivatives at the beginning of each period. In case notional amounts are not denominated in Euros, the amounts presented are the equivalent in Euros of the notional amounts, using the exchange rates prevailing at year-end.

## Debt Sensitivity to Exchange Rates

(Euro million)

## Expected Maturity Date

	Notes	2007	2008	2009	2010	2011	Thereafter	Total	Fair Value(1)
<b>Debt exposure to Non-European Monetary Union currencies</b>									
<b>Exposure to the Euro/U.S. dollar exchange rate</b>									
Loans (US\$)		0	0	0	0	0	0	1	1
Average Interest Rate		3.07%	0.75%	0.75%	0.75%	0.75%	0.35%	1.28%	
Loans (US\$)		11	10					21	21
Average Spread ref. US\$ Libor		1.54%	1.65%					1.58%	
<b>Exposure to the Euro/Brazilian Real exchange rate</b>									
Loans (BR\$)		0	0	0	20			21	23
Average Interest Rate		9.15%	9.27%	9.39%	9.45%			9.31%	
Loans (US\$) with associated US\$/BR\$ swaps	(2)	197	93	0	17			306	365
Average Spread ref. % of CDI		100.18%	102.27%	95.43%	95.43%			100.33%	
Loans (JPY) with associated JPY/BR\$ swaps	(2)	59	112					172	188
Average Spread ref. % of CDI		98.32%	100.95%					99.36%	
Bonds (BR\$)			89				178	267	276
Average Spread ref. % of CDI		104.15%	104.15%	104.02%	104.02%	104.02%	104.02%	104.06%	
Loans (BR\$)			2					2	4
Average Spread ref. % of CDI		100.00%	100.00%					100.00%	
Loans (BR\$)		17	3	3	3	2		29	29
Average Spread ref. TJLP		4.10%	4.60%	4.60%	4.60%	4.60%		4.34%	
Loans (BR\$)		3	1	1	1	0		5	5
Average Spread ref. UMBND		13.12%	13.23%	13.23%	12.23%	13.23%		13.18%	
<b>Exposure to other currencies exchange rates</b>									
Loans (Other currencies)		1	2	2	2	2	0	8	8

(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	2007	2008	2009	2010	2011	Thereafter	Fair Value
<b>Exposure to the Euro/U.S. dollar exchange rate</b>	(2)							
Pay fixed Euro, receive floating U.S. dollar swaps		2	1	0				(0)
Average €/US\$ exchange rate		1.12	1.12	1.12				
Pay floating Euro, receive floating U.S. dollar swaps		40	32	24	16	8		(10)
Average €/US\$ exchange rate		1.07	1.07	1.07	1.07	1.07		
Final exchange of former €/US\$ swaps		200	200	200				35
Average €/US\$ exchange rate		1.09	1.09	1.09				
€/US\$ Forwards		200	200	200				(35)
Average exchange rate		1.09	1.09	1.09				
€/US\$ Calls		200	200	200				(35)
Average exchange rate		1.09	1.09	1.09				
<b>Exposure to the Euro/Brazilian Real exchange rate</b>								
Pay floating Brazilian Real, receive fixed Euro swaps		1						(0)
Average exchange rate		2.89						
<b>Exposure to the U.S. dollar/Brazilian Real exchange rate</b>	(3)							
Pay floating Brazilian Real, receive fixed U.S. dollar swaps		306	110	16	15	0		(70)
Average exchange rate		2.07	2.19	2.41	2.37	3.00		
<b>Exposure to the Japanese Yen/ Brazilian Real exchange rate</b>	(4)							
Pay floating Brazilian Real, receive fixed Japanese Yen swaps		160	107					(26)
Average exchange rate		0.02	0.02					

- (1) All the amounts refer to the notional amounts of derivatives at the beginning of each period. In case notional amounts are not denominated in Euros, the amounts presented are the equivalent in Euros of the notional amounts, using the exchange rates prevailing at year-end.
- (2) Most derivatives were entered into in order to hedge exchange rate risk resulting from U.S. dollar-denominated debt.
- (3) Most derivatives were entered into by Brazilian subsidiaries in order to hedge exchange rate risk resulting from U.S. dollar-denominated debt.
- (4) All derivatives were entered into by Brazilian subsidiaries in order to hedge exchange rate risk resulting from Japanese Yen-denominated debt.

## Derivatives Sensitivity to Equity Price Risk

(Euro million)

## Expected Maturity Date(1)

	Notes	2007	2008	2009	2010	2011	Thereafter	Fair Value
<b>Equity Derivatives</b>								
<b>Equity Swaps</b>								

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	<u>Notes</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Thereafter</u>	<u>Fair Value</u>
Equity Swaps on PT Multimédia Shares		276	276					17
Average Initial Price		9.02	9.02					

(1)

All amounts refer to the notional amounts of derivatives, at the beginning of each period.

**Fair Value of Derivatives Contracts in 2006**

(Euro millions)

Fair value of contracts outstanding at December 31, 2005	(97.6)
Fair value adjustments:	
Incomes	(144.9)
Reserves	25.6
Additions and cancellations	88.0
Foreign currency translation adjustments and other	2.2
	<hr/>
Fair value of contracts outstanding at December 31, 2006	(126.7)
	<hr/>

**Fair Value of Derivatives Contracts in 2006**

(Euro millions)

**Expected Maturity Date**

<b>Source of Fair Value</b>	<b>Less than 1 year</b>	<b>1 - 3 years</b>	<b>4 - 5 years</b>	<b>In Excess of 5 years</b>	<b>Total Fair Value</b>
Prices provided by other external sources	0.0	(7.8)	(13.8)	0.0	(21.7)
Prices based on models and other valuation methods	(65.6)	(22.4)	1.0	0.0	(87.0)
Total	(65.6)	(30.3)	(12.8)	0.0	(108.7)

**ITEM 12 DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

We are not required to provide the information called for by Item 12.

**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**

**Disclosure Controls and Procedures**

We carried out an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our "disclosure controls and procedures" for the year ended December 31, 2006. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error, and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures were effective in providing reasonable assurance that information required to be disclosed in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is gathered and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

**Management's Annual Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not necessarily prevent or detect some misstatements. It can only provide reasonable assurance regarding financial statement preparation and presentation. Also, projections of any evaluation of effectiveness for future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the degree of compliance with the policies or procedures may deteriorate over time.

Management assessed the effectiveness of its internal control over financial reporting for the year ended December 31, 2006. The assessment was based on criteria established in the framework "Internal Controls Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on the assessment, our management has concluded that as of December 31, 2006, our internal control over financial reporting was effective.

Management's assessment, as well as the effectiveness of internal control over financial reporting as of December 31, 2006 has been audited by Deloitte & Associados, SROC, S.A., an independent registered public accounting firm, as stated in their report, which is included under "Item 18. Financial Statements."

**Changes in Internal Control Over Financial Reporting**

There were no material changes in our internal control over financial reporting during the period covered by this Annual Report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 16A AUDIT COMMITTEE FINANCIAL EXPERT**

The shareholders of Portugal Telecom adopted changes to Portugal Telecom's corporate governance structure at the General Meeting of Shareholders held on June 22, 2007. Those changes included the replacement of the former statutory audit board with an audit committee consisting of three non-executive board members and the granting of significant supervisory authority to the audit committee, as described in "Item 10 Additional Information Corporate Governance Summary of Significant Differences Between Portuguese Corporate Governance Practices and the New York Stock Exchange's Corporate Governance Standards Committees". Prior to June 22, 2007, Portugal Telecom had an audit committee consisting of non-executive members of its Board of Directors that had the advisory functions described in that section.

Thomas Paes de Vasconcellos, who was a member of the prior audit committee and is a member of the new audit committee, was previously determined by our Board of Directors to be an "audit committee financial expert," as that term is defined in Item 16A of Form 20-F, and to be independent in his capacity as a member of the prior audit committee. See "Item 6 Directors, Senior Management and Employees Directors and Senior Management" for information regarding the experience of Mr. Paes de Vasconcellos. Mr. Paes de Vasconcellos is also an expert in accordance with Portuguese requirements.

**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 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](http://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 2005 and 2006, the remuneration of our independent auditors was as follows.

	2005		2006	
	€	%	€	%
Audit Fees	1,438,400	59%	1,686,520	60
Audit-Related Fees(1)	467,896	19%	679,890	24%
Tax Fees(2)	307,135	12%	52,003	2%
All Other Fees(3)	245,370	10%	382,455	14%
<b>Total</b>	<b>2,458,801</b>	<b>100%</b>	<b>2,800,867</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 2005, the All Other Fees category primarily included training services.

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 Portugal Telecom's Audit Committee does not provide for a *de minimis* exception to the pre-approval of non-audit services. 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.

**ITEM 16D EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

PT did not purchase any PT shares in 2006 due to the tender offer launched by Sonaecom on February 6, 2006.

As of December 31, 2006, we had outstanding equity swaps with respect to 20,640,000 of our own shares in connection with the share buyback program announced in 2005. As of June 15, 2007, we had outstanding equity swaps with respect to 45,686,311 of our own shares in connection with our new share buyback program approved in April 2007.

**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.

The financial pages in this Annual Report on Form 20-F include audited financial statements of UOL, one of our equity investees, for the years ended December 31, 2005 and 2006. See "Item 4A Unresolved Staff Comments".

**ITEM 19 EXHIBITS**

- 1.1 Articles of Association of Portugal Telecom, SGPS S.A., as amended on June 22, 2007.
- 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, incorporated by reference to Exhibit A of Portugal Telecom, SGPS S.A.'s Registration Statement on Form F-6 (File No. 333-10500) filed with the Commission on June 25, 1999.
- 2.2 Amended and Restated Programme Agreement in respect of a €7,500,000,000 Global Medium Term Note Programme, dated November 7, 2006, 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., Barclays Bank PLC, Banco Millennium BCP Investimento, S.A., BNP Paribas, Caixa Geral de Depósitos, S.A., Calyon, Merrill Lynch International, Morgan Stanley & Co. International Limited, Deutsche Bank AG, London Branch, Goldman Sachs International, Citigroup Global Markets Limited and UBS Limited.
- 2.3 Fifth Supplemental Trust Deed in respect of a €7,500,000,000 Global Medium Term Note Programme, dated November 7, 2006, among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS S.A., PT Comunicações, S.A. and Citicorp Trustee Company Limited.
- 2.4 Keep Well Agreement in respect of a €7,500,000,000 Global Medium Term Note Programme, dated November 7, 2006, between Portugal Telecom, SGPS S.A. and Portugal Telecom International Finance B.V.
- 2.5 Amended and Restated Agency Agreement in respect of a €7,500,000,000 Global Medium Term Note Programme, dated November 7, 2006, between Portugal Telecom International Finance B.V., Portugal Telecom, SGPS S.A., PT Comunicações, S.A., Citibank N.A. (New York), Citibank N.A.(London), The Bank of New York, BNP Paribas Luxembourg and Citicorp Trustee Company Limited.
- 2.6 Keep Well Agreement in respect of a €7,500,000,000 Global Medium Term Note Programme, dated November 7, 2006, between PT Comunicações, S.A and Portugal Telecom International Finance B.V.

- 2.7 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, 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 (File No. 001-13758).
- 2.8 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, 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 (File No. 001-13758).
- 2.9 Programme Agreement in respect of a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998, among Portugal Telecom, SGPS 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, incorporated by reference to Exhibit 2.11 of Portugal Telecom, SGPS S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999 (File No. 001-13758).
- 2.10 Deed of Purchase of Indebtedness relating to a €2,000,000,000 Global Medium Term Note Programme, dated December 17, 1998 by Portugal Telecom, SGPS S.A., incorporated by reference to Exhibit 2.12 of Portugal Telecom, SGPS S.A.'s annual report on Form 20-F filed with the Commission on June 28, 1999 (File No. 001-13758).
- 2.11 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, SGPS 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, incorporated by reference to Exhibit 10.15 of Portugal Telecom, SGPS S.A.'s Registration Statement on Form F-1 (File No. 333-10434) filed with the Commission on June 11, 1999.
- 2.12 Subscription Agreement relating to the issuance by Portugal Telecom International Finance B.V. of €1,000,000,000 3.75% Notes due 2012, dated March 23, 2005 among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS S.A., PT Comunicações, S.A., Merrill Lynch International, Morgan Stanley & Co. International Limited, Banco BPI, S.A., Banco Espírito Santo de Investimento, S.A., Caixa-Banco de Investimento, S.A., ABN AMRO Bank N.V., Barclays Bank PLC, BNP Paribas and Dresdner Bank AG London Branch.
- 2.13 Subscription Agreement relating to the issuance by Portugal Telecom International Finance B.V. of €500,000,000 4.375% Notes due 2017, dated March 23, 2005 among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS S.A., PT Comunicações, S.A., Merrill Lynch International, Morgan Stanley & Co. International Limited, Banco BPI, S.A., Banco Espírito Santo de Investimento, S.A., Caixa-Banco de Investimento, S.A., ABN AMRO Bank N.V., Barclays Bank PLC, BNP Paribas and Dresdner Bank AG London Branch.

- 2.14 Subscription Agreement relating to the issuance by Portugal Telecom International Finance B.V. of €500,000,000 4.50% Notes due 2025, dated June 15, 2005 among Portugal Telecom International Finance B.V., Portugal Telecom, SGPS S.A., PT Comunicações, S.A. and Citigroup Global Markets Limited.
- 2.15 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, SGPS S.A., incorporated by reference to Exhibit 10.16 of Portugal Telecom, SGPS S.A.'s Registration Statement on Form F-1 (File No. 333-10434) filed with the Commission on June 11, 1999.
- 4.1 Consulting Agreement (Instrumento Particular de Prestação de Serviços de Consultoria), dated as of January 7, 1999, between Portugal Telecom, SGPS S.A. and Telesp Celular S.A. (English translation), 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 (File No. 001-13758).
- 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., 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 (File No. 001-13758).
- 4.3 Amended and Restated Shareholders Agreement, dated as of September 21, 2005, by and among Telefónica Móviles, S.A., Portugal Telecom, SGPS S.A., PT Móveis, SGPS, S.A. and Brasilcel N.V., in relation to Brasilcel N.V. (Vivo) (portions omitted pursuant to a request for confidential treatment, which has been granted), 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 April 21, 2006 (File No. 001-13758).
- 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., 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 (File No. 001-13758).
- 4.5 Universal Service Convention, dated as of December 30, 2002, among PT Comunicações S.A., the Autoridade Nacional das Comunicações (ANACOM) and the Direção Geral do Comércio e da Concorrência.
- 4.6 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 State and PT Comunicações.
- 4.7 Universal Mobile Telecommunications System (UMTS) License, dated January 11, 2001, issued to TMN Telecomunicações Móveis Nacionais, S.A. by the Portuguese State, as amended February 10, 2004.
- 4.8 Authorization Terms of the Personal Mobile Service entered into by (i) ANATEL and Telesp Celular S.A. and (ii) ANATEL and Global Telecom S.A. (now Vivo S.A.), incorporated by reference to Exhibit 4.1 to the Annual Report on Form 20-F/A of Telesp Celular Participações S.A. for the year ended December 31, 2002 filed with the Commission on June 24, 2003 (File No. 333-09470).
- 4.9 Authorization Term of the Personal Mobile Service entered into by ANATEL and Tele Centro Oeste Celular Participações S.A. (now merged with and into Vivo S.A.), incorporated by reference to Exhibit 4.1 to the Annual Report on Form 20-F/A of Tele Centro Oeste Celular Participações S.A. for the year ended December 31, 2002 filed with the Commission on June 27, 2003 (File No. 001-14489).

- 4.10 Authorization Terms of the Personal Mobile Service entered into by (i) ANATEL and Telebahia Celular S.A. (now merged with and into Vivo S.A. and (ii) ANATEL and Telergipe Celular S.A. (now merged with and into Vivo S.A.), incorporated by reference to Exhibit 4.1 to the Annual Report on Form 20-F/A of Tele Leste Celular Participações S.A. for the year ended December 31, 2002 filed with the Commission on June 24, 2003 (File No. 001-14481).
- 4.11 Authorization Terms of the Personal Mobile Service entered into by (i) ANATEL and Telerj Celular S.A. (now merged with and into Vivo S.A. and (ii) ANATEL and Telest Celular S.A. (now merged with and into Vivo S.A.), incorporated by reference to Exhibit 4.1 to the Annual Report on Form 20-F/A of Tele Sudeste Celular Participações S.A. for the year ended December 31, 2002 filed with the Commission on June 24, 2003 (File No. 001-14485).
- 4.12 Form of Management Agreement entered into with certain members of the Executive Committee, incorporated by reference to Exhibit (e) to the Statement on Schedule 14D-9 filed with the Commission on January 18, 2007 (File No. 005-79679).
- 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.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and Board of Directors of  
Portugal Telecom, SGPS, S.A.  
Lisbon, Portugal**

We have audited the accompanying consolidated balance sheets of Portugal Telecom, SGPS, S.A. and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, recognized income and expense and cash flows for each of the three years in the period ended December 31, 2006. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statements 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 financial position of Portugal Telecom, SGPS, S.A. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations, recognized income and expense and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with International Financial Reporting Standards (IFRS) and International Financial Reporting Standards as adopted by the European Union (EU-IFRS).

International Financial Reporting Standards (IFRS) and International Financial Reporting Standards as adopted by the European Union (EU-IFRS) vary in certain significant respects from accounting principles generally accepted in the United States of America (US GAAP). Information relating to the nature and effect of such differences is presented in Notes 47, 48 and 49 to the consolidated financial statements.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 29, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

/S/ DELOITTE & ASSOCIADOS, SROC S.A.

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DELOITTE & ASSOCIADOS, SROC S.A.  
Lisbon, Portugal  
June 29, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and Board of Directors  
of Portugal Telecom, SGPS, S.A.  
Lisbon, Portugal**

We have audited management's assessment included in the accompanying Form 20-F, that Portugal Telecom, SGPS, S.A. and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provide a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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In our opinion management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, based on our audit, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006, of the Company and our report dated June 29, 2007 expressed an unqualified opinion on those financial statements.

/S/ DELOITTE & ASSOCIADOS, SROC S.A.

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DELOITTE & ASSOCIADOS, SROC S.A.  
Lisbon, Portugal  
June 29, 2007

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## PORTUGAL TELECOM, SGPS, SA

**CONSOLIDATED INCOME STATEMENT**  
**FOR THE YEARS ENDED 31 DECEMBER 2006, 2005 AND 2004**  
(Amounts stated in Euro)

	Notes	2006	2005	2004
<b>CONTINUED OPERATIONS</b>				
<b>REVENUES</b>				
Services rendered	6	5,783,556,158	5,836,879,781	5,520,498,731
Sales	6	461,218,596	447,461,824	365,755,000
Other revenues	6	98,172,268	101,076,689	81,125,527
		<b>6,342,947,022</b>	<b>6,385,418,294</b>	<b>5,967,379,258</b>
<b>COSTS, EXPENSES, LOSSES AND INCOME</b>				
Wages and salaries	8	668,383,435	667,331,163	631,802,408
Post retirement benefits	9	(72,114,978)	(21,605,155)	58,772,000
Direct costs	10	908,351,001	881,181,310	852,033,698
Costs of products sold	11	596,513,104	652,281,025	595,755,989
Support services		230,004,854	230,180,097	203,832,384
Marketing and publicity		155,401,134	184,409,651	159,807,836
Supplies and external services	12	1,025,503,161	958,527,829	810,365,725
Indirect taxes	14	177,251,170	166,036,274	123,239,627
Provisions and adjustments	38	230,193,672	171,477,441	168,820,055
Depreciation and amortisation	32 and 33	1,209,777,642	1,120,668,813	934,936,568
Impairment losses	30			28,000,000
Curtailement costs, net	9	20,302,638	314,309,785	165,590,740
Losses on disposals of fixed assets, net		8,123,362	1,178,075	9,231,899
Other costs, net	15	98,431,053	17,652,164	83,565,440
		<b>5,256,121,248</b>	<b>5,343,628,472</b>	<b>4,825,754,369</b>
<b>Income before financial results and taxes</b>		<b>1,086,825,774</b>	<b>1,041,789,822</b>	<b>1,141,624,889</b>
Net interest expense		227,245,692	257,637,731	204,881,312
Net foreign currency exchange gains		(4,891,607)	(41,335,993)	4,461,601
Losses (gains) on financial assets	16	(18,278,335)	8,765,259	(11,598,497)
Equity in earnings of associated companies, net	30	(131,354,166)	(238,226,177)	(20,866,910)
Net other financial expenses	17	52,289,059	64,453,097	55,616,214
		<b>125,010,643</b>	<b>51,293,917</b>	<b>232,493,720</b>
<b>Income before taxes</b>		<b>961,815,131</b>	<b>990,495,905</b>	<b>909,131,169</b>
Minus: Income taxes	18	7,687,318	323,273,235	209,984,648
<b>Net income from continued operations</b>		<b>954,127,813</b>	<b>667,222,670</b>	<b>699,146,521</b>

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	Notes	2006	2005	2004
<b>DISCONTINUED OPERATIONS</b>				
Net income from discontinued operations	19		21,732,952	26,065,182
<b>NET INCOME</b>		<b>954,127,813</b>	<b>688,955,622</b>	<b>725,211,703</b>
Attributable to minority interests	20	87,368,156	34,970,803	102,012,269
<b>Attributable to equity holders of the parent</b>	<b>22</b>	<b>866,759,657</b>	<b>653,984,819</b>	<b>623,199,434</b>
<b>Earnings per share from continued operations</b>				
Basic	22	0.78	0.55	0.51
Diluted	22	0.77	0.54	0.50
<b>Earnings per share from total operations</b>				
Basic	22	0.78	0.57	0.53
Diluted	22	0.77	0.56	0.52

The accompanying notes form an integral part of these financial statements.

## PORTUGAL TELECOM, SGPS, SA

**CONSOLIDATED BALANCE SHEET**  
**31 DECEMBER 2006 AND 2005**  
(Amounts stated in Euro)

	Notes	2006	2005
<b>ASSETS</b>			
<b>Current Assets</b>			
Cash and cash equivalents		548,464,617	612,158,485
Short-term investments	23	1,535,233,729	3,299,609,953
Accounts receivable trade	24	1,181,912,412	1,389,229,606
Accounts receivable other	25	218,912,177	244,263,314
Inventories	26	130,280,564	152,172,630
Taxes receivable	27	211,747,572	203,813,170
Prepaid expenses	28	121,714,749	146,271,926
Other current assets	29	50,405,004	106,210,553
		<b>3,998,670,824</b>	<b>6,153,729,637</b>
<b>Total current assets</b>			
<b>Non-Current Assets</b>			
Accounts receivable trade		916,813	677,552
Accounts receivable other	25	15,237,939	19,804,605
Taxes receivable	27	124,531,128	117,244,409
Prepaid expenses		2,628,424	3,429,929
Investments in group companies	30	499,098,279	425,602,626
Other investments	31	132,391,079	96,079,089
Intangible assets	7.e) and 32	3,490,881,263	3,601,620,470
Tangible assets	7.e) and 33	3,942,033,190	4,062,003,121
Post retirement benefits	9	134,060,519	
Deferred taxes	18	1,167,007,154	1,387,811,009
Other non-current assets	29	663,792,688	760,811,964
		<b>10,172,578,476</b>	<b>10,475,084,774</b>
<b>Total non-current assets</b>			
<b>Total assets</b>		<b>14,171,249,300</b>	<b>16,628,814,411</b>
<b>LIABILITIES</b>			
<b>Current Liabilities</b>			
Short-term debt	34	1,372,724,030	2,415,606,371
Accounts payable trade		635,712,710	716,143,471
Accounts payable other	35	479,376,513	413,744,612
Accrued expenses	36	680,217,532	707,921,185
Deferred income	37	215,738,311	208,155,446
Taxes payable	27	316,962,828	237,236,979
Provisions	38	105,151,491	163,098,954
Other current liabilities	39	82,495,889	85,612,446
		<b>3,888,379,304</b>	<b>4,947,519,464</b>
<b>Total current liabilities</b>			
<b>Non-Current Liabilities</b>			
Medium and long-term debt	34	4,467,537,132	5,168,626,522
Accounts payable other		56,453	2,473,302
Taxes payable	27	25,787,484	32,413,222
Deferred income		380,097	429,155
Provisions	38	102,633,567	115,423,190
Post retirement benefits	9	1,807,570,587	2,635,883,744
Deferred taxes	18	90,377,817	334,867,077
Other non-current liabilities	39	682,488,921	809,101,370

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	Notes	2006	2005
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total non-current liabilities</b>		<b>7,176,832,058</b>	<b>9,099,217,582</b>
		<u>          </u>	<u>          </u>
<b>Total liabilities</b>		<b>11,065,211,362</b>	<b>14,046,737,046</b>
		<u>          </u>	<u>          </u>
<b>SHAREHOLDERS' EQUITY</b>			
Share capital	40	395,099,775	1,128,856,500
Capital issued premium	40		91,704,891
Treasury shares	40	(187,612,393)	(102,044,948)
Legal reserve	40	82,706,881	179,229,361
Reserve for treasury shares	40		125,428,500
Accumulated earnings	40	1,965,055,467	405,216,985
		<u>          </u>	<u>          </u>
<b>Equity excluding minority interests</b>		<b>2,255,249,730</b>	<b>1,828,391,289</b>
Minority interests	20	850,788,208	753,686,076
		<u>          </u>	<u>          </u>
<b>Total equity</b>		<b>3,106,037,938</b>	<b>2,582,077,365</b>
		<u>          </u>	<u>          </u>
<b>Total liabilities and shareholders' equity</b>		<b>14,171,249,300</b>	<b>16,628,814,411</b>
		<u>          </u>	<u>          </u>

The accompanying notes form an integral part of these financial statements.

## PORTUGAL TELECOM, SGPS, SA

**CONSOLIDATED STATEMENTS OF RECOGNISED INCOME AND EXPENSES**  
**FOR THE YEARS ENDED 31 DECEMBER 2006, 2005 AND 2004**  
(Amounts stated in Euro)

	Notes	2006	2005	2004
<b>Income and expenses recognised directly in shareholders' equity</b>				
Accrued post-retirement liability				
Net actuarial gains	9.6	319,415,213	(730,276,049)	(177,822,165)
Tax effect(i)	18	(100,691,917)	199,547,931	48,589,906
Financial instruments and investments				
Hedge accounting(ii)	41	25,598,738	56,482	(10,493,312)
Investments available for sale				
Change in fair value	31	19,831,643	(6,774,190)	3,950,643
Transferred to profit and loss on sale	16		5,960,000	
Tax effect(i)	18	(12,223,825)	208,370	1,799,234
Foreign currency translation adjustments(iii)		(79,860,785)	700,952,138	16,245,986
		<b>172,069,067</b>	<b>169,674,682</b>	<b>(117,729,708)</b>
<b>Income recognised in the consolidated income statement</b>		<b>954,127,813</b>	<b>688,955,622</b>	<b>725,211,703</b>
<b>Total income recognised</b>		<b>1,126,196,880</b>	<b>858,630,304</b>	<b>607,481,995</b>
Attributable to minority interests		87,368,156	34,970,803	102,012,269
<b>Attributable to equity holders of the parent</b>		<b>1,038,828,724</b>	<b>823,659,501</b>	<b>505,469,726</b>

- (i) In 2006, the tax effect includes the tax impact on deferred taxes of the change in tax rate from 1 January 2007, which amounts to Euro 16,231,317 (Note 18).
- (ii) In 2006 and 2005, this caption includes a cost of Euro 7 million and a gain of Euro 0.2 million, respectively, which were transferred to profit and loss. The remaining amounts in this caption are related to the change in the fair value of these derivatives.
- (ii) Gains recorded in 2005 are mainly related to the appreciation of the Real against the Euro from 3.6147 as at 31 December 2004 to 2.744 as at 31 December 2005, while losses recorded in 2006 are basically related with the devaluation of the Real against the Euro from 2.744 to 2.8118 as at 31 December 2006.

The accompanying notes form an integral part of these financial statements.

## PORTUGAL TELECOM, SGPS, SA

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED 31 DECEMBER 2006, 2005 AND 2004**  
(Amounts stated in Euro)

Notes	2006	2005	2004
<b>OPERATING ACTIVITIES</b>			
Collections from clients	7,392,240,379	7,187,846,822	6,765,478,256
Payments to suppliers	(3,668,694,463)	(3,808,664,290)	(3,387,233,324)
Payments to employees	(711,353,490)	(660,821,689)	(784,151,515)
Payments relating to income taxes	(54,315,840)	(71,572,316)	(66,581,360)
Payments relating to post retirement benefits	9 (561,853,113)	(699,806,967)	(298,566,473)
Payments relating to indirect taxes and other	43.a ) (608,188,638)	(554,681,592)	(270,061,577)
	<b>1,787,834,835</b>	<b>1,392,299,968</b>	<b>1,958,884,007</b>
<b>INVESTING ACTIVITIES</b>			
Cash receipts resulting from			
Short-term financial applications	43.b ) 20,265,545,874	10,933,899,233	13,379,457,500
Financial investments	43.c ) 6,895,804	391,815,749	21,243,239
Tangible fixed assets	11,480,821	12,699,978	35,745,251
Intangible assets			3,569
Subsidies for investments	129,093	1,572,005	2,978,958
Interest and related income	238,967,185	262,021,737	263,302,910
Dividends	43.d ) 36,110,881	21,424,425	16,179,018
Other investing activities	43.e ) 53,796,064	12,365,601	32,613,516
	<b>20,612,925,722</b>	<b>11,635,798,728</b>	<b>13,751,523,961</b>
Payments resulting from			
Short-term financial applications	43.b ) (18,501,169,649)	(12,727,737,929)	(12,613,040,697)
Financial investments	43.f ) (95,036,377)	(27,168,785)	(291,933,807)
Tangible fixed assets	(818,459,845)	(760,210,386)	(608,912,964)
Intangible assets	(21,061,568)	(16,216,709)	(15,693,023)
Other investing activities	(29,382,265)	(15,205,147)	(36,461,034)
	<b>(19,465,109,704)</b>	<b>(13,546,538,956)</b>	<b>(13,566,041,525)</b>
Cash flow from investing activities(2)	<b>1,147,816,018</b>	<b>(1,910,740,228)</b>	<b>185,482,436</b>
<b>FINANCING ACTIVITIES</b>			
Cash receipts resulting from			
Loans obtained	43.g ) 16,283,725,363	24,239,836,385	17,151,950,966
Increases in share capital and paid-in surplus	43.h ) 39,292	12,798,336	92,370,662
Subsidies	3,795,801	1,913,794	368,297
Other financing activities	43.i ) 282,301	18,189,355	68,594,130
	<b>16,287,842,757</b>	<b>43,126,085,870</b>	<b>17,313,284,055</b>
Payments resulting from			
Loans repaid	43.g ) (18,024,793,291)	(22,276,187,094)	(17,878,783,743)
Lease rentals (principal)	(32,959,253)	(12,928,273)	(25,338,455)
Interest and related expenses	(560,221,757)	(487,392,109)	(536,079,186)

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	Notes	2006	2005	2004
Dividends	43.j )	(581,488,701)	(445,415,157)	(297,052,335)
Acquisition of treasury shares	40.3		(340,455,888)	(495,312,220)
Other financing activities	43.k )	(81,046,856)	(120,171,654)	(38,908,099)
		(19,280,509,858)	(42,535,898,175)	(19,271,474,038)
Cash flow from financing activities(3)		(2,992,667,101)	590,187,695	(1,958,189,983)
Change in cash and cash equivalents(4)=(1)+(2)+(3)		(57,016,248)	71,747,435	186,176,460
Change in cash and cash equivalents of discontinued operations			8,442,819	(13,595,857)
Effect of exchange differences		(6,677,620)	103,849,227	10,500,915
Cash and cash equivalents at the beginning of the period		612,158,485	428,119,004	245,037,486
Cash and cash equivalents at the end of the period		548,464,617	612,158,485	428,119,004

The accompanying notes form an integral part of these financial statements.

**PORTUGAL TELECOM, SGPS, SA**

**Notes to the Consolidated Financial Statements**

**(Amounts stated in Euros, except where otherwise stated)**

**1. Introduction**

**a) Parent company**

Portugal Telecom, SGPS, SA (formerly Portugal Telecom, SA, "Portugal Telecom") and subsidiaries ("Group", "Portugal Telecom Group", or "the Company"), are engaged in rendering a comprehensive range of telecommunications and multimedia services in Portugal and other countries, including Brazil.

Portugal Telecom was incorporated on 23 June 1994, under Decree-Law 122/94, as a result of the merger, effective 1 January 1994, of Telecom Portugal, SA ("Telecom Portugal"), Telefones de Lisboa e Porto (TLP), SA ("TLP") and Teledifusora de Portugal, SA ("TDP"). On 12 December 2000, Portugal Telecom, SA changed its name to Portugal Telecom, SGPS, SA, and became the holding company of the Group.

As a result of the privatization process, between 1 June 1995 and 4 December 2000, Portugal Telecom's share capital is mainly owned by private shareholders. On 31 December 2006, the Portuguese State owned, directly or indirectly, 7% of the total ordinary shares and all of the A Shares (Note 40.1) of Portugal Telecom.

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 Group is engaged in rendering a comprehensive range of telecommunications and multimedia services in Portugal and abroad, including Brazil.

In Portugal, fixed line services are rendered by PT Comunicações, SA ("PT Comunicações"), under the provisions of the Concession Agreement entered into with the Portuguese State on 20 March 1995 in accordance with Decree-Law 40/95, for an initial period of thirty years, subject to renewal for subsequent periods of fifteen years. On 11 December 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 rendered through PT Prime Soluções Empresariais de Telecomunicações e Sistemas, SA ("PT Prime"), which is also an Internet Service Provider ("ISP") for large clients.

ISP services for residential clients are rendered through PT.com Comunicações Interactivas, SA ("PT.com), which also provides services relating to the conception, design and exhibit of publicity and information space on Internet portals.

Mobile services in Portugal are rendered by TMN Telecomunicações Móveis Nacionais, SA ("TMN"), under a GSM license granted by the Portuguese State in 1992 (period of 15 years) and a UMTS license obtained in 19 December 2000 (period of 15 years). During 2006, ANACOM granted to TMN the renewal of the GSM license until 16 March 2022.

PT Multimédia Serviços de Telecomunicações e Multimedia, SGPS, SA ("PT Multimedia") is the Group's subsidiary for multimedia operations. Through its subsidiary TV Cabo Portugal, SA ("TV

Cabo"), PT Multimedia renders cable and satellite television services in mainland Portugal, Madeira and Azores. PT Multimedia also renders other multimedia services in Portugal, namely the editing and selling of DVD and movies through Lusomundo Audiovisuais, SA ("Lusomundo Audiovisuais") and the distribution and exhibition of movies through Lusomundo Cinemas, SA ("Lusomundo Cinemas").

In Brazil, the Group renders mobile telecommunications services through Brasilcel NV ("Brasilcel" or "Vivo"), a joint venture incorporated in 2002 by Portugal Telecom (through PT Móveis, SGPS, SA "PT Móveis") and Telefónica (through Telefónica Móviles, SA) to join the mobile operations of each group. Currently, Vivo, through its company Vivo, SA, provides mobile services in the Brazilian states of São Paulo, Paraná, Santa Catarina, Rio de Janeiro, Espírito Santo, Bahia, Sergipe, Rio Grande do Sul, and eleven states in the Midwestern and Northern regions of Brazil.

On 5 December 2005, the Boards of Directors of the holding companies of Vivo, including Telesp Celular Participações, SA ("TCP"), Tele Centro Oeste Celular Participações, SA ("TCO"), Tele Sudeste Celular Participações, SA ("Telesudeste"), Tele Leste Celular Participações, SA ("Teleleste") and Celular CRT, SA ("Celular CRT") approved the proposal to carry out a corporate restructuring. On 22 February 2006, the shareholders of those companies approved, in the respective Extraordinary General Meetings, the corporate restructuring of the Vivo group companies. This restructuring consisted of the merger of shares of TCO into TCP and the merger of Telesudeste, Teleleste and Celular CRT into TCP. After this restructuring, TCP was renamed to Vivo Participações SA. As a consequence of such restructuring, the shareholders of TCO, Telesudeste, Teleleste and Celular CRT received shares of TCP, in accordance with the exchange ratios determined based on the respective valuations: 3.0830 new shares or ADS of TCP for every 1 share or ADS of TCO, 3.2879 new shares or ADS of TCP for every 1 share or ADS of Telesudeste, 3.8998 new shares or ADS of TCP for every 1 share or ADS of Teleleste, and 7.0294 new shares of TCP for every 1 share of Celular CRT. Following this operation, all operating companies were fully controlled by Vivo Participações, SA. In October 2006, Vivo completed a further restructuring with the merger into Global Telecom (the company that provided mobile services in the states of Paraná and Santa Catarina and that was fully owned by TCP) of all other companies of Vivo that provided mobile services in the remaining states mentioned above. In connection with this transaction, Global Telecom was renamed Vivo, SA.

The consolidated financial statements for the year ended 31 December 2006 were approved by the Board of Directors and authorized for issue on 21 March 2007.

## **2. Basis of presentation**

Consolidated financial statements are presented in Euros, which is the currency of the majority of the Portugal Telecom's operations. Financial statements of foreign subsidiaries are translated to Euros according to accounting principles described in Note 3.q).

The consolidated financial statements of Portugal Telecom are prepared under International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"), and include all interpretations of the International Financial Reporting Interpretation Committee ("IFRIC") as at 31 December 2006. For Portugal Telecom, there are no differences between IFRS as adopted by the EU and IFRS published by the International Accounting Standards Board.

Consolidated financial statements were prepared assuming the continuity of operations, based on accounting records of all subsidiaries (Exhibit I).

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reported periods (Note 3).

**a) Consolidation principles**

**Controlled entities**

Portugal Telecom has fully consolidated the financial statements of all controlled entities. Control is achieved where the Group has the majority of the voting rights or has the power to govern the financial and operating policies of an entity. In any case, where the Group does not have the majority of the voting rights but in substance controls the entity, the financial statements of the entity are fully consolidated (See Exhibit I).

The interest of any third party in the shareholders' equity and net income of fully consolidated companies is presented separately in the consolidated balance sheet and consolidated income statement, under the caption "Minority interests" (Note 20).

Losses applicable to the minorities in excess of the minority's interest in the subsidiary's equity are allocated against the interest of the Group, except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses. Any future gains reported by the subsidiary are allocated against the interest of the Group, until the excess losses recognised by the Group are covered.

From 1 January 2004, assets, liabilities and contingent liabilities of an acquired subsidiary are measured at fair value at acquisition date. Any excess amount to the identifiable net assets is recognised as goodwill. If the acquisition cost is lower than the fair value of identifiable net assets acquired, the difference is recognised as a gain in the net income for the period the acquisition occurs. Minority interests are presented proportionally to the fair value of identifiable net assets.

The results of subsidiaries acquired or disposed during the period are included in the consolidated income statement from the effective date of the acquisition or up to the effective date of disposal, as appropriate.

All intra-group transactions, balances, income and expenses are eliminated on the consolidation process. Gains obtained in intra-group transactions are also eliminated on the consolidation process.

Where necessary, adjustments are made to the financial statements of subsidiaries to adjust their accounting policies in line with those adopted by the Group.

### **Interests in joint ventures**

Portugal Telecom has proportionally consolidated the financial statements of jointly controlled entities beginning on the date the joint control is effective. Under this method, assets, liabilities, income and expenses of the entity are added, on a proportional basis, to the corresponding consolidated caption. Financial investments are classified as jointly controlled entities if the joint control agreement clearly demonstrates the existence of joint control.

All transactions and balances with jointly controlled entities are eliminated to the extent of the Group's interest in the joint venture.

Jointly controlled entities are presented in Exhibit III.

### **Investments in associates**

An associate is an entity over which the Group has significant influence. Significant influence is the power to participate in the financial and operating policies of the entity but not to control or jointly control those policies.

Financial investments in associated companies are accounted for under the equity method (Exhibit II). Under this method, investments in associated companies are carried in the consolidated balance sheet at cost, adjusted periodically for the Group's share in the results of the associated company, recorded as part of financial results under the caption "Equity in earnings and losses of associated companies" (Note 30), and certain other changes recorded against net assets acquired. In addition, financial investments are adjusted for any impairment losses that may occur.

Losses in associated companies in excess of the cost of acquisition are not recognised, except where the Group has assumed any commitment to cover those losses.

Any excess of the cost of acquisition over the Group's share of the net fair value of the identifiable assets, liabilities and contingent liabilities of the associate recognised at the date of acquisition is recorded as goodwill. The goodwill is included within the carrying amount of the investment and is assessed annually for impairment as part of the investment. If the acquisition cost is lower than the fair value of identifiable net assets, the difference is recorded as a gain in the net income for the period the acquisition occurs.

Dividends received from associated companies are recorded as a reduction in the value of financial investments.

Profits and losses occurring in transactions with associated companies are eliminated to the extent of the Group's interest in the associate, and recorded against the corresponding financial investment.

### **Non-current assets held for sale**

Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded

as met, only when: (i) the sale is highly probable and the asset is available for immediate sale in its present condition; (ii) the Group has assumed a commitment to the sale; and (iii) the sale is expected to be completed within one year. Non-current assets and companies classified as held for sale are measured at the lower of the assets' previous carrying amount and the fair value less costs to sell.

### **Goodwill**

Goodwill represents the excess of the cost of acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the subsidiary, jointly controlled or associated entity recognised at the date of acquisition, in accordance with IFRS 3. Considering the exception of IFRS 1, the Group used the provisions of IFRS 3 only for acquisitions that occurred after 1 January 2004. Goodwill related to acquisitions made up to 1 January 2004 was recorded at the carrying amount of those acquisitions as of that date, and was subject to annual impairment tests thereafter.

Goodwill related to foreign investments is carried at the reporting currency of the investment, being translated to Euros at the exchange rate prevailing at the balance sheet date. Exchange gains or losses are recognised in the Statement of Recognised Income and Expenses under the caption "Cumulative foreign currency translation adjustments".

Goodwill is recognised under the captions "Investment in group companies" (Associates Note 30) and "Intangible assets" (Subsidiaries and jointly controlled entities Note 32) and is not amortised.