As filed with the Securities and Exchange Commission on June 25, 2003.

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 20-F

ANNUAL REPORT PURSUANT TO SECTION 13

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002

Commission File Number: 1-10749

Teléfonos de México, S.A. de C.V.

(Exact name of registrant as specified in its charter)

Telephones of Mexico

(Translation of registrant s name into English)

United Mexican States

(Jurisdiction of incorporation or organization)

Parque Vía 190, Colonia Cuauhtémoc, 06599 México, D.F., México

(Address of principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class	Name of each exchange on which registered
American Depositary Shares, each representing 20 Series L Shares, without par value (L Share ADSs)	New York Stock Exchange
Series L Shares, without par value (L Shares)	New York Stock Exchange (for listing purposes only)

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

American Depositary Shares, each representing 20 Series A Shares, without par value (A Share ADSs)

Series A Shares, without par value (A Shares)

SECURITIES FOR WHICH THERE IS A REPORTING OBLIGATION PURSUANT TO SECTION 15(d) OF THE ACT: None

The number of outstanding shares of each class of capital or common stock as of December 31, 2002 was:

4,136 million	AA Shares
289 million	A Shares
8,352 million	L Shares

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 x No ¨

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

Item 17 ¨ Item 18 x

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Item 3. Key Information

Selected Financial Data

The selected consolidated financial data set forth below have been derived from our audited consolidated financial statements for each of the years in the five-year period ended December 31, 2002, which have been reported on by Mancera, S.C., a member of Ernst & Young Global, independent public accountants. The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by reference to, our consolidated financial statements and notes thereto included elsewhere in this Annual Report.

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Mexico, or Mexican GAAP, which differ in certain respects from generally accepted accounting principles in the United States, or U.S. GAAP. Note 18 to our audited consolidated financial statements provides a description of the principal differences between Mexican GAAP and U.S. GAAP, as they relate to us; a reconciliation to U.S. GAAP of operating income, net income and total stockholders equity; and a condensed statement of cash flows under U.S. GAAP.

Pursuant to Mexican GAAP, in the consolidated financial statements and the selected consolidated financial data set forth below:

- nonmonetary assets (including plant, property and equipment of Mexican origin) and stockholders equity are restated for inflation based on the Mexican National Consumer Price Index; plant, property and equipment of non-Mexican origin are restated based on the rate of inflation in the country of origin and converted into Mexican pesos using the prevailing exchange rate at the balance sheet date,
- gains and losses in purchasing power from holding monetary assets and liabilities are recognized in income, and
- all financial statements are restated in constant pesos as of December 31, 2002.

We have not reversed the effect of inflation accounting under Mexican GAAP in the reconciliation to U.S. GAAP of our net income and stockholders equity, except with respect to the methodology for restatement of plant, property and equipment of non-Mexican origin. See Note 18 to the consolidated financial statements.

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	Year ended December 31,				
	2002	2001	2000	1999	1998
	(in millions of constant pesos as of December 31, 2002, except per share data)				
Income Statement Data:					
Mexican GAAP:					
Operating revenues	P. 112,860	P. 117,292	P. 112,630	P. 102,402	P. 96,576
Operating costs and expenses	73,243	72,273	68,817	61,462	58,685
Operating income	39,617	45,019	43,813	40,940	37,891
Income from continuing operations	19,568	24,833	27,585	25,065	17,312
Income from discontinued operations(1)			1,626	5,147	4,837
Net income	19,568	24,833	29,211	30,212	22,149
Income per share from continuing operations Basic(2)	1.507	1.834	1.880	1.661	1.096
Income per share from continuing operations Diluted(2)	1.482	1.721	1.779	1.621	1.096
Net income per share Basic(2)	1.507	1.834	1.991	2.002	1.401
Net income per share Diluted(2)	1.482	1.721	1.885	1.957	1.401
Dividends per share(2)(3)	0.545	0.490	0.445	0.388	0.350
U.S. GAAP:					
Operating revenues	P. 112,860	P. 117,292	P. 112,630	P. 102,402	P. 96,576
Operating costs and expenses	78,652	80,109	75,360	68,371	64,847
Operating income	34,208	37,183	37,270	34,031	31,729
Income from continuing operations	17,760	21,378	25,531	23,880	16,891
Income from discontinued operations(1)			1,376	4,304	4,220
Net income	17,760	21,378	26,907	28,184	21,111
Income per share from continuing operations Basic(2)	1.368	1.579	1.740	1.582	1.069
Income per share from continuing operations Diluted(2)	1.349	1.478	1.645	1.544	1.069
Net income per share Basic(2)	1.368	1.579	1.834	1.868	1.336
Net income per share Diluted(2)	1.349	1.478	1.735	1.825	1.336
Dividends per share(2)(3)	0.545	0.490	0.445	0.388	0.350

	December 31,				
	2002	2001	2000	1999	1998
	(in millions of constant pesos as of December 31, 2002)				
Balance Sheet Data:					
Mexican GAAP:					
Plant, property and equipment, net	P. 122,956	P. 120,978	P. 117,544	P. 117,759	P. 136,516
Total assets of continuing operations	168,792	165,855	173,125	164,241	175,503
Total assets of discontinued operations(1)				73,629	58,020
Total assets	168,792	165,855	173,125	237,870	233,523
Total debt	66,134	73,717	82,116	58,771	65,495
Total stockholders equity(4)	61,164	53,656	54,569	147,048	143,016
U.S. GAAP:					
Plant, property and equipment, net	P. 133,771	P. 143,096	P. 136,111	P. 138,231	P. 150,023
Total assets of continuing operations	180,960	189,356	193,817	187,187	192,076
Total assets of discontinued operations(1)				74,377	58,847
Total assets	180,960	189,356	193,817	261,564	250,923

Total debt	66,134	73,717	82,116	58,771	65,495
Total stockholders equity[4]	57,800	55,917	53,451	136,031	125,412

(1) In 1998, 1999 and 2000 the businesses we spun off to América Móvil in September 2000 are presented as discontinued operations. See Telmex History under Item 4.

(2) We have not presented net income or dividends on a per ADS basis. Each L Share ADS represents twenty L Shares and each A Share ADS represents twenty A Shares.

(3) Nominal amounts.

(4) The decrease in 2000 was due to the spin-off of América Móvil.

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EXCHANGE RATES

Mexico has a free market for foreign exchange, and the Mexican government allows the peso to float freely against the U.S. dollar. For much of 1998, the foreign exchange markets were volatile as a result of financial crises in Asia and Russia and financial turmoil in certain Latin American countries, including Brazil and Venezuela. The peso declined during this period, but was relatively stable from 1999 until 2001. In 2002 and early 2003 the peso declined significantly, but in March 2003, it began to rise in value. There can be no assurance that the government will maintain its current policies with regard to the peso or that the peso will not further depreciate or appreciate significantly in the future.

The following table sets forth, for the periods indicated, the high, low, average and period-end noon buying rate in New York City for cable transfers in pesos published by the Federal Reserve Bank of New York, expressed in pesos per U.S. dollar. The rates have not been restated in constant currency units.

Period	High	Low	Average(1)	Period End
1998	P. 8.04	P. 10.63	P. 9.24	P. 9.90
1999	9.24	10.60	9.56	9.48
2000	9.18	10.09	9.47	9.62
2001	8.95	9.97	9.33	9.16
2002	9.00	10.43	9.66	10.43
2002:				
December	10.10	10.43	10.23	10.43
2003:				
January	10.32	10.98	10.62	10.90
February	10.06	10.77	10.95	11.03
March	10.66	11.24	10.91	10.78
April	10.31	10.77	10.59	10.31
May	10.11	10.42	10.25	10.34

(1) In the case of annual periods, average of month-end rates.

On June 24, 2003 the noon buying rate was P.10.5320 to U.S.$1.00.

We will pay any cash dividends in pesos, and exchange rate fluctuations will affect the U.S. dollar amounts received by holders of ADSs on conversion by the depositary of cash dividends on the shares represented by such ADSs. Fluctuations in the exchange rate between the peso and the U.S. dollar have affected the U.S. dollar equivalent of the peso price of our shares on the Mexican Stock Exchange and, as a result, have also affected the market price of the ADSs.

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RISK FACTORS

Risks Relating to Our Business Generally

Increasing Competition Could Adversely Affect Our Revenues and Profitability

Our results of operations have been affected by the opening of the Mexican market for long distance services to competition beginning in August 1996 and the availability of interconnection to our network beginning January 1, 1997. Competing carriers have won a share of the long distance market, and prices have fallen steadily as real rates have fallen and customer discounts have increased. The effects of increased competition have been particularly severe in international long distance service, where our revenues declined from 1996 through 1998 and again in 2000 through 2002. We believe the decline in our international traffic volume has been adversely affected by an unauthorized practice referred to as illegal bypass, which occurs when an incoming international call is routed into Mexico through private circuits or other channels and then handled as a domestic call. We estimate that illegal bypass represented a loss of revenues of approximately P.1,157 million in 2002, an amount equal to 12.2% of our total international long distance revenue for that year. The practice is difficult to prevent and is likely to arise whenever there is a substantial price advantage to be gained by competing carriers.

Competition in local service, principally from wireless service providers, has been developing since 1999. In December 2002, there were approximately 26.2 million cellular lines in service compared with approximately 15.4 million fixed lines in service (14.4 million of which are part of our network). At present, 19 competitive fixed-line local operators have been granted licenses, primarily in Mexico City, Guadalajara, Monterrey, Puebla and other large cities.

The effects of increased competition on our business are highly uncertain and will depend on a variety of factors, including Mexican economic conditions, regulatory developments including the lowering of interconnection fees, the behavior of our customers and competitors and the effectiveness of measures we take.

Dominant Carrier Regulations and Other Regulatory Developments Could Hurt Our Business by Limiting Our Ability to Pursue Competitive and Profitable Strategies

Our business is subject to extensive regulation, and it can be adversely affected by changes in law, regulation or regulatory policy. The Mexican Competition Commission has determined that we are a dominant provider of certain telecommunications services, and Mexican law provides for the regulatory authorities to impose additional regulations on a dominant provider. In September 2000, the Mexican Federal Telecommunications Commission *(Comisión Federal de Telecomunicaciones,* or Cofetel) adopted regulations that apply specifically to us as a dominant carrier. In 2001, a Mexican court held that the determination that we are a dominant carrier was procedurally defective, but the Mexican Competition Commission promptly addressed the defect and issued a second resolution with the same findings. We have brought legal proceedings challenging the validity of the Competition Commission s second resolution. In May 2002, a federal court nullified several resolutions issued by the Competition Commission and Cofetel, including the September 2000 resolution adopting the dominant carrier regulations. We cannot predict the outcome of the proceedings regarding the Competition Commission or whether Cofetel will issue new regulations that are substantially similar to the prior dominant carrier regulations. We believe that if dominant carrier regulations are eventually implemented, the new rules and the related regulatory procedures will reduce our flexibility to adopt competitive tariff policies.

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The United States has initiated World Trade Organization (WTO) dispute settlement with Mexico regarding alleged illegal barriers to competition in the Mexican telecommunications market. The United States claims that Mexico has not complied with its WTO commitments, alleging in particular that (i) Mexico has not ensured that we provide international termination to U.S. telecommunications carriers at cost-based and reasonable rates, (ii) Mexico has failed to ensure that U.S. companies can route their calls into and out of Mexico over leased lines and (iii) Mexico s rules authorizing the Mexican carrier with the largest market share to negotiate rates on behalf of all Mexican carriers are anticompetitive. An adverse decision by the WTO could lead to trade sanctions against Mexico and could prompt changes in regulation affecting our business.

Shifting Usage Patterns Could Adversely Affect Our Revenues

Our fixed-line network services face increasing competition due to shifting usage patterns resulting from the adoption of popular new technologies, including wireless devices for voice and other communications, and the subsequent substitution of these technologies for fixed-line phones. For example, we estimate that an increasing proportion of calls that previously would have been made over our fixed network are now being made on wireless telephones outside our network. There can be no assurance that this process will not adversely affect our traffic volume and our results of operations.

Risks Relating to Our Controlling Shareholder and Capital Structure

We Are Controlled by One Shareholder

A majority of the voting shares of our company (68.9% as of April 30, 2003) is indirectly controlled by Carso Global Telecom, S.A. de C.V., which is controlled by Carlos Slim Helú and members of his immediate family. Carso Global Telecom has the effective power to designate a majority of the members of our Board of Directors and to determine the outcome of other actions requiring a vote of the shareholders, except in very limited cases that require a vote of the holders of L Shares.

The Protections Afforded to Minority Shareholders in Mexico Are Different from Those in the United States

Under Mexican law, the protections afforded to minority shareholders are different from those in the United States. In particular, the law concerning fiduciary duties of directors is not well developed, there is no procedure for class actions or shareholder derivative actions and there are different procedural requirements for bringing shareholder lawsuits. As a result, in practice it may be more difficult for minority shareholders of Telmex to enforce their rights against us or our directors or controlling shareholder than it would be for shareholders of a U.S. company.

We Engage in Transactions with Affiliates That May Create the Potential for Conflicts of Interest

We engage in transactions with certain subsidiaries of Grupo Carso, S.A. de C.V. and Grupo Financiero Inbursa, S.A., both of which are under common control with Carso Global Telecom. Transactions with subsidiaries of Grupo Carso include the purchase of network construction services and materials, and transactions with Grupo Financiero Inbursa include banking services and insurance. We also engage in transactions with América Móvil, which is controlled by América Telecom, S.A. de C.V. América Telecom, like Carso Global Telecom, is controlled by Carlos Slim Helú and members of his immediate family. Transactions with América Móvil include agreements implementing the spin-off of certain of our businesses to América Móvil and providing for transitional services, as well as ongoing commercial relationships. We also make investments jointly with our affiliates as well as sell our investments to our affiliates. Investment transactions with our affiliates include an investment in Prodigy Communications Corporation, or Prodigy (which we sold to an affiliate of SBC International in November 2001), an investment in The Telvista Company and the sale of our subsidiary Kb/Tel. Our transactions with affiliates may create the potential for conflicts of interest.

Holders of L Shares and L Share ADSs Have Limited Voting Rights

Our bylaws provide that holders of L Shares are not permitted to vote except on such limited matters as the transformation or merger of Telmex or the cancellation of registration of the L Shares with the Mexican National Banking and Securities Commission or any stock exchange on which they are listed. If you hold L Shares or L Share ADSs, you will not be able to vote on most matters, including the declaration of dividends, that are subject to a shareholder vote in accordance with our bylaws.

Holders of ADSs Are Not Entitled to Attend Shareholders Meetings, and They May Only Vote Through the Depositary

Under Mexican law, a shareholder is required to deposit its shares with a Mexican custodian in order to attend a shareholders meeting. A holder of ADSs will not be able to meet this requirement, and accordingly is not entitled to attend shareholders meetings. A holder of ADSs is entitled to instruct the depositary as to how to vote the shares represented by ADSs, in accordance with procedures provided for in the deposit agreements, but a holder of ADSs will not be able to vote its shares directly at a shareholders meeting or to appoint a proxy to do so.

You May Not Be Entitled to Participate in Future Preemptive Rights Offerings

Under Mexican law, if we issue new shares for cash as part of a capital increase, we generally must grant our shareholders the right to purchase a sufficient number of shares to maintain their existing ownership percentage in Telmex. Rights to purchase shares in these circumstances are known as preemptive rights. We may not legally be permitted to allow holders of ADSs or holders of L Shares or A Shares in the United States to exercise any preemptive rights in any future capital increase unless we file a registration statement with the U.S. Securities and Exchange Commission, or SEC, with respect to that future issuance of shares. At the time of any future capital increase, we will evaluate the costs and potential liabilities associated with filing a registration statement with the SEC and any other factors that we consider important to determine whether we will file such a registration statement.

We cannot assure you that we will file a registration statement with the SEC to allow holders of ADSs or U.S. holders of L Shares or A Shares to participate in a preemptive rights offering. As a result, the equity interest of such holders in Telmex may be diluted proportionately. In addition, under current Mexican law, it is not practicable for the depositary to sell preemptive rights and distribute the proceeds from such sales to ADS holders.

Our Bylaws Restrict Transfers of Shares in Some Circumstances

Our bylaws provide that any acquisition or transfer of more than 10% of our capital stock by any person or group of persons acting together requires the approval of our Board of Directors. If you wish to acquire or transfer more than 10% of our capital stock, you will not be able to do so without the approval of the Board of Directors.

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Our Bylaws Restrict the Ability of Non-Mexican Shareholders to Invoke the Protection of Their Governments with Respect to Their Rights as Shareholders

As required by Mexican law, our bylaws provide that non-Mexican shareholders shall be considered as Mexicans in respect of their ownership interests in Telmex and shall be deemed to have agreed not to invoke the protection of their governments in certain circumstances. Under this provision, a non-Mexican shareholder is deemed to have agreed not to invoke the protection of his own government by asking such government to interpose a diplomatic claim against the Mexican government with respect to the shareholder s rights as a shareholder, but is not deemed to have waived any other rights it may have, including any rights under the U.S. securities laws, with respect to its investment in Telmex. If you invoke such governmental protection in violation of this agreement, your shares could be forfeited to the Mexican government.

Our Bylaws May Only Be Enforced in Mexico

Our bylaws provide that legal actions relating to the execution, interpretation or performance of the bylaws may be brought only in Mexican courts. As a result, it may be difficult for non-Mexican shareholders to enforce their shareholder rights pursuant to the bylaws.

It May Be Difficult to Enforce Civil Liabilities Against Us or Our Directors, Officers and Controlling Persons

Telmex is organized under the laws of Mexico, and most of our directors, officers and controlling persons reside outside the United States. In addition, all or a substantial portion of our assets and their assets are located in Mexico. As a result, it may be difficult for investors to effect service of process within the United States on such persons or to enforce judgments against them, including in any action based on civil liabilities under the U.S. federal securities laws. There is doubt as to the enforceability against such persons in Mexico, whether in original actions or in actions to enforce judgments of U.S. courts, of liabilities based solely on the U.S. federal securities laws.

Risks Relating to Developments in Mexico and Other Emerging Market Countries

Economic and Political Developments May Adversely Affect Our Business

Our business operations and assets are located in Mexico. As a result, our business may be significantly affected by the general condition of the Mexican economy, by devaluation of the peso, by inflation and high interest rates in Mexico, or by political developments in Mexico.

Mexico Has Experienced Adverse Economic Conditions

Mexico has experienced a prolonged period of slow growth since 2001 primarily as a result of the downturn in the U.S. economy. In 2002, Mexico s gross domestic product, or GDP, grew by 0.9% and inflation rose to 5.7%. In 2001, GDP declined by 0.3% while inflation decreased to 4.4%. For 2003, the Mexican government has estimated that GDP growth will be 3.0% and inflation is expected to be 3.0%, though these estimates may not prove to be accurate.

If the Mexican economy falls into a recession or if inflation and interest rates increase significantly, our business, financial condition and results of operations could suffer material adverse consequences because, among other things, demand for telecommunications services may decrease and consumers may find it difficult to pay for the services we offer.

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Depreciation or Fluctuation of the Peso Relative to the U.S. Dollar Could Adversely Affect Our Financial Condition and Results of Operations

Primarily because of our U.S. dollar-denominated indebtedness, we are affected by fluctuations in the value of the peso against the U.S. dollar. In 2002, the peso depreciated against the U.S. dollar at year-end by approximately 12.8%, and the average value of the peso against the U.S. dollar during 2002 was 4.2% lower than in 2001, contributing to our net foreign exchange loss of P.4,445 million at year-end 2002. In 2001, the peso appreciated against the U.S. dollar by 4.8% at year-end, and the average value of the peso against the U.S. dollar during 2001 was 1.7% higher than in 2000. In 2000, the peso depreciated slightly against the U.S. dollar at year-end, but the average value of the peso against the U.S. dollar during 2000 was 1.0% higher than in 1999. Future depreciation or devaluation of the peso may result in further net foreign exchange losses.

Severe devaluation or depreciation of the peso may also result in disruption of the international foreign exchange markets and may limit our ability to transfer or to convert pesos into U.S. dollars and other currencies for the purpose of making timely payments of interest and principal on our indebtedness. While the Mexican government does not currently restrict, and for many years has not restricted, the right or ability of Mexican or foreign persons or entities to convert pesos into U.S. dollars or to transfer other currencies out of Mexico, the government could institute restrictive exchange rate policies in the future. Currency fluctuations will probably continue to affect our financial income and expense and our revenues from international settlements.

High Levels of Inflation and High Interest Rates in Mexico Could Adversely Affect Our Financial Condition and Results of Operations

Mexico has experienced high levels of inflation and high domestic interest rates. The annual rate of inflation, as measured by changes in the National Consumer Price Index, was 5.7% for 2002. Inflation for the first quarter of 2003 was 1.3%. If inflation in Mexico does not remain within the government s projections, we might not be able to raise our rates to keep pace with inflation, and more generally, the adverse effects of high inflation on the Mexican economy might result in lower demand or lower growth in demand for telecommunications services.

Interest rates on 28-day Mexican treasury bills, or *Cetes*, averaged 7.1% during 2002. On April 30, 2003, the 28-day *Cetes* rate was 6.7%. High interest rates in Mexico could adversely affect our financing costs.

Developments in the U.S. Economy May Adversely Affect Our Business

Economic conditions in Mexico are heavily influenced by the condition of the U.S. economy due to various factors, including commercial trade pursuant to the North American Free Trade Agreement (NAFTA), U.S. investment in Mexico and immigration in the United States. Events and conditions affecting the U.S. economy may adversely affect our business, results of operations, prospects and financial condition.

Developments in Other Emerging Market Countries May Adversely Affect the Market Price of Our Securities

The market value of securities of Mexican companies is, to varying degrees, affected by economic and market conditions in other emerging market countries. Although economic conditions in such countries may differ significantly from economic conditions in Mexico, investors reactions to developments in any of these other countries may have an adverse effect on the market value of securities of Mexican issuers. In late October 1997, prices of both Mexican debt securities and

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Mexican equity securities dropped substantially, precipitated by a sharp drop in value of Asian markets. Similarly, in the second half of 1998, prices of Mexican securities were adversely affected by the economic crises in Russia and in Brazil. There can be no assurance that the market value of our securities would not be adversely affected by events elsewhere, especially in emerging market countries.

Political Events in Mexico Could Affect Mexican Economic Policy and Our Operations

The national elections held in July 2000 ended 71 years of rule by the Institutional Revolutionary Party (PRI) with the election of president Vicente Fox, a member of the National Action Party (PAN), and resulted in the increased representation of opposition parties in the Mexican Congress and in mayoral and gubernatorial positions. Neither the PRI nor the PAN currently has a majority in the Congress or Senate. The lack of a majority party in the legislature and the lack of alignment between the legislature and the President has resulted in deadlock and has prevented the timely implementation of legislative and economic reforms. Continued delays could have a material adverse effect on the Mexican economy and on our business.

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FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. We may from time to time make forward-looking statements in our periodic reports to the SEC on Form 6-K, in our annual report to shareholders, in offering circulars and prospectuses, in press releases and other written materials, and in oral statements made by our officers, directors or employees to analysts, institutional investors, representatives of the media and others. Examples of such forward-looking statements include:

- projections of operating revenues, net income (loss), net income (loss) per share, capital expenditures, dividends, capital structure or other financial items or ratios,
- statements of our plans, objectives or goals, including those relating to competition, regulation and rates,
- statements about our future economic performance or that of Mexico or other countries, and
- statements of assumptions underlying such statements.

Words such as believe, anticipate, plan, expect, intend, target, estimate, project, predict, forecast, guideline, should and intended to identify forward-looking statements but are not the exclusive means of identifying them.

Forward-looking statements involve inherent risks and uncertainties. We caution you that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. These factors, some of which are discussed under Risk Factors beginning on page 4, include economic and political conditions and government policies in Mexico or elsewhere, inflation rates, exchange rates, regulatory developments, technological improvements, customer demand and competition. We caution you that the foregoing list of factors is not exclusive and that other risks and uncertainties may cause actual results to differ materially from those in forward-looking statements.

Forward-looking statements speak only as of the date they are made. We do not undertake to update such statements in light of new information or new developments.

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ITEM 4. INFORMATION ON THE COMPANY

TELMEX

We own and operate the largest telecommunications system in Mexico. We are the only nationwide provider of fixed-line telephony services and the leading provider of fixed local and long distance telephone services as well as Internet access in Mexico. We also provide other telecommunications and telecommunications-related services such as connectivity, Internet services, directory and interconnection services to other carriers and paging service.

At March 31, 2003, we had 14.7 million local fixed lines in service, up 8.3% over March 31, 2002. In long distance services, we estimate that during December 2002, our share of traffic in cities open to competition was 73.3% for domestic long distance and 68.7% for international long distance calls originating in Mexico.

Of our consolidated revenues in 2002, 47.1% was attributable to local service, 34.0% was attributable to long distance service and 13.8% was attributable to interconnection. Included in long distance revenues are revenues from connectivity (which consists of data transmission services for private and shared networks), accounting for 5.9% of consolidated revenues, and Internet services, accounting for 5.1% of consolidated revenues. Other services, including yellow pages and equipment sales, accounted for 5.1% of consolidated revenues.

History

We were formed in 1947 under private foreign ownership to acquire the Mexican telephone business of a wholly-owned subsidiary of the L.M. Ericsson group of Sweden. In 1950, we acquired the Mexican telephone business of a wholly-owned subsidiary of the International Telephone and Telegraph Company, which operated the only other national telephone network in Mexico at that time. In 1972, the Mexican federal government acquired the majority of our capital stock. In December 1990, the government sold shares representing voting control of our company. The government sold the balance of its shares in a series of transactions beginning in May 1991.

In September 2000, we spun off our Mexican wireless business and, with limited exceptions, our international operations into América Móvil, a new Mexican corporation. The spin-off was conducted by means of the procedure under Mexican corporate law called *escisión*. The spin-off was completed on February 7, 2001, when shares and ADSs of América Móvil started trading separately from our shares and ADSs on the Mexican Stock Exchange, the New York Stock Exchange and NASDAQ.

In the years since our privatization, we have evolved from a state-owned commodity business to a fully integrated private-sector service provider. Consumption of telephone services has grown rapidly as we modernized our equipment, rebuilt our external infrastructure, optimized our network architecture, digitalized our local and long distance switches and built a fully redundant nationwide fiber optic network. We have expanded both the volume and scope of our services, to reach 20,848 communities and provide a range of services from the most essential voice communications to products where voice, data and video converge.

Business Strategy

We operate in the Mexican markets for wireline voice telecommunications and Internet and data service. We expect that these markets will see continuing growth in demand, increasingly intense competition and growing diversification of service offerings, particularly if the Mexican and U.S.

economies recover. We expect that any decline in our market share as a result of increasing competition will be at least partly offset by the overall growth in the market. We think our strengths under these conditions include the following:

our strong competitive position in the Mexican markets for fixed voice telephony and Internet and data businesses, with nationwide coverage, the largest market share and strong brand recognition;

our ability to offer integrated telecommunications solutions throughout Mexico;

the size and technological sophistication of our network infrastructure, which includes Mexico s largest fiber optic network; and

our strong financial position and stable cash flow.

We intend to maintain our leadership in traditional wireline voice telecommunications and to take advantage of the potential for growth in connectivity and Internet-related businesses in Mexico. To this end, our business strategy highlights the following:

For our lower income customers and those affected by the current economic downturn, we provide extensive prepaid offerings, ranging from prepaid cards for use in public telephones to prepaid residential services, including Multifon Home (*Multifon Hogar*) and Multifon Kit. We also offer a discounted Internet access plan for use during off-peak hours.

We have tailored our products and services to meet customer needs. For customers of our telecommunications services, we have emphasized enhanced services such as caller ID, call waiting, three-way calling, call forwarding and voice mail. For Internet access accounts, we have expanded our Prodigy Internet Plus, or PIP, product line and introduced nationwide access numbers.

We are meeting the growing demand for online applications and services by expanding our fiber optic network s coverage in urban areas and increasing availability through asymmetric digital subscriber line (ADSL) technology marketed under the brand name Prodigy Infinitum. We are also working to expand broadband availability beyond the 1,036 service areas we currently reach.

We are anticipating and fulfilling commercial customer needs in distinctive sectors, including large corporations, medium-sized businesses, entrepreneurs and home-based businesses, by focusing on designing and operating their networks.

While building on our core voice communications business with its strong penetration and brand recognition, we are promoting our ability to provide integrated value-added services, including connectivity, advanced data services, hosting of data processing functions, e-commerce support, customer premises equipment and tailored business solutions for particular industries.

We are implementing a transition in network design that will gradually integrate our separate service infrastructures and management systems under a common infrastructure with high speed multi-service nodes that have the capacity to provide voice, data, Internet and video services. This redesigned network will allow us to improve flexibility in offering services and increase efficiency in network management.

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Significant Subsidiaries and Investees

The following table sets forth our significant subsidiaries and investees accounted for using the equity method at December 31, 2002:

Name of Company	Jurisdiction of Establishment	Percentage of Ownership and Voting Interest	Description
Compañía de Teléfonos y Bienes Raíces, S.A. de C.V.	Mexico	100%	Real estate company owning our facilities
Alquiladora de Casas, S.A. de C.V.	Mexico	100%	Real estate company owning our facilities
Teléfonos del Noroeste, S.A. de C.V., or Telnor	Mexico	100%	Fixed-line network concessionaire for the state of Baja California Norte and the San Luis Rio Colorado region of the state of Sonora
Anuncios en Directorios, S.A. de C.V.	Mexico	100%	Producer of yellow pages directories
Uninet, S.A. de C.V.	Mexico	100%	Provider of Internet access to Telmex and commercial customers
Consorcio Red Uno, S.A. de C.V.	Mexico	100%	Supplier of telecommunications network integration services and information systems
Telmex USA, L.L.C.	Delaware	100%	Authorized reseller of long distance services and holder of FCC authorization to provide facility-based long distance services in the United States
T1MSN Corporation*	Delaware	50%	Joint venture with Microsoft to establish an Internet portal for the Spanish-speaking Americas
Technology and Internet, L.L.C.*	Delaware	50%	Company investing in e-commerce enterprises in the United States and Latin America
The Telvista Company*	Delaware	45%	Provider of telemarketing services in the United States and Mexico

* Investments accounted for using the equity method.

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Overview

The following table gives selected data on the size and usage of our network, excluding the wireless operations that were spun-off to América Móvil in September 2000:

	December 31,				
	2002	2001	2000	1999	1998
Lines in service (thousands)	14,446	13,372	12,069	10,878	9,927
Internet access accounts (thousands)	1,165	913	634	403	146
Connectivity line equivalents (thousands)	2,021	1,574	997	507	371
Lines in service per employee	301.2	272.8	247.4	222.7	202.4
Domestic long distance call minutes for the year (millions)	14,347	14,251	12,309	10,419	9,077
International long distance call minutes for the year (millions)[1]	4,922	4,404	5,521	4,192	3,286

(1) Includes incoming and outgoing traffic.

In 2002, the *Centro Mexicano de Filantropía, A.C.*, the Mexican Center of Philanthropy, recognized us as a socially responsible company by awarding us the ESR-2002. Also in 2002, Forbes magazine named us the best telecommunications company in the world for 2001 in its annual review of the financial and growth performance of companies with sales or market capitalization of at least U.S.$5 billion. In 2000, the Mexican government recognized our technological strength by awarding us the National Technology Award for outstanding use and management of technological resources as well as for improvement in products, services and processes to benefit customers.

Local Service

Our network included 14.4 million local fixed lines in service at December 31, 2002, reflecting 1,611 thousand new lines and 537 thousand disconnections in 2002. Despite the 8.0% increase in the number of lines in service, local traffic in 2002 increased by only 0.4% compared to 2001 for a total of 25,678 million calls. The relative decrease in billed traffic in 2002 was attributable primarily to the weak Mexican economy and the consumption patterns of new customers with less disposable income.

Our network is 100% digital, with all of our lines connected to digital exchanges. During 2002, customers made increasing use of digital services, such as caller ID, call waiting, three-way calling, call forwarding and voice mail. The number of lines with digital services in use at year-end 2002 was 4.4 million (30.2% of the total number of lines in service), representing an increase of 36.1% from 2001. This increase was due largely to a promotional campaign we began in 2001 to promote the use of digital services and maximize the value of fixed lines. We have also added features based on these services to the telephones and handsets we sell.

We provide local telephone service to 20,848 communities throughout Mexico. Lines in service are concentrated in large urban areas. Of all lines in service, 36.4% are in the Mexico City, Monterrey and Guadalajara areas, and 25.0% are in the Mexico City area alone. We provide service to 14,531 rural communities, exceeding our obligations to extend services to rural areas.

Our charges for fixed-line local telephone service comprise (a) installation charges, (b) monthly line rental charges, (c) monthly measured service charges, and (d) charges for other services, such as the transfer of a line to another address and reconnection. Residential customers pay a fixed charge per local call in excess of a monthly allowance of 100 local calls, and commercial customers pay for every local call at the same fixed rate per call. In December 2002, approximately

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54.0% of residential customers made fewer than 100 local calls per month, an increase of 2.5% compared with December 2001. The concession we hold to operate a public network for basic telephone services (the Concession) permits, but does not require, us to base our charges on the duration of each call, with a monthly allowance of free calls or call minutes for residential customers. We currently do not charge by duration of invoiced calls in any region, except in the case of prepaid services.

We offer prepaid local and long distance service through our Ladatel and Multifon calling cards. Multifon cards, originally developed for use with public phones and invoiced fixed-line phones, are now available for our Multifon residential lines. Multifon Home offers prepaid local and long distance service on home telephones. For a total cost of P.999, Multifon Kit provides installation, a handset and P.100 of airtime for calls to the United States and Canada. In the case of our Multifon products, customers do not pay monthly rent and prepaid fixed-line service is charged on a per-minute basis like public telephony services.

In October 2002, we announced that we would not increase rates for local telephone service during 2003. No rate increases have been made since March 2001, when we increased our monthly line rental charges for residential customers by 6.5% and monthly measured service charges for all customers by 6.4%. In 2000, we increased our local service rates by 6.1%, with the exception of commercial installation fees. Rate increases are described in this paragraph in nominal terms, without taking account of inflation.

We hold frequency concessions acquired at auctions in 1997 and 1998. We use the frequencies primarily for long distance transmission and to provide fixed-wireless services where the local loop is not available.

Long Distance Service

We are the leading provider of domestic and international long distance telecommunications services in Mexico. Our domestic long distance transmission network consists of more than 74,000 kilometers of optical fiber connecting Mexico s major cities, and includes secondary branches and an additional transmission ring around Mexico City designed to avoid network congestion. International long distance traffic with the United States, Canada, Central America and other countries is carried by a combination of the fiber optic network, microwave transmission, satellite systems and submarine cable. See Network.

Our charges for domestic long distance service are based on call duration and the type of service, e.g., direct-dial or operator-assisted. Charges for international long distance calls are based on type of service, call duration and the region of the world called. In October 2002, we announced that we would not increase our nominal rates for domestic and international long distance service in 2003. Our nominal rates for domestic and international long distance service have remained unchanged since March 1999.

We offer a variety of long distance discount plans that reduce the effective rates paid by our customers based on volume, time of use or other factors. For domestic long distance service, beginning in 2000, high volume corporate clients pay P.1.00 per minute, which represents a discount of up to 61.2% from our nominal rate, while other customers that maintain service with us receive discounts of up to 39% as well as a 50% discount on calls made between 8:00 p.m. and 7:59 a.m. from Monday to Saturday and all day Sunday. More recently, we have introduced Favorite Lada Destinations *(Lada Favorito)*, a plan offering discounts on calls to cities in Mexico pre-selected by customers.

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For international long distance service, customers receive a 33.3% discount on calls made to the United States and Canada between 7:00 p.m. and 6:59 a.m. from Monday to Friday, all day Saturday, and between 12:00 a.m. and 4:59 p.m. on Sunday.

Revenues from international long distance service include net payments under bilateral agreements with foreign carriers. The agreements govern the rates of our payment to foreign carriers for completing international calls from Mexico and by foreign carriers to us for completing international calls to Mexico. The rates of payment under such agreements are negotiated with each foreign carrier. Settlements among carriers are normally made monthly on a net basis. Settlement amounts payable to us in respect of calls from the United States to Mexico generally exceed amounts payable by us in respect of calls from Mexico to the United States. As a result, we receive monthly net settlement payments from U.S. carriers. We make monthly settlement payments to other international carriers taken as a whole.

The international settlement rates that U.S. carriers pay to foreign carriers have been subject to intense downward pressure due to competition and regulatory factors, including initiatives by the United States government. Since 1997, there has been a cumulative reduction of 75.7% in our settlement rates for U.S. carriers. In 2001, we reached agreements with most U.S. carriers to reduce settlement rates for 2001 by 18.4% from U.S.$0.19 per minute to U.S.$0.155 per minute for 2001. The agreements established further rate reductions to U.S.$0.135 per minute for 2002 and U.S.$0.10 per minute for 2003. The companies also agreed to request that the respective Mexican and U.S. regulatory authorities modify by January 1, 2004 the regulatory regime governing the negotiation of settlement rates. In Mexico, this would mean eliminating requirements that (i) all carriers pay the same rates, (ii) incoming international calls be distributed among the Mexican carriers in proportion to the outgoing calls they originate and (iii) the Mexican carrier with the largest market share on a particular international route negotiate rates for all Mexican carriers on that route.

In early 2002, we agreed with the U.S. carriers to further reduce settlement rates for the period from March 2002 through December 2003. Under these agreements, rates for northbound (Mexico to the United States) and southbound (the United States to Mexico) traffic will no longer be in parity. All northbound calls will be settled at U.S.$0.055 per minute. Settlement rates for southbound calls will be based on a rate structure that applies one of three factors, depending on the termination point of international calls. As a result, we receive U.S.$0.055 per minute for calls terminating in Mexico s three largest cities (Mexico City, Guadalajara and Monterrey), U.S.$0.085 per minute for calls terminating in the next 200 largest cities and U.S.$0.1175 per minute for calls terminating anywhere else in Mexico. The agreements also reaffirmed the parties commitment to request that the relevant authorities modify the regulations governing the negotiation of settlement rates. In March 2002, we submitted the proposed agreements, including the request for regulatory change, to the Mexican authorities for approval and Cofetel approved the rate structure in October 2002. The agreements were submitted to the U.S. Federal Communications Commission, or the FCC, but no action has been taken. The request for a change in regulation remains pending with Cofetel.

We believe that our international traffic volume has been adversely affected by an unauthorized practice in Mexico referred to as illegal bypass, in which incoming international calls are carried over leased lines and then connected to the public switched network in Mexico, thus avoiding settlement payments. Illegal bypass is technically difficult to prevent or to measure, but we believe that illegal bypass was primarily responsible for the decline in the number of minutes of international long distance traffic from 1997 to 1998, and that the growth of illegal bypass was reduced in 1999 and in 2000 by the reduction in settlement and interconnection rates. In December 2000, we agreed with the two leading competing long distance carriers on a package of measures to eliminate illegal bypass. Despite these efforts, we believe that illegal bypass continues to negatively impact our

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revenues. There can be no assurance that our international traffic volume and our results of operations will not continue to be adversely affected by unauthorized bypass.

Public Telephony

We have several programs to meet the need for different kinds of public telephone service in different areas. We had more than 725 thousand fixed public telephones in operation at December 31, 2002, an increase of 2.5% compared with 2001.

In 2002, we sold over 266 million prepaid cards under the brand name Ladatel for use in public phones and 7.7 million prepaid cards under the brand name Multifon for use in public and residential telephones, an increase of 2.0% over 2001. This represents an average of almost three cards per Mexican resident. We have installed Internet kiosks in public places so that our customers have access to Internet products and services by using Ladatel cards. Sales of prepaid cards accounted for 6.8% of our consolidated revenues in 2002.

In 2003, we launched the Count on Telmex (*Cuenta con Telmex*) card. The key feature of the Count on Telmex card is its rechargeable magnetic strip, which allows customers to make telephone calls and to use services provided by Grupo Financiero Inbursa to withdraw cash from automatic teller machines, make credit or debit purchases in more than 13 million locations world-wide, and make deposits and pay telephone bills through Telmex stores (*Tiendas Telmex*). The card also may be recharged at more than 170 thousand Ladatel phones for a fee payable to us. We have introduced several reward programs that promote frequent card use, including providing customers with points that may be applied to long distance calls.

In the increasingly competitive market to provide telecommunications services, independent operators have installed public telephones for which we provide access. There were 15,954 independently operated public telephones at December 31, 2002, an increase of 32.0% compared with 2001.

Interconnection

In accordance with the Federal Telecommunications Law, we provide interconnection service pursuant to which (a) long distance, local and cellular carriers operating in Mexico establish points of interconnection between their networks and our network and (b) we carry calls between the points of interconnection and our customers. When a customer of another carrier calls a local service customer of ours, we complete the call by carrying the call from the point of interconnection to the particular customer, and when a local service customer of ours who has preselected a competing long distance carrier makes a long distance call, we carry the call from the customer to the point of interconnection with the relevant carrier s network. We have one rate for interconnecting all categories of carriers and all types of calls.

Our revenues from interconnection represented 13.8% of our consolidated revenues in 2002. Revenues from our customers under the calling party pays system for calls from fixed lines to mobile lines represented 93.0% of our interconnection revenues in 2002. We pay 76.0% of the amounts received under the calling party pays system to the cellular carriers whose customers receive calls from our customers.

Interconnection fees, and interconnection practices more generally, have been the focus of controversy among competing long distance carriers in Mexico as in many other countries. Such carriers have contended that the technical and financial terms of interconnection are unfair to them, and they have responded with a variety of measures, including the following: seeking action from Cofetel and other Mexican governmental and regulatory agencies; enlisting the support of foreign governments, including the U.S. government, in seeking action from Cofetel and other Mexican agencies; opposing our applications for licenses from the U.S. Federal Communications Commission; commencing proceedings in Mexican courts; publicizing their grievances; and withholding payment of interconnection fees due to us. For three consecutive years beginning in December 2000, we reached agreements with competing long distance carriers that address many of the disputes over interconnection. See Regulation Interconnection.

Connectivity and Internet Services

Connectivity consists of the unbiased relay of voice, video and data between two or more end points. Internet services connect both business and residential customers to the Internet through either a dedicated or dial-up connection.

During 2002, the number of line equivalents provided by means of connectivity increased by 28.4% to 2,021 thousand, and revenue from connectivity represented 5.9% of our consolidated revenues. Our principal product offerings for connectivity are Ladalinks (*Ladaenlaces*) and Frame Relay. Using equipment installed on-site, Ladalinks customers have dedicated network links that transmit information at speeds ranging from 64 Kbps (which we market under the brand name DS0 (in copper) or E0 (in fiber optic)) to 622 Mbps (which we market under the brand name STM4). Frame Relay is a protocol for transmission of data, voice and video over a shared digital network. The speed of Frame Relay transmission ranges from 64 Kbps to 2,048 Kbps. As with Ladalinks, Frame Relay offers extensive technical assistance and customer support.

Internet services represented 5.1% of our consolidated revenues in 2002. The number of Internet customers increased to 1,165 thousand, an increase of 27.6% compared with 2001. Business and residential customers connect to the Internet using telephone lines or broadband connections. Our broadband services, including Prodigy Turbo and Prodigy Infinitum, make it possible for customers to use our high-capacity connectivity services with applications such as video-conferencing, file transfer, terminals, e-mail and protocol conversion. Prodigy Turbo operates over dedicated integrated services digital network(ISDN)lines that allow customers to connect to the Internet at 128 Kbps. Prodigy Infinitum operates over dedicated ADSL lines that allow customers to connect to the Internet at 256 Kbps, 512 Kbps and 2Mbps. At year-end 2002, we had 67 thousand customers using our ADSL broadband services. We further expanded our broadband offerings with the launch of Prodigy Mobile (*Prodigy Móvil*), a high-speed wireless connection for residential and business customers. Prodigy Mobile works with any of the ADSL technology speeds and is based on the Wireless Fidelity IEE802.11b norm, or WiFi. WiFi allows a wireless connection at a speed of up to 11Mbps at a range that extends 20 and 100 meters.

We estimate that we are the leading Internet access provider in Mexico in terms of the number of subscribers. By March 31, 2003, the number of Internet service subscribers was 1,234 thousand compared with 986 thousand as of March 31, 2002, representing an increase of 25.1%. Much of the growth in this segment is attributable to the Prodigy Internet Plus package we launched in 1999, which for a fixed price provides a customer with a multi-media personal computer, a personal web page, an e-mail account and two years of unlimited access time. This program accounted for 271 thousand subscribers in 2002, or 23.2% of the total number of Internet access accounts subscribers at year-end.

Consistent with our strategy of providing value-added services to maximize the value of residential and business Internet accounts, we introduced three new services: (i) Prodigy Internet i-call, a service that notifies customers of incoming calls and allows them to answer the call without disconnecting from the Internet, (ii) Prodigy Single-Dial (*Marcación Única Prodigy*), a service that provides traveling customers with a nationwide access number that allows them to connect from anywhere in Mexico at the rate for local calls and (iii) Prodigy Patrol, a service that allows Prodigy Internet, Prodigy Internet Plus and Prodigy Infinitum customers to limit access to certain web sites.

As part of our strategy of offering a wide array of services to our lower-income customers, we introduced a product combining goods and services: Internet access with a personal computer. For a monthly fee this product, Prodigy Internet Plus-Home or PIP-Home *(Prodigy Internet Plus-Hogar* or *PIP-Hogar)*, provides unlimited Internet access during non-peak hours and billed access during peak hours.

Through TRIARA, our Internet data platform which provides infrastructure for Internet and computer data services, we provide hosting, co-location and outsourcing products in Mexico. These products offer our corporate customers significant savings in the computer infrastructure and telecommunications investments necessary to have a web site or carry out high-performance Internet projects. In 2002, TRIARA was selected as the provider for NIC of Mexico, the company that registers and controls the domain name .mx . Initiatives like TRIARA provide platforms through which we serve other segments of the connectivity market, such as small and medium-sized businesses. In 2002, we introduced personalized e-mail accounts for small businesses and audio and Internet-based video transmission products for medium-sized businesses.

We also supply telecommunications network integration services and information systems through our wholly-owned subsidiary Red Uno.

In March 2000, we launched T1MSN, an Internet portal aimed at the Spanish-speaking Americas. T1MSN is a 50-50 joint venture between Microsoft Corporation and us. T1MSN takes advantage of Microsoft s world-class technologies and our leading infrastructure, operations and regional knowledge to offer users a broad range of communication services and superior content in Spanish, such as easy and secure shopping services and enhanced communication features. In September 2001, T1MSN acquired Yupi, an operator of a popular Spanish-language portal that targets Internet users in the United States and in certain Latin American countries.

We operate a web-based service called Eficentrum, which is a horizontal business-to-business market for the indirect exchange of goods and services. Eficentrum s business plan emphasizes economies of scale, administrative savings, better purchasing management, fast payment, expeditious delivery services and direct contact with manufacturers. The current volume of transactions has made Eficentrum the biggest horizontal portal in Mexico. We plan to implement other new e-commerce initiatives in different market sectors, thereby continuing to broaden our range of services to the corporate sector.

Yellow Pages Directory

We provide various other telecommunications and telecommunications-related services, including yellow pages and other directory services.

We offer both a printed and an Internet-based Yellow Pages directory. Advertising in our 2002 Yellow Pages printed edition was purchased by 25.4% of our commercial customers. We estimate that we have 98% of the market share in printed directory services. During 2002, the Yellow Pages web site averaged 828 thousand page views per month, an increase of 4.6% compared with 2001. The number of Internet directory users increased 25.1% compared with 2001, reaching 390 thousand in 2002.

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Operations in the United States

In April 2003, the FCC granted our U.S. subsidiary, Telmex U.S.A., a facility-based authorization that permits us to install and operate telecommunications facilities in the United States. We also hold an FCC authorization to resell long distance services in the United States. We are in the process of evaluating potential future operations in the United States.

Network

Our technologically advanced, high-capacity and high-speed fiber optic network, the largest in Mexico, extends over 74,000 kilometers, has connections via submarine cables with 40 countries and connects most major cities throughout Mexico. As a result of substantial investments, our network has been 100% digital since 2000, with fully digital switching and transmission.

Our network includes installed telephones and switchboards, a switching network, access lines connecting customers to switches, trunk lines connecting switches and long distance transmission equipment. In addition, we use a cross-connect network for our connectivity services and routers for our Internet services.

Fiber optic cable is used to transmit both voice and high bandwidth applications such as ADSL, video and image data. The network is fully redundant and is supported by fiber-optic ground rings, an intercontinental submarine cable known as Columbus II and a submarine cable system known as Maya 1, all of which feature automatic restoration capacity in 50 milliseconds. In addition, our digital microwave network serves as a secondary backup to the fiber optic network and as a primary means of transmission for rural areas and small towns, where optical fiber is not available. Our network has been constructed with uniform transmission network architecture, using Dense Wave-length Division Multiplexing (DWDM) and Syncronous Digital Hierarchy (SDH) technologies, resulting in a highly robust, reliable and resilient network that operates at speeds up to 80 Gbps.

International long distance traffic with the United States and Canada is carried by terrestrial and submarine fiber optic cables. Traffic with Belize is carried by microwave digital transmission, while traffic with other countries is carried by both cable and satellite transmission systems. We have an ownership interest in the 12,297-kilometer submarine cable Columbus II, which links the Americas and Continental Europe. We also have an ownership interest in 31 submarine cables for the transmission of traffic throughout the Americas, Europe, Asia and Australia.

In 2000, the Maya 1, submarine cable system was put in service to join North, Central and South America with state-of-the-art technology, increasing international communications transmission quality and capacity throughout the region. The Maya 1 submarine cable has permitted us to meet rising traffic demands and continue growth while we broaden our services to other countries.

Core Network

Our core transport network has been constructed to allow transmission using SDH technology over a series of connected rings. The rings give us the ability to protect information carried on the network from the origin to the destination with a self-repairing mechanism for equipment and links failures around the rings, which minimizes the risk of interruption of the signal in the event of damage in our network. With this structure we are able to achieve end-to-end network availability with switching protection times of less than 50 milliseconds.

We control and monitor our network equipment performance and traffic levels and manage the routing of traffic, the loading of switches and other network functions through centralized network management. The single centralized management of our network facilitates geographical expansion of the network and permits the exploitation of higher capacity system as required. SDH provides a reliable platform for future information, communications and entertainment services. SDH is also well suited to operate asynchronous transfer mode (ATM) technology, which is required for advanced multi-service transport.

Traffic on our network is directed by both voice and data high capacity switches that are essential for routing information from one point to another. The SDH technology used in the network gives flexibility in the geographic siting of switches and enables us to handle more traffic with fewer switches than a traditional analog network. In addition, switched network traffic can be re-routed over the transport network to avoid congestion in periods of heavy usage.

Next Generation Network

In the face of new challenges arising from telecommunication globalization and the ongoing development of new technologies, we are evolving our current infrastructure to a Next Generation Network, or NGN. During this transition, we plan to gradually integrate our service infrastructures and management systems under a common infrastructure with multi-service nodes that have the capacity to provide simultaneously voice, data and video services. This is achieved by integrating separate service infrastructures, such as telephony, Internet access, intelligent network and data, through multi-service nodes using optics technologies as a common transport. The NGN will allow us to improve flexibility in offering broadband services, increase efficiency in managing our network, improve service quality will be the media to upgrade current network platforms.

The successful growth of the NGN has depended on the expansion of IP-oriented services, such as data and voice virtual private networks (VPNs). We have upgraded our data IP network towards the implementation of a Multi Protocol Label Switching (MPLS) platform.

Through the NGN, we are deploying a packet-based platform, which will permit greater efficiency in the creation of multi-service networks to carry information based on standard formats. By utilizing this packet technology, we can provide superior local access network interconnection, data transmission and flexible bandwidth delivery.

Billing and Customer Service

For corporate customers, we offer SI@NA, an Internet service that permits customers to analyze their telecommunications spending. Residential customers may also access billing information over the Internet using the Telmex on-line *(Telmex en Línea)* service. Since 1998, we have been providing our customers with a bill format that details their local service usage.

We provide customer service through a network of customer service centers and call centers. These customer service centers have evolved from their traditional purpose as places for payment to become Telmex stores that offer telecommunications products and services. Large corporate customers also receive customer service from dedicated customer service personnel. Through our Integrated Solutions *(Solución Integral)* service, we assist corporate customers in meeting their telecommunications needs by providing them with integrated telecommunications solutions consisting of a broad range of telecommunications services. We offer service level agreements to corporate customers that set service standards and guarantee continuity of service. In 2002, our billing, collection and pricing process obtained ISO 9001:2000 certification from the Mexican Institute of Normalization and Certification.

Competition

The Mexican market for fixed-line domestic and international long distance services was opened to competition beginning in 1996. Twenty-two carriers have been granted licenses to provide long distance service in Mexico, eight of which have commenced operations. Alestra (a joint venture led by Alfa, S.A. de C.V., Grupo Financiero BBVA Bancomer, S.A. de C.V., and AT&T Corp.) and Avantel (a joint venture led by Grupo Financiero Banamex and WorldCom, Inc.) have made the most substantial investments in infrastructure and marketing. Most competing carriers have been principally focused on the long distance market, although some carriers also provide certain business customers with direct access to their long distance networks using lines leased from us. In addition to granting concessions to new competitors, the Communications Ministry has established technical rules and basic access rates for interconnection between our competitors and us. During the last three years we have negotiated these rates with our competitors.

Customers are free to choose a competing carrier at any time. Customers can also access the long distance carrier of their choice by dialing a toll-free number, which permits the carrier to bill the customer directly. An independent organization confirms all requests to change long distance carriers. In addition to pre-subscription, customers will eventually be able to select a long distance carrier on a call-by-call basis by dialing a three-digit prefix. In general, our competitors have focused their attention on obtaining market share in Mexico s most profitable markets, such as the major cities and high-volume users of international and domestic long distance.

Competition in the Mexican market for fixed-line local services began in 1999. As of December 31, 2002, 19 carriers have been granted licenses to provide local fixed wire and wireless telephony and 13 carriers have been granted licenses for cellular and mobile telephony. At present, there are nine competitive local operators, primarily in Mexico City and other large cities. Avantel, Axtel and Maxcom are our principal fixed-line competitors. To date, our competitors in local service have focused on servicing first-time customers and providing second lines in new housing as well as inducing our customers to switch carriers.

The competitive environment in the Mexican telecommunications market has been the subject of controversy and of attention from Mexican regulators and from abroad. In particular, the Mexican Competition Commission has determined that we are a dominant provider of certain telecommunications services, and Mexican law provides for the regulatory authorities to impose additional regulations on a dominant provider. In September 2000, Cofetel adopted specific regulations applicable to us as a dominant carrier, although these regulations were later nullified by a federal court in 2002. See Regulation Dominant Carrier Regulations. In July 2001, in response to a withdrawn December 1995 claim by a competitor, the Competition Commission ruled that we had engaged in anti-competitive practices. In October 2001, the Competition Commission ruled that we had engaged in discriminatory practices in connection with the sale of private lines to Internet service providers.

In August 2000, the United States initiated WTO dispute settlement against Mexico regarding alleged illegal barriers to competition in the Mexican telecommunications market. The allegations related to our status as a dominant telecommunications provider in Mexico and the interconnection fees and charging mechanisms for international calls. On April 2, 2001, the United States Trade Representative announced that if sufficient progress were not made to resolve the dispute by June 1, 2001, the United States would renew its request for a dispute settlement panel at the WTO.

On February 13, 2002, the United States requested that the WTO establish a panel to address claims that Mexico has not complied with its WTO commitments, alleging in particular that (i) Mexico has not ensured that we provide international termination to U.S. telecommunications carriers at cost-

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based and reasonable rates, (ii) Mexico has failed to ensure that U.S. companies can route their calls into and out of Mexico over leased lines and (iii) Mexico s rules authorizing the Mexican carrier with the largest market share to negotiate rates on behalf of all Mexican carriers are anticompetitive. Consistent with its standard procedures, on April 17, 2002, the WTO established the dispute settlement panel requested by the United States. We expect that it will take the panel until later this year to resolve the dispute, and panel decisions are then subject to appeal to the WTO. While we believe that the claims made by the United States are politically motivated and incorrect, an adverse decision by the panel could lead to trade sanctions against Mexico and could prompt changes in regulation affecting our business.

In December 2000, we entered into agreements with our two principal long distance competitors, Alestra and Avantel, that addressed a variety of outstanding issues. In 2001, our remaining long distance competitors agreed to the same terms and conditions we had previously agreed upon with Alestra and Avantel. The agreements confirmed the parties acceptance of interconnection rates imposed by Cofetel for long distance calls, resolved previous disputes over rates and provided for the payment of outstanding unpaid fees by each party. We received U.S.$139.0 million (net of tax) in cash in the fourth quarter of 2000 as a result of the settlement. The agreements also establish pricing and quality standards for the provision of services between us and the other carriers, requiring us to provide discounts and establishing mechanisms to monitor compliance. We agreed to submit to Cofetel proposals to eliminate illegal bypass and to modify the allocation of incoming international calls. The parties also agreed to withdraw their outstanding legal proceedings relating to the matters in dispute. The agreements do not address the dominant carrier regulations adopted by Cofetel.

In December 2001, we entered into agreements with all our long distance competitors regarding the interconnection rates for 2002 and additional discounts for interconnection facilities and call attempts. We also reached agreements with our competitors regarding discounts on private lines and on other services. In February and March 2003 we agreed with nearly all of the long distance carriers to maintain the interconnection rates set forth in the December 2001 agreements. In addition, we agreed to a discount on the amounts being paid to cover the investments we made to modify our network for interconnection. See Regulation Interconnection.

The effects of competition on us depend, in part, on the business strategies of competitors, the general economic and business climate in Mexico, including demand growth, interest rates, inflation, exchange rates, and regulatory developments. The effects could include loss of market share and pressure to reduce rates for our services. Our strategies to meet competition are intended to limit our loss of market share.

During December 2002, we estimate our market share to be 73.3% in domestic long distance service and 68.7% in international long distance measured on the basis of total number of billed minutes generated by our local customers making domestic and international long distance calls in cities open to competition. Our market share in Internet access is estimated to be 57.0%, measured on the basis of the total number of Internet access accounts in Mexico. We believe that, at present, competitors do not have a material share of the market for fixed-line local service, but we expect that this will change as the number of competitors grows and their market strategies develop. In local service, we also face competition from cellular carriers, which we estimate had a combined total of 26.2 million cellular lines in service at year-end 2002. We anticipate intensifying competition as a result of increased marketing strategies employed by cellular carriers.

Investments and Joint Ventures

We occasionally make investments and joint ventures in telecommunications-related businesses within and outside Mexico. The aggregated cost of such investment in 2002 was U.S.$7

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million. We also invest in publicly traded equity securities of companies in technology and communications businesses. As of December 31, 2002, we had P.1,585 million of marketable securities on our balance sheet. Our marketable securities are carried at market value, and gains and losses are recognized in our statement of income.

We had an interest in Prodigy Communications Corporation, one of the largest providers of Internet access in the United States, which we sold in November 2001 for U.S.$82.6 million. Pursuant to a license agreement, we retain the right to use the Prodigy name in Mexico free of charge and in perpetuity (subject to prior termination by mutual agreement of the parties).

In January 2002, we and certain partnerships affiliated with Forstmann Little & Co. entered into a stock purchase agreement with XO Communications, Inc., a financially-troubled U.S. competitive telecommunications service provider. We and Forstmann Little agreed to pay U.S.$400 million each to XO in exchange for common stock representing approximately 40% of the outstanding shares of XO after giving effect to a financial restructuring. Our agreement with XO was subject to a number of conditions, including a financial restructuring of XO to achieve the capital structure specified in the agreement, regulatory approvals and a number of other conditions. In October 2002, we and Fortsmann Little mutually agreed with XO to terminate the agreement, each paying XO U.S.$12.5 million, thus releasing all parties from any related claims.

We may expand our presence in telecommunications outside Mexico, especially in the United States and in Latin America, through selective investments and strategic alliances. There can be no assurance as to the extent, timing or cost of future international investments.

We have invested in equity securities and several series of bonds issued by MCI, Inc. (formerly known as WorldCom, Inc.), a U.S. based telecommunications company that is in Chapter 11 proceedings under the U.S. bankruptcy code. As of May 30, 2003, we held approximately U.S.$1,759 million in face amount of the bonds, with a market value of approximately U.S.$519 million at such date. For a number of reasons, we could face difficulty selling some or all of these bonds in the near term and their long-term value is highly uncertain.

Property

We have transmission facilities, exchanges, outside plant and commercial and administrative offices throughout Mexico. We own most of the locations of our exchanges and offices and lease other locations. We hold a small number of operating properties under financial leases, but the aggregate amount of such financing is not material to our operations as a whole. We carry casualty insurance against loss or damage to buildings and equipment contained in buildings and do not carry insurance against most other risks.

We have purchased equipment from a variety of suppliers, and there are sufficient alternative sources of equipment so that interruption of any source would be unlikely to cause a significant disturbance to our operations or our investment plan.

The Telmex Foundation

Since 1996, we have sponsored an independent philanthropic foundation called Fundación Telmex, A.C., or the Telmex Foundation, that is active in the areas of education, health, justice and culture. During 2002, the Telmex Foundation provided 8,314 scholarships to outstanding students, donated 1,050 personal computers that benefited 39 institutions and provided 10,000 eyeglasses for children. We have no ownership interest in the Telmex Foundation and we do not consolidate it in our financial statements. We contributed P.528.5 million in 2001 and P.1,377.0 million in 2000. We did

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not contribute to the Telmex Foundation in 2002. We do not expect to contribute to the Telmex Foundation in 2003.

The Telmex Foundation expanded its efforts in conjunction with Mexican government health agencies in providing specialized health care to people in remote areas through a surgery program that funded treatment for over 15,193 patients in 2002. The organ donation and transplant initiative was formally integrated into the Telmex Foundation s programs in 2002 as part of an effort to increase participation in organ donor registries. The Telmex Foundation distributed 23 million volunteer organ donation cards through telephone bills and in stores. In cooperation with non-governmental organizations, the Telmex Foundation provided assistance to 7,968 persons charged with minor crimes whose lack of financial resources prevented them from otherwise posting bail.

CAPITAL EXPENDITURES

The following table sets forth, in constant pesos as of December 31, 2002, our capital expenditures, before retirements, for each year in the three-year period ended December 31, 2002, restated in 2000 to reflect the spin-off of América Móvil:

	Year ended December 31,		
	2002	**2001**	**2000**
		(in millions of pesos)	
Exchanges and power	P. 1,589	P. 4,320	P. 5,129
Telephone equipment.	204	611	580
Outside plant	3,385	7,203	5,442
Transmission	4,071	8,446	5,076
Land and buildings	508	1,113	723
Miscellaneous	1,599	1,838	2,835
Investment in affiliates, subsidiaries and other	79	134	1,745
Total capital expenditures	P. 11,435	P. 23,665	P. 21,530

We have budgeted capital expenditures in an amount equivalent to approximately U.S.$1.1 billion for the year 2003. See Liquidity and Capital Resources under Item 5.

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REGULATION

Our business is subject to comprehensive regulation and oversight by the Communications Ministry and Cofetel. The Communications Ministry is part of the executive branch of the Mexican federal government, and Cofetel is an agency of the Communications Ministry. Regulation and oversight are governed by the *Ley de Vias Generales de Comunicación* (the Law of General Means of Communication, or the General Communications Law), the Telecommunications Regulations adopted under such law, the Federal Telecommunications Law, the Concession and other concessions and license agreements granted by the Communications Ministry.

Set forth below is a summary of certain provisions of the General Communications Law, the Federal Telecommunications Law, the Telecommunications Regulations and our Concession.

General

The General Communications Law, the Federal Telecommunications Law and the Telecommunications Regulations provide the general legal framework for the regulation of telecommunications services in Mexico. The Federal Telecommunications Law replaced most of the provisions of the General Communications Law relating to telephone communications, but those provisions of the General Communications Law not specifically addressed in the Federal Telecommunications Law, such as rules governing local and long distance carriers, remain in effect. Regulations implementing particular provisions of the Federal Telecommunications Law have been issued by the Communications Ministry or Cofetel. Regulations implementing other provisions of the Federal Telecommunications Law are pending. The objectives of the Federal Telecommunications Law are to promote the efficient development of the telecommunications industry, to encourage fair competition in the provision of quality, low-priced services and to assure satisfactory breadth of coverage of the Mexican population.

In October 2001, the Mexican Congress announced the beginning of a process to reform the Federal Telecommunications Law. Some of the proposals that have been discussed, such as strengthening the regulatory power of Cofetel, stimulating increased investment in telecommunications and increasing competition, could have a material effect on our operations. We are unable to predict whether or when such amendments may be implemented and, if implemented, their effect on our business.

Regulatory Oversight

The Communications Ministry is the Mexican government agency principally responsible for regulating telecommunications services. The Ministry s approval is required for any change in our bylaws. It also has broad powers to monitor our compliance with the Concession and it may revoke our Concession or temporarily seize or expropriate our assets. The Ministry may require us to supply it with such technical, administrative and financial information as it may request. We regularly provide reports to Cofetel on our operations, financial performance and other matters. We are also required to publish our annual network expansion program, and we must advise Cofetel of the progress of our expansion program on an annual basis.

The Federal Telecommunications Law provided for the establishment of an administrative agency, Cofetel, to regulate the telecommunications industry. Cofetel commenced operations in August 1996. It is an independent agency within the Communications Ministry, with four commissioners appointed by the Communications Ministry on behalf of the President of Mexico, one of whom is appointed as chairman. Many of the powers and obligations of the Communications

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Ministry under the Federal Telecommunications Law and the Telecommunications Regulations have been delegated to Cofetel.

Mexican law gives certain rights to the government in its relations with concessionaires and provides that we may not sell or transfer any of our assets unless we give the government a right of first refusal. If the government declines to exercise its right, our unions also have a right of first refusal. In addition, Mexican law permits the government to expropriate our assets in certain circumstances.

Concessions

Under the Federal Telecommunications Law and the Telecommunications Regulations, a provider of public telecommunications services must operate under a concession granted by the Communications Ministry. Such a concession may not be transferred or assigned without the approval of the Communications Ministry. A concession to provide public fixed-network long distance services has a term for up to 30 years and may be extended for additional 30-year terms. Our Concession was granted in 1976 and amended in August 1990, and will expire in 2026. Our subsidiary Telnor holds a separate concession in two states in northwestern Mexico, which will expire in 2026. The material terms of the Telnor concession are essentially the same as the Concession.

Operators of private networks that do not use electro-magnetic frequencies are not required to obtain a concession to provide private telecommunications services but are required to obtain approval from the Communications Ministry.

In addition to the Concession, we currently hold concessions for the use of frequencies to provide wireless local access and point-to-point and point-to-multipoint transmission, which we obtained from Cofetel through a competitive bidding process. These concessions are granted for a term up to 20 years and may be extended for additional 20-year terms.

Termination of the Concession

The Concession provides that it will remain in force until 2026, and that we may renew it for an additional 15 years subject to additional requirements the Communications Ministry may impose. Thereafter, it may be renewed for successive 30-year terms as provided under the Federal Telecommunications Law.

The Concession provides that upon its expiration the government is entitled to purchase our telecommunications assets at a price determined on the basis of an appraisal by a public official, and the Telecommunications Regulations provide that upon expiration of the Concession the government has a right of first refusal to acquire our telecommunications assets. The General Communications Law, however, provides that upon expiration of the Concession our telecommunications assets will revert to the government free of charge. There is substantial doubt as to whether the provisions of the Concession and the Telecommunications Regulations would prevail, and accordingly there can be no assurance that upon expiration of the Concession our telecommunications assets would not revert to the government free of charge.

The General Communications Law and the Concession include various provisions under which the Concession may be terminated before its scheduled expiration date. Under the General Communications Law, the Communications Ministry may cause early termination of the

Concession in certain cases, including:

failure to expand telephone services at the rate specified in the Concession;

- interruption of all or a material part of the services provided by us;
- transfer or assignment without Ministry approval of the Concession or any asset used to provide telephone service;
- violation of the prohibition against ownership of our shares by foreign states;
- any material modification of the nature of our services without prior Ministry approval, and
- breach of certain other obligations under the General Communications Law.

In addition, the Concession provides for early termination by the Communications Ministry following administrative proceedings in the event of:

- a material and continuing violation of any of the conditions set forth in the Concession;
- material failure to meet any of the service expansion requirements under the Concession;
- material failure to meet any of the requirements under the Concession for improvement in the quality of service;
- engagement in any telecommunications business not authorized under the Concession and requiring prior approval of the Communications Ministry;
- following notice and a cure period, failure without just cause to allow other concessionaires to interconnect their telephone networks to our telephone network; or
- our bankruptcy.

The General Communications Law provides that in the event of early termination of the Concession for specified causes, including violation of the prohibition on ownership of our shares by foreign states, we would forfeit all of our telecommunications assets to the government. In the event of early termination of the Concession for any other cause, the General Communications Law provides that a portion of our telecommunications assets would revert to the government free of charge, and that we may be required to dismantle the remaining portion. There is substantial doubt as to whether the provisions of the Concession and the Telecommunications Regulations regarding the consequences of expiration of the Concession would apply to mitigate the provisions of the General Communications Law in the event of early termination.

Dominant Carrier Regulations

The Federal Telecommunications Law provides that if a company is determined to be dominant in a relevant market, the Communications Ministry has the power to adopt specific regulations on rates, quality of service and information provided by a dominant provider. In February 1998, the Mexican Competition Commission issued a resolution confirming its determination that we are a dominant carrier in the following markets: (1) local telephone service, (2) access service, (3) inter-urban transport, (4) domestic long distance service, and (5) international long distance service. This resolution was held unconstitutional in May 2001.

In September 2000, Cofetel adopted specific regulations, which we refer to as the dominant carrier regulations, applicable to us as a dominant carrier. These resolutions were nullified in May 2002. The dominant carrier regulations applied to the five markets identified by the Competition

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Commission in 1998, and also to certain other services, including directory assistance, operator services and billing and collection services. They imposed standards for the quality of our services, and required that we prepare and provide specific information and specific tariff regulations. We have met or exceeded the standards established in the former regulations on quality of services and on information, and we believe we will be able to continue doing so without significant cost or competitive impact.

The most significant elements of the dominant carrier regulations were three specific rules on tariffs.

First, our prices for covered services must always exceed a floor price based on total average costs. The Concession says our price for any service must exceed the average incremental cost, and while the methodology for determining total average costs is not clear, it would presumably result in a higher floor price for the services to which it applies.

Second, the regulations prohibit any rate or rate package that reduces our operating margin in a competitive market, except as a defensive response to competitors rates that present a risk of substantial loss of market share.

Third, prices for services (other than interconnection) that we provide to other carriers would, for the first time, be subject to prior approval of Cofetel.

It is difficult to assess the impact these regulations would have had on tariffs or competition, in part because neither the methodologies nor the procedures were fully specified. We believe, however, that if similar rules were implemented in the future, they would, to some degree, reduce our flexibility to adopt competitive tariff policies.

After the Competition Commission issued the February 1998 resolution, we commenced constitutional proceedings in the Mexican Federal courts challenging the validity of the resolution, and we commenced a proceeding in the Mexican federal courts challenging the validity of the dominant carrier regulations. We asserted that they constituted a unilateral amendment of the terms of our Concession, which we believe is not permitted under the Mexican constitution or the terms of the Concession itself. We also asserted that the determination that we are a dominant carrier, on which Cofetel s power to issue these regulations was predicated, was flawed because the Competition Commission made its determinations in 1997 in reliance on earlier findings that were out of date, and because its determinations did not extend to all the markets covered by the dominant carrier regulations. Finally, we objected to the specific tariff regulations imposed by the dominant carrier regulations on a variety of grounds, including that they gave Cofetel excessive discretion, that they would unfairly burden competition and that they did not adequately permit us to recover our investments in infrastructure.

Following several appeals, the February 1998 resolution of the Competition Commission was held unconstitutional in May 2001. It is our assertion that all subsequent rulings by government agencies (including Cofetel) which relied upon the 1998 Resolution are also unconstitutional. We filed petitions to have dominant carrier regulations based on the 1998 Resolution declared unconstitutional, and in May 2002, several resolutions issued by the Competition Commission and Cofetel were nullified, including the September 2000 resolution adopting the dominant carrier regulations.

On May 21, 2001, the Competition Commission addressed the defect of the February 1998 resolution and issued a new resolution with the same terms in which it concluded that we are a dominant carrier in the same five markets. This resolution was affirmed by the Commission following an appeal, and in September 2001, we commenced constitutional proceedings in the Mexican federal courts challenging the validity of this new resolution. We cannot predict the outcome of these

proceedings or predict whether Cofetel will issue new regulations that are substantially similar to the prior dominant carrier regulations that were nullified in May 2002.

Rates

The General Communications Law, the Federal Telecommunications Law and the Telecommunications Regulations provide that the basis for setting rates of a telecommunications concessionaire is set forth in its concession.

Under the Concession, our rates in any period for basic telephone services, including installation, monthly rent, measured local service and long distance service, are subject to a ceiling on the price of a basket of such services weighted to reflect the volume of each service provided by us during the preceding period. Within this aggregate price cap, we are free to determine the structure of our own rates. We must publish our rates and register them with Cofetel before they may take effect.

The price cap varies directly with the Mexican National Consumer Price Index, permitting us to raise nominal rates to keep pace with inflation, subject to consultation with the Communications Ministry. In recent years, we have not raised our nominal rates to the full extent that would be permitted to keep pace with inflation. Under the Concession, the price cap is also adjusted downward periodically to pass on the benefits of increased productivity to our customers. The Concession fixed the adjustment for 1998 and 1999 at 0.74% per quarter in nominal terms, and requires the Communications Ministry to set a new periodic adjustment for every four-year period so as to permit us to maintain an internal rate of return equal to our weighted average cost of capital. The Communications Ministry fixed the adjustment per quarter in nominal terms at 1.11% for 1999-2002 and at 0.74% for 2003-2006.

For services extending beyond basic telephone service, under the Concession we are permitted to set our prices free of rate regulation. These services include connectivity, directory services and services based on digital technology such as caller ID, call waiting, speed calling, automatic redialing, three party calling and call forwarding. We are required to register the types, but not the rates, of new value-added services.

Expansion and Modernization Requirements

The Concession imposes a number of requirements for expansion and modernization of our telephone system. Most of these requirements were met by the end of 1994 and the remaining requirements were met by the end of 1998, including the requirement to reduce the maximum waiting period for new service in cities with automatic exchanges to one month by the year 2000.

Service Quality Requirements

The Concession also sets forth extensive goals for the quality and continuity of our service, including reductions in line failures, reductions in repair time, reductions in the time required to obtain dial tone, improvements in the percentage of calls completed on the first attempt and reductions in installation time. We are required to provide rebates to our customers if we fail to meet certain of the standards for quality of service set forth in the Concession. We have not been required to make any material general rebates since 1994.

Competition

The Telecommunications Regulations and the Concession contain various provisions designed to introduce competition in the provision of communications services. In general, the Communications

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Ministry is authorized to grant concessions to other parties for the provision of any of the services provided by us under the Concession. On August 10, 1996, the Communications Ministry opened to competition the Mexican market for fixed-line domestic and international long distance telephone services. There are currently eight competing long distance carriers operating in Mexico and concessions have been granted to a total of 22 long distance companies, 11 of which also have concessions for international long distance services.

In 1998, the Communications Ministry began granting licenses to competing local service carriers. As of December 31, 2002, there are 19 competitive fixed-line local operators that have been granted licenses, primarily in Mexico City, Guadalajara, Monterrey, Puebla and other large cities. See Telmex Competition. Concessions are not required to operate certain private local telecommunications networks or to provide value-added services, although other authorizations may be required.

The Communications Ministry released in June 1996 rules governing long distance services, together with basic technical plans for numbering and for signaling that address a number of technical issues including several relating to the commencement of competition in long distance services. The long distance rules establish the general framework for competitive long distance services, including rules regarding customer selection of carriers, allocation of service-related liabilities, subscription, billing and collection. They also provide for certain consultation and information-sharing mechanisms among service providers and with the Communications Ministry.

The Federal Telecommunications Law provides that the Communications Ministry may authorize resellers of long distance telecommunications services, but no regulations have been adopted implementing that provision of the law. The Communications Ministry may grant permits to long distance resellers in the future, and the impact on our operations and revenues is uncertain.

In December 1996, Cofetel issued rules governing international long distance services, covering matters such as international interconnection and mechanisms for routing calls into and out of Mexico. International traffic must be carried by Mexican concessionaires and through authorized international gateways consistent with the Cofetel s international long distance rules, and international long distance carriers must route traffic in and out of Mexico using uniform settlement rates negotiated with foreign carriers.

Incoming international calls are distributed among the Mexican carriers in proportion to the settlement fees paid in connection with outgoing international traffic originated by each of them. In 2001, we agreed with U.S. carriers to request that the respective Mexican and U.S. regulatory authorities modify the applicable regulations. In Mexico, these regulatory modifications would include, among others, the elimination of requirements that (i) all carriers pay the same rates, (ii) incoming international calls be distributed among the Mexican carriers in proportion to the outgoing calls they originate and (iii) the Mexican carrier with the largest market share on a particular international route negotiate rates for all Mexican carriers on that route.

In early 2002, we agreed to further settlement rate reductions with all U.S. carriers with which correspond. The agreements provided for settlement rates based on a rate structure that applies one of three factors, depending on the termination point of international calls. The agreements also reaffirmed the parties commitment to request that the relevant authorities modify the regulations governing the negotiation of settlement rates. In March 2002, we submitted the proposed agreements to the Mexican authorities for approval and Cofetel approved the rate structure in October 2002. The agreements were submitted to the FCC, but no action has been taken. The request for a change in regulation remains pending with Cofetel. We cannot yet predict the effects of any modification of the current proportionate return system on our financial performance or on our competitive situation.

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The competitive environment in the Mexican telecommunications industry has been the subject of controversy and of attention from Mexican regulators and from abroad.

- In September 2000, Cofetel adopted specific regulations applicable to us as a dominant carrier. These regulations were invalidated in May 2002. See Regulation Dominant Carrier Regulations.

- In the area of domestic interconnection, there has been extensive litigation, but agreements reached since December 2000 have reduced the level of controversy. See Telmex Competition.

- The United States has initiated WTO dispute settlement regarding alleged illegal barriers to competition in the Mexican telecommunications market and its claims will be addressed by a WTO dispute panel. See Telmex Competition.

Interconnection

Since January 1, 1997, we have been required under the Federal Telecommunications Law to permit any other long distance concessionaire to connect to our network in a manner that enables customers to choose the network by which their long distance calls are carried. The Communications Ministry issued the technical rules for the interconnection of competing long distance carriers with our network in July 1994, specifying that there would be an unlimited number of long distance concessions and that we would be required to provide interconnection points in 60 cities by December 1997 and in over 200 cities by the year 2000. We fulfilled these requirements. In addition, in 1997, Cofetel issued rules governing the interconnection rights and obligations of local service concessionaires. The rules require local service concessionaires to provide interconnection on a nondiscriminatory basis to any other concessionaire.

In June 1997, Cofetel ruled that we are entitled to recover certain costs of modifying our network to accommodate interconnection, by collecting a specific additional fee from all long distance carriers including ourselves over a period of seven years. The costs would be allocated among carriers pursuant to specific allocation mechanisms for each category of cost. One carrier commenced legal proceedings against the government in connection with the recovery of our interconnection investments. While resolution of these proceedings was pending, none of the carriers paid the additional fee.

The Concession provides that other terms of interconnection, including fees, are to be negotiated between us and each other long distance carrier, and that, in the event the parties are unable to agree, the Communications Ministry may impose terms on us and the other carriers. We were unable to agree with our competitors on interconnection rates for 1997 through 2000, and accordingly Cofetel imposed rates.

The interconnection fees imposed by Cofetel have been the subject of numerous legal challenges. We also brought proceedings contesting our obligation to renew the existing service agreements with competing carriers based on the new interconnection tariffs, on the grounds that the carriers had not honored the current agreements.

In December 2000, we reached an agreement with the two leading competing long distance carriers that addressed many of the outstanding disputes over interconnection. We agreed to the fixed tariff of U.S.$0.0125 per minute for interconnection of domestic long distance calls to the local network, which had been imposed by Cofetel in October 2000. We agreed on a variety of technical issues relating to interconnection and a mechanism for the recovery of our investment in modifying our

network to accommodate interconnection, by charging a supplemental interconnection fee to all long distance carriers including ourselves. The parties also agreed to withdraw their outstanding legal proceedings relating to interconnection, and they settled and paid all disputed amounts, which related primarily to interconnection fees. As a consequence of our agreements with other long distance carriers, all prior legal disputes regarding interconnection rates have been dismissed and all disputed amounts have been paid.

In December 2001, we agreed with the two leading competing long distance carriers to reduce the interconnection rate from U.S.$0.0125 to U.S.$0.00975 per minute and per interconnection point for 2002, with an additional discount of 15% for interconnection facilities and of 50% for call attempts. We also agreed to significant discounts on private lines and on other services. The remaining long distance carriers entered into agreements with us on the same terms in early 2002. The 2002 rate represented a decrease of 22% compared with the prior rate and is lower than the average international rate. Mutual discounts were also negotiated up to 45% below the best market rate offered to the public in local and long-distance private interconnection links and 45% below the price of co-location registered with Cofetel.

In February and March 2003 we agreed with nearly all of the long distance carriers to maintain the interconnection rate of U.S.$0.00975 per minute and per interconnection point for 2003. In addition, we agreed to a discount of the amounts being paid to cover the investments we made to modify our network for interconnection. Since 1997, we have reduced our interconnection rates by a total of 83.6%.

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Item 5. Operating and Financial Review and Prospects

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in this Annual Report.

Our consolidated financial statements have been prepared in accordance with Mexican GAAP, which differ in certain respects from U.S. GAAP. Note 18 to our audited consolidated financial statements provides a description of the principal differences between Mexican GAAP and U.S. GAAP, as they relate to us; a reconciliation to U.S. GAAP of operating income, net income and total stockholders equity; and a condensed statement of cash flows under U.S. GAAP.

Mexican GAAP requires that the financial statements recognize certain effects of inflation. In particular,

- nonmonetary assets (including plant, property and equipment of Mexican origin) and stockholders equity are restated for inflation based on the Mexican National Consumer Price Index; plant, property and equipment of non-Mexican origin are restated based on the rate of inflation in the country of origin and converted into Mexican pesos using the prevailing exchange rate at the balance sheet date,
- gains and losses in purchasing power from holding monetary assets and liabilities are recognized in income, and
- all financial statements are restated in constant pesos as of December 31, 2002.

We have not reversed the effect of inflation accounting under Mexican GAAP in the reconciliation to U.S. GAAP of our net income and stockholders equity, except with respect to the methodology for restatement of plant, property and equipment of non-Mexican origin. See Note 18 to the consolidated financial statements.

Results of Operations

We classify our operating revenues as local, long distance, interconnection and other. Revenues from long distance services include revenues from connectivity and Internet services. Other revenues are derived principally from equipment sales and telephone-related services such as directory services.

The principal factors affecting our revenues from local and long distance services have been rates and the volume of usage of telephone services. In addition, our financial statements have been restated in constant pesos and accordingly, the effect of rates on revenues is analyzed in terms of constant pesos as of December 31, 2002. When nominal rates do not increase by at least the rate of inflation, real rates decline.

In 2002, our results of operation were affected by a weak economic environment and declining real rates due to our decision not to increase our nominal rates and to increase discounts for some services, which resulted in lower revenues and lower margins. The number of lines in service continued to grow, but average revenue per line declined, partly because we have added new customers who have less disposable income and make less use of their lines. To reduce the impact of these factors, we implemented cost controls to reduce variable costs and defend our margins. We also experienced significant foreign exchange losses due to the devaluation of the peso.

In 2001, our results of operations were affected by changes in our rate structure, the impact of competition in long distance services and continued growth in demand for all services except

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international long distance. Growing demand and the expansion of our network resulted in growth in lines in service and increased domestic long distance traffic. International long distance traffic decreased in 2001 compared to 2000. For both domestic and international long distance service, prices fell as our real rates dropped due to our decision (i) not to raise our nominal rates and (ii) to increase customer discounts. Growth in cellular telecommunications and the introduction of calling party pays also greatly increased our interconnection revenues and expenses.

Competition and changing technologies have had extensive effects on our results of operation. In long-distance services, competition has reduced our market share and fostered competitive pressure on prices. In local service, the rapid growth in mobile telecommunications has made them the principal competitor for our local network. Growth in broadband access is a new development that will affect usage of other services, and we cannot yet predict the effect on our results of operations. We believe we are well positioned to continue meeting these challenges, but we cannot assure you as to the effect of competition and changing usage patterns on our results of operations and financial condition. In 2003, we expect only limited growth in usage and penetration of our telephony services, as the effect of expected continued economic weakness will be only partly offset by continued growth in demand for connectivity and Internet services. The outlook for stabilization of our margins and growth in our revenues is uncertain.

Our results of operations will also continue to be affected by the state of the Mexican economy, which is strongly influenced by the state of the U.S. economy. Demand for telecommunications services has been adversely affected since 2001 by the weak Mexican economy. Devaluation of the peso, such as occurred in 2002, also results in exchange losses on our foreign currency-denominated indebtedness.

Summary of Operating Income and Net Income

In the table below we set forth our operating revenues, operating costs and expenses (each expressed as a percentage of total operating revenues) and operating income as well as our comprehensive financing cost, provisions and net income for each of the years in the three-year period ended December 31, 2002.

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	Year ended December 31,					
	2002		2001		2000	
	(millions of pesos)	(percentage of operating revenue)	(millions of pesos)	(percentage of operating revenue)	(millions of pesos)	(percentage of operating revenue)
Operating revenues:						
Local service	P. 53,190	47.1%	P. 55,408	47.2%	P. 52,102	46.3%
Domestic long distance service	28,900	25.6	30,127	25.7	28,261	25.1
International long distance service	9,474	8.4	9,959	8.5	12,549	11.1
Interconnection service	15,560	13.8	15,546	13.3	13,824	12.3
Other	5,736	5.1	6,252	5.3	5,894	5.2
Total operating revenues	112,860	100.0	117,292	100.0	112,630	100.0
Operating costs and expenses:						
Cost of sales and services	25,649	22.7	25,546	21.8	24,338	21.6
Commercial, administrative and general	16,547	14.7	18,115	15.4	18,210	16.2
Interconnection	11,479	10.2	10,370	8.8	7,588	6.7
Depreciation and amortization	19,568	17.3	18,242	15.6	18,681	16.6
Total operating costs and expenses	73,243	64.9	72,273	61.6	68,817	61.1
Operating income	39,617	35.1%	45,019	38.4%	43,813	38.9%
Comprehensive financing cost:						
Interest income	(1,225)		(1,352)		(3,562)	
Interest expense	6,046		7,396		11,023	
Exchange loss (gain), net	4,444		(1,225)		(90)	
Monetary gain, net	(2,795)		(2,279)		(3,785)	
	6,470		2,540		3,586	
Income before income tax and employee profit sharing	33,147		42,479		40,227	
Provisions for:						
Income tax	10,325		14,036		8,647	
Employee profit sharing	3,002		3,155		3,649	
	13,327		17,191		12,296	
Income before equity in results of affiliates	19,820		25,288		27,931	
Equity in results of affiliates	(252)		(455)		(346)	
Income from continuing operations	19,568		24,833		27,585	