MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
For the Six Months Ended June 30, 2004

In the following discussion and analysis of our financial condition and results of operations, unless the context indicates or otherwise requires, references to "we," "us," "our" or "PLDT Group" mean the Philippine Long Distance Telephone Company and its consolidated subsidiaries, and references to "PLDT" mean the Philippine Long Distance Telephone Company, not including its consolidated subsidiaries (see Note 2 – Basis of Financial Statement Preparation to the accompanying financial statements for a list of these subsidiaries, including a description of their respective principal business activities).

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying financial statements and the related notes. Our financial statements, and the financial information discussed below, have been prepared in accordance with Philippine generally accepted accounting principles, or Philippine GAAP, which differs in certain significant respects from generally accepted accounting principles in the United States.

The financial information appearing in this report and in the accompanying financial statements is stated in Philippine pesos. All references to "pesos," "Philippine pesos" or "Php" are to the lawful currency of the Philippines; all references to "U.S. dollars," "US$" or "dollars" are to the lawful currency of the United States; all references to "Japanese yen," "JP¥" or "¥" are to the lawful currency of Japan and all references to "Euro" or "€" are to the lawful currency of the European Union. Translations of Philippine peso amounts into U.S. dollars in this report and in the accompanying financial statements were made based on the exchange rate of Php56.176 to US$1.00, the volume weighted average exchange rate at June 30, 2004 quoted through the Philippine Dealing System.

Some information in this report may contain forward-looking statements within the meaning of Section 27A of the U.S. Securities Act of 1933 and Section 21E of the U.S. Securities Exchange Act of 1934. We have based these forward-looking statements on our current beliefs, expectations and intentions as to facts, actions and events that will or may occur in the future. Such statements generally are identified by forward-looking words such as "believe," "plan," "anticipate," "continue," "estimate," "expect," "may," "will" or other similar words.

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. We have chosen these assumptions or bases in good faith, and we believe that they are reasonable in all material respects. However, we caution you that forward-looking statements and assumed facts or bases almost always vary from actual results, and the differences between the results implied by the forward-looking statements and assumed facts or bases and actual results can be material, depending on the circumstances. When considering forward-looking statements, you should keep in mind the description of risks and cautionary statements in this report. You should also keep in mind that any forward-looking statement made by us in this report or elsewhere speaks only as of the date on which we made it. New risks and uncertainties come up from time to time, and it is impossible for us to predict these events or how they may affect us. We have no duty to, and do not intend to, update or revise the forward-looking statements in this report after the date hereof. In light of these risks and uncertainties, any forward-looking statement made in this report or elsewhere might not occur.

Financial Highlights

(in millions)	June 30, 2004 (Unaudited)	December 31, 2003(1) (Audited)	Increase (Decrease) Amount	%
Consolidated Balance Sheets				
Total assets	Php300,899	Php297,626	Php3,273	1
Property, plant and equipment – net	243,444	244,427	(983)	–
Total debt	146,263	159,814	(13,551)	(8)
Total stockholders' equity	104,830	93,578	11,252	12
Debt to equity ratio	1.40x	1.71x	–	–

	Six Months Ended June 30,			
			Increase	
	2004	2003(1)	Amount	%
		(Unaudited)		
Consolidated Statements of Income				
Operating revenues	Php55,597	Php46,219	Php9,378	20
Operating expenses	33,055	31,919	1,136	4
Net operating income	22,542	14,300	8,242	58
EBIT(2)	21,449	8,060	13,389	166
EBITDA(3)	34,694	19,756	14,938	76
Net income	12,008	1,785	10,223	573
Operating margin	41%	31%	–	–
EBITDA margin	62%	43%	–	–
Consolidated Statements of Cash Flows				
Net cash provided by operating activities	Php35,010	Php23,081	Php11,929	52
Net cash used in investing activities	11,496	5,699	5,797	102
Capital expenditures	11,576	5,340	6,236	117
Net cash used in financing activities	20,352	17,090	3,262	19

(1) As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.

(2) EBIT is defined as earnings before minority interest in net income (losses) of consolidated subsidiaries, adding back interest expense and related items, taxes and deducting interest income. EBIT should not be considered in isolation or as a substitute for operating income, net income, cash flows from operating activities and other income or cash flow statement data prepared in conformity with generally accepted accounting principles, or as a measure of profitability or liquidity.

(3) EBITDA is defined as earnings before minority interest in net income (losses) of consolidated subsidiaries, adding back interest expense and related items, taxes, depreciation and amortization, deducting interest income and is presented because it is generally accepted as providing useful information regarding a company's ability to service and/or incur debt. EBITDA should not be considered in isolation or as a substitute for operating income, net income, cash flows from operating activities and other income or cash flow statement data prepared in conformity with generally accepted accounting principles, or as a measure of profitability or liquidity.

EBIT and EBITDA, on a consolidated basis for the six months ended June 30, 2004 and 2003, are derived as follows:

	Six Months Ended June 30,			
			Increase	
	2004	2003(b)	Amount	%
		(Unaudited)		
(in millions)				
Earnings before minority interest in net income of consolidated subsidiaries(a)	Php12,026	Php1,567	Php10,459	667
Add: Interest expense and related items - net(a)	5,868	5,592	276	5
Provision for income tax(a)	4,020	1,146	2,874	251
Less: Interest income(a)	465	245	220	90
EBIT	21,449	8,060	13,389	166
Add: Depreciation and amortization(a)	13,245	11,696	1,549	13
EBITDA	Php34,694	Php19,756	Php14,938	76

(a) See statements of income in the accompanying financial statements.

(b) As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.

Overview

We are the largest and most diversified telecommunications company in the Philippines. We have organized our business into three main segments:

- *Wireless* — wireless telecommunications services provided by PLDT's subsidiaries, Smart Communications, Inc., our cellular service provider, and Mabuhay Satellite Corporation, ACeS Philippines Cellular Satellite Corporation, and Telesat, Inc., our satellite and very small aperture terminal, or VSAT, operators;
- *Fixed Line* — fixed line telecommunications services primarily provided through PLDT. We also provide fixed line services through PLDT's subsidiaries PLDT Clark Telecom, Inc., Subic Telecommunications Company, Inc., Maratel, Inc. and Bonifacio Communications Corporation, which together account for approximately 1% of our consolidated fixed lines in service, and PLDT Global Corporation; and
- *Information and Communications Technology* — information and communications infrastructure and services for internet applications, internet protocol-based solutions and multimedia content delivery provided by PLDT's subsidiary ePLDT, Inc.; internet access services provided by ePLDT's subsidiary Infocom Technologies, Inc.; and e-commerce, call centers and IT-related services provided by other investees of ePLDT, as described in *Note 9 – Investments* to the accompanying financial statements.

Results of Operations

The table below shows the contribution by each of our business segments to our consolidated operating revenues, operating expenses and net operating income (losses) for the six months ended June 30, 2004 and 2003. Most of our revenues are derived from our operations within the Philippines. Our revenues derived from outside the Philippines consist primarily of revenues from incoming international calls to the Philippines.

	Six Months Ended June 30,					
					Increase (Decrease)	
	2004	**%**(1)	**2003**(2)	**%**(1)	**Amount**	**%**
			(Unaudited)			
(in millions)						
Operating Revenues						
Wireless	Php31,231	56	Php22,493	49	Php8,738	39
Fixed line	23,384	42	22,862	49	522	2
Information and communications technology	982	2	864	2	118	14
	55,597	100	46,219	100	9,378	20
Operating Expenses						
Wireless	15,841	28	14,610	32	1,231	8
Fixed line	16,241	29	16,289	35	(48)	–
Information and communications technology	973	2	1,020	2	(47)	(5)
	33,055	59	31,919	69	1,136	4
Net Operating Income (Losses)						
Wireless	15,390	28	7,883	17	7,507	95
Fixed line	7,143	13	6,573	14	570	9
Information and communications technology	9	–	(156)	–	165	106
	Php22,542	41	Php14,300	31	Php8,242	58

(1) Operating expenses and net operating income (losses) are computed as a percentage of operating revenues.
(2) As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.

Consolidated Operating Revenues

Largely driven by the continued strong growth of our wireless business, particularly Smart's cellular business, our consolidated operating revenues for the first half of 2004 increased by Php9,378 million, or 20%, to Php55,597 million from Php46,219 million in the same period in 2003. The revenue contribution of our wireless business accounted for 56% of our consolidated operating revenues for the first half of 2004, compared to 49% in the same period in 2003. Smart contributed Php30,903 million in revenues for the first half of 2004, an increase of 40% over its revenue contribution of Php22,117 million for the same period in 2003.

Wireless

Our wireless business segment offers cellular services as well as satellite, VSAT, and other services.

The following table summarizes our consolidated operating revenues from our wireless business for the six months ended June 30, 2004 and 2003 by service segment:

	Six Months Ended June 30,					
					Increase (Decrease)	
	2004	%	2003	%	Amount	%
			(Unaudited)			
(in millions)						
Wireless services:						
Cellular	Php30,903	99	Php22,117	98	Php8,786	40
Satellite, VSAT and others	328	1	376	2	(48)	(13)
Total	Php31,231	100	Php22,493	100	Php8,738	39

Our wireless service revenues increased by Php8,738 million, or 39%, to Php31,231 million in the first half of 2004 from Php22,493 million in the same period in 2003 mainly as a result of the continued strong growth in revenues generated from Smart's cellular service. Accordingly, as a percentage of our consolidated operating revenues, wireless service revenues increased to 56% in the first half of 2004 from 49% in the same period in 2003.

Cellular Service

Our cellular service revenues consist of:

- revenues derived from actual usage of the network by prepaid subscribers and any unused peso value of expired prepaid cards or electronic air time loads, net of discounts given to dealers;
- monthly service fees from postpaid subscribers, including (1) charges for calls in excess of allocated free local calls, (2) toll charges for national and international long distance calls, (3) charges for text messages of our GSM service customers in excess of allotted free text messages, and (4) charges for value-added services, net of related content provider costs;
- revenues generated from incoming calls and messages to our subscribers, net of interconnection expenses; fees from reciprocal traffic from international correspondents; and revenues from inbound international roaming calls for the GSM service;
- service fees charged to Pilipino Telephone Corporation, or Piltel, for using Smart's GSM network for Piltel's *Talk 'N Text* prepaid cellular service; and

- other charges, including those for reconnection and migration.

Proceeds from the sale of handsets and SIM packs are not recorded as part of cellular service revenues. Gains on the sale of handsets are offset against selling and promotions expense, while losses on the sale of handsets and SIM packs are included as part of selling and promotions expense.

Our cellular service revenues in the first half of 2004 amounted to Php30,903 million, an increase of Php8,786 million, or 40%, from Php22,117 million in the same period in 2003. Cellular service revenues accounted for 99% of our wireless revenues and contributed 56% to our consolidated operating revenues in the first half of 2004, compared to 48% in the same period in 2003. This increase was primarily due to the growth in Smart's subscriber base, which increased by 4,331,123, or 53%, from 8,143,389 as of June 30, 2003 to 12,474,512 as of June 30, 2004. The strong subscriber growth offset the decline in blended monthly gross and net ARPU, which dropped by 13% and 10%, respectively.

Smart markets nationwide cellular communications services under the brand names *Smart Buddy, Smart Gold, addict mobile, Smart Infinity* and *Smart Kid. Smart Buddy* is a prepaid service while *Smart Gold, addict mobile*, *Smart Infinity* and *Smart Kid* are postpaid services, which are all provided through Smart's digital GSM network. Introduced in April 2003, *addict mobile* offers exclusive multimedia content to subscribers and features personalized means for internet surfing, allowing subscribers to apply their allocated free credits towards their choice of data and value-added services. *Smart Infinity* is a premium postpaid plan, launched in January 2004 that caters to affluent and highly mobile market, offering first class quality services, including a round-the-clock dedicated personal concierge service, international assistance services, premium handset packages and exclusive lifestyle content. *Smart Kid*, launched in May 2004, is especially designed for children, ages 5 to 12 years old, and is equipped with "Family Finder" which automatically forwards the child's call to pre-assigned numbers on the phone, a location-based finder service to enable them to keep in touch with their family members, as well as educational value-added services content.

The following table summarizes key measures of our cellular business as of and for the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,			
			Increase	
	2004	**2003**	**Amount**	**%**
		(Unaudited)		
(in millions)				
Cellular revenues	Php30,903	Php22,117	Php8,786	40
GSM	30,643	21,937	8,706	40
By component	*27,193*	*19,767*	*7,426*	*38*
Voice	14,508	11,525	2,983	26
Data	12,685	8,242	4,443	54
By service type	*27,193*	*19,767*	*7,426*	*38*
Prepaid	25,165	18,178	6,987	38
Postpaid	2,028	1,589	439	28
GSM-Others(1)	*3,450*	*2,170*	*1,280*	*59*
Others(2)	260	180	80	44

	As of June 30,			
			Increase	
	2004	2003	Amount	%
	(Unaudited)			
GSM Cellular subscriber base	12,474,512	8,143,389	4,331,123	53
Prepaid	12,200,978	7,920,447	4,280,531	54
Postpaid	273,534	222,942	50,592	23
Systemwide subscriber base(3)	16,028,407	10,363,725	5,664,682	55

	Six Months Ended June 30,			
			Increase	
	2004	2003	Amount	%
	(Unaudited)			
Traffic volumes (in millions)				
Calls (in minutes)	2,041	1,709	332	19
Domestic	1,456	1,198	258	22
International	585	511	74	14
Inbound	511	442	69	16
Outbound	74	69	5	7
Text messages – outbound	16,774	10,744	6,006	56

(1) Refers to other non-subscriber-related revenues, such as facility service fees from Smart's revenue-sharing agreement with Piltel and inbound international roaming fees.

(2) Refers to all other services consisting primarily of revenues from Smart Money Holdings Corporation, public calling offices and SMARTalk payphones, and a small number of leased line contracts.

(3) Includes Piltel's Talk'N Text subscribers of 3,553,895 and 2,220,336 as of June 30, 2004 and 2003, respectively. Talk'N Text is a prepaid GSM service provided by Piltel using Smart's GSM network under a revenue-sharing agreement.

Voice Services

Smart's revenues from voice services, which include all voice traffic and voice value-added services such as voice mail and international roaming, increased by Php2,983 million, or 26%, to Php14,508 million in the first half of 2004 from Php11,525 million in the same period in 2003 mainly due to the increase in subscriber base.

Prior to January 2004, *Smart Buddy* subscribers were charged a rate of Php8.00 per minute for calls made during peak hours and Php4.00 per minute for calls made during off-peak hours regardless of whether the calls were made to subscribers within the Smart network or to other mobile operators' networks. Beginning January 2004, Smart implemented all-day flat air time rates for calls made by its prepaid subscribers. Calls terminating to other Smart and Piltel's *Talk 'N Text* subscribers are charged Php6.50 per minute, while an all-day flat rate of Php7.50 per minute is charged for calls terminating to other cellular network subscribers as well as local and NDD calls.

Air time rates for postpaid subscribers vary depending on type of postpaid plan selected by subscribers. Beginning January 25, 2004, *Smart Gold*, *Smart Infinity* and *addict mobile* launched flat rate-regular plans and consumable plans.

Data Services

Smart's revenues from cellular data services, which include all text messaging-related services as well as value-added services, increased by Php4,443 million, or 54%, to Php12,685 million in the first half of 2004 from Php8,242 million in the same period in 2003. Cellular data

services accounted for 41% of Smart's GSM cellular revenues in the first half of 2004, compared to 38% in the same period in 2003. Text messaging-related services contributed revenues of Php11,675 million in the first half of 2004, compared to Php7,720 million in the same period in 2003, and accounted for 92% and 94% of the total cellular data revenues for the first half of 2004 and 2003, respectively. The increase in revenues from text messaging-related services resulted mainly from a 56% increase in volume of text messages to 16,774 million outbound messages in the first half of 2004 from the 10,744 million outbound messages handled in the same period in 2003. Value-added services contributed revenues of Php1,010 million in the first half of 2004, increasing by Php488 million, or 93%, from Php522 million in the same period in 2003.

The following table shows the breakdown of Smart's cellular data revenues for the six months ended June 30, 2004 and 2003:

	Six months ended June 30,		**Increase (Decrease)**	
	2004	**2003**	**Amount**	**%**
		(Unaudited)		
(in millions)				
Text messaging				
Domestic	Php10,859	Php6,865	Php3,994	58
International	816	855	(39)	(5)
	11,675	7,720	3,955	51
Value-added services				
Non-Zed(1)	Php559	Php233	Php326	140
Smart Zed™	197	210	(13)	(6)
Mobile Banking, Roaming SMS, WAP, *Smart Money*	254	79	175	222
	1,010	522	488	93
Total	Php12,685	Php8,242	Php4,443	54

(1) Value-added services developed by Smart on its own platform.

Facility Services

Smart's revenues from GSM service in the first half of 2004 and 2003 included facility service fees totaling Php2,814 million and Php1,823 million, respectively, representing Smart's 50% share from Piltel's *Talk 'N Text* revenues, net of interconnection fees. As of June 30, 2004, Piltel had 3,553,895 *Talk 'N Text* subscribers compared to 2,220,336 subscribers as of June 30, 2003 using Smart's GSM network pursuant to a facilities service agreement between Smart and Piltel. See *Note 15 – Related Party Transactions* to the accompanying financial statements for a description of this agreement.

Subscriber Base, ARPU and Churn Rates

Of Smart's 12,474,512 GSM subscribers as of June 30, 2004, prepaid subscribers accounted for approximately 98% while postpaid subscribers accounted for the remaining 2%. Smart's prepaid GSM subscriber base grew by 54% to 12,200,978 as of June 30, 2004 from 7,920,447 as of June 30, 2003, whereas Smart's postpaid GSM subscriber base increased by 23% to 273,534 as of June 30, 2004 from 222,942 as of June 30, 2003. Smart's prepaid and postpaid net subscriber activations totaled 2,369,843 and 24,557, respectively, in the first half of 2004, or a monthly average addition of 394,974 prepaid and 4,093 postpaid subscribers. Smart's prepaid GSM gross activations in the first half of 2004 averaged 616,395 subscribers per month compared to an average of 438,900 subscribers per month in the same period in 2003.

Revenues attributable to Smart's prepaid service amounted to Php25,165 million in the first half of 2004, a 38% increase over the Php18,178 million earned in the same period in 2003.

Net prepaid revenues in the first half of 2004 accounted for 93% of GSM voice and data revenues, compared to 92% in the same period in 2003. Revenues attributable to Smart's postpaid service amounted to Php2,028 million in the first half of 2004, a 28% increase over the Php1,589 million earned in the same period in 2003. Net postpaid revenues in the first half of 2004 accounted for 7% of GSM voice and data revenues, compared to 8% in the same period in 2003.

The following table summarizes Smart's usage-based monthly ARPUs for the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,							
	Gross		(Decrease)		Net		(Decrease)	
	2004	2003	Amount	%	2004	2003	Amount	%
	(Unaudited)							
Prepaid	Php459	Php530	Php(71)	(13)	Php381	Php421	Php(40)	(10)
Postpaid	1,709	1,734	(25)	(1)	1,282	1,302	(20)	(2)
Blended	489	563	(74)	(13)	402	445	(43)	(10)

ARPU is computed for each month by dividing the revenues for the relevant services for the month by the average of the number of subscribers at the beginning and at the end of the month. Gross monthly ARPU is computed by dividing the revenues for the relevant services, gross of dealer discounts and allocated content-provided costs, including interconnection income but excluding inbound roaming revenues, by the average number of subscribers. Net monthly ARPU, on the other hand, is calculated based on revenues net of dealer discounts and allocated content-provided costs and interconnection income net of interconnection expense. ARPU for any period of more than one month is calculated as the simple average of the monthly ARPUs in that period.

Smart's prepaid service revenues consist mainly of charges for subscribers' actual usage of their prepaid cards. Gross monthly ARPU for Smart's prepaid GSM service in the first half of 2004 was Php459, a decrease of 13%, compared to Php530 in the same period in 2003. The decline was attributable mainly to a decrease in the average outbound local voice revenue per subscriber in the first half of 2004. On a net basis, ARPU in the first half of 2004 decreased by 10% to Php381 from Php421 in the same period in 2003. The lower rate of decrease in net ARPU compared to the decrease in gross ARPU resulted mainly from a lower average interconnection expense per subscriber on the back of the increasing percentage of Smart-to-Smart traffic to local voice traffic, to 64% in the first half of 2004 from 58% in the same period in 2003, as well as lower dealer discounts on *Smart Load.* Smart currently expects its prepaid ARPUs to continue to decline now that lower-denomination reloads are available and as it continues its expansion into the lower end of the market.

Monthly ARPU for Smart's postpaid GSM service is calculated in a manner similar to that of prepaid service, except that the revenues consist mainly of monthly service fees and charges on usage in excess of the monthly service fees. Until April 2003, pre-termination fees were reported as part of usage revenues and included in the calculation of postpaid ARPUs; pre-termination fees of Php196 million were included in the ARPU computation during the first quarter of 2003, which were subsequently reversed in the second quarter of 2003. ARPU is a measure associated with a subscribers' actual usage of the network on which pre-termination fees would have had no effect. Beginning the first half of 2003, pre-termination fees were included, upon collection, under "Others" of "GSM Revenues" and are therefore no longer included for the purpose of calculating ARPUs.

Gross and net monthly ARPUs for postpaid GSM subscribers in the first half of 2004 slightly decreased by 1% and 2%, respectively, compared to the ARPU levels in the same period in 2003. Smart's GSM monthly gross blended ARPU was Php489 in the first half of 2004, a decrease of 13% compared to Php563 in the same period in 2003. Blended net monthly ARPU decreased by 10% to Php402 in the first half of 2004 from Php445 in the same period in 2003.

Smart's 50% share of Piltel's revenues from *Talk 'N Text* under a revenue-sharing agreement between Smart and Piltel is not included in the computations of Smart's ARPUs.

Churn, or the rate at which existing subscribers have their service canceled in a given period, is computed based on total disconnections in the period, net of reconnections in the case of postpaid subscribers, divided by the average of the number of subscribers at the beginning and the end of a month, all divided by the number of months in the same period.

In the past, a prepaid cellular subscriber was recognized as an active subscriber when that subscriber activated and used the SIM card in the handset, which already contains Php50 of pre-stored air time (reduced from Php100 in April 2004). Subscribers can reload their air time by purchasing prepaid "call and text" cards that are sold in denominations of Php300, Php500 and Php1,000 or, by purchasing additional air time "over the air" via *Smart Load* in smaller denominations of Php30, Php60, Php115 and Php200, by receiving loads of Php2, Php5, Php10 and Php15 via *Pasa Load*, or through their handsets using *Smart Money*. Reloads have validity periods ranging from one day to two months, depending on the amount reloaded. A GSM prepaid account is disconnected if the subscriber does not reload within four months after the full usage or expiry of the last reload. Our current policy is to recognize a prepaid subscriber as "active" only when the subscriber activates and uses the SIM card and reloads at least once during the month of initial activation or in the immediate succeeding month. For example, if a customer activated a SIM card in April 2004 but had not reloaded by May 31, 2004, this customer would not be counted as a subscriber. The rationale for this change stems from our observance of the aggressive "SIM-swapping" activities in the market beginning February 2004. "SIM-swapping" refers to the promotional activity wherein subscribers can exchange their current prepaid SIM card for another operator's SIM card at no cost to the subscriber. We believe that these activities have given rise to a situation where certain subscribers may swap their SIM cards between mobile operators upon full usage of the pre-stored air time, which, without the adjustment to subscriber recognition, would have led, based on the approach used in the past, to an overstatement of our prepaid subscriber base. Without this change in subscriber recognition, our prepaid subscriber base would have been recorded at 12,703,101, a difference of 502,123 subscribers, from our reported prepaid subscriber base of 12,200,978 as of June 30, 2004.

For Smart's prepaid GSM subscribers, the average monthly churn rate for the first half of 2004 was 2.0%, compared to 3.1% for the same period in 2003. In line with the various churn management initiatives implemented to address increased churn rates, in May 2003, Smart introduced *Smart Load*, an "over-the-air" electronic loading facility designed to make reloading of air time credits more convenient for, and accessible to consumers. These "over-the-air" reloads, which have both voice and text functions, are packaged in smaller denominations of Php30, Php60, Php115 and Php200, but have shorter validity periods of three days, six days, 12 days and 30 days, respectively. Starting with just 50,000 outlets when it was launched, *Smart Load's* distribution network now encompasses over 500,000 retail agents, approximately 90% of which are micro businesses. As of June 30, 2004, approximately 91% of *Smart Buddy* subscribers were using *Smart Load* as their reloading mechanism. In the first half of 2004, *Smart Load* has accounted for approximately 61% of sales derived from reloads.

On December 24, 2003, Smart introduced *Pasa Load* (literally means "transfer load"), a derivative service of *Smart Load* that allows for Php10 load transfers to other *Smart Buddy* and Piltel *Talk 'N Text* subscribers. On January 25, 2004, denominations of Php2, Php5 and Php15 were added to the *Pasa Load* menu. All *Pasa Load* denominations have a one-day expiry period. We believe that *Smart Load* and *Pasa Load* will encourage subscribers to stay within our cellular network instead of churning and re-subscribing at a later time.

Beginning April 18, 2004, *Pasa Load* was also made available to Smart postpaid subscribers as well with identical denominations to those offered to prepaid subscribers. The denominations have a similar one-day load expiry. The sender will be billed the amount of the load and a Php1.00 transaction fee which will be added on top of the monthly service fee.

The average monthly churn rate for Smart's postpaid GSM subscribers for the first half of 2004 was 0.4%, compared to 3.9% in the same period in 2003. Smart's policy is to redirect outgoing calls to an interactive voice response system if the postpaid subscriber's account is either 45 days overdue or the subscriber has exceeded the prescribed credit limit. If the subscriber does not make a payment within 44 days of redirection, the account is disconnected. Within this 44-day period, a series of collection activities are implemented, involving the sending of a collection letter, call-out reminders and collection messages via text messaging.

Satellite, VSAT and Other Services

Our revenues from satellite, VSAT and other services consist mainly of rentals received for the lease of Mabuhay Satellite's transponders and Telesat's VSAT facilities to other companies and charges for ACeS Philippines' satellite phone service. Total revenues from these services for the first half of 2004 amounted to Php328 million, a decrease of Php48 million, or 13%, from Php376 million in the same period in 2003.

Fixed Line

Our fixed line business provides local exchange service, international and national long distance services, data and other network services, and miscellaneous services. Revenues generated from this business for the first half of 2004 totaled Php23,384 million, an increase of Php522 million, or 2%, from Php22,862 million for the same period in 2003. This increase was due to higher revenues generated from our international and national long distance services and data and other network services, partially offset by decreased revenues from local exchange service and miscellaneous services. As a percentage of our consolidated operating revenues, however, fixed line revenues decreased for the first half of 2004 to 42% from 49% in the same period in 2003 principally due to the continued strong growth of our wireless business.

The following table summarizes our consolidated operating revenues from our fixed line business for the six months ended June 30, 2004 and 2003 by service segment:

	Six Months Ended June 30,					
					Increase (Decrease)	
	2004	%	2003	%	Amount	%
	(Unaudited)					
(in millions)						
Fixed line services:						
Local exchange	Php10,379	44	Php10,465	46	Php(86)	(1)
International long distance	6,356	27	6,049	26	307	5
National long distance	3,487	15	3,292	14	195	6
Data and other network	3,019	13	2,876	13	143	5
Miscellaneous	143	1	180	1	(37)	(21)
Total	Php23,384	100	Php22,862	100	Php522	2

Local Exchange Service

Our local exchange service revenues consist of:

- flat monthly fees for our postpaid service;
- installation charges and other one-time fees associated with the establishment of customer service;
- fixed charges paid by other telephone companies, charges retained by PLDT for calls terminating to cellular subscribers within the local area, and local access charges paid by cellular operators for calls by cellular subscribers that terminate to our local exchange network;
- revenues from usage of prepaid cards for calls within the local area and any unused peso value of expired prepaid cards;
- call revenues generated from payphones and coin-operated phones; and
- charges for special features, including bundled value-added services such as call waiting, call forwarding, multi-party conference calling, speed calling and caller ID.

The following table summarizes key measures of our local exchange service business segment as of and for the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,			
			Increase (Decrease)	
	2004	2003	Amount	%
	(Unaudited)			
Consolidated local exchange revenues (in millions)	Php10,379	Php10,465	Php(86)	(1)
Number of fixed lines in service:				
PLDT Group	2,154,354	2,085,243	69,111	3
PLDT	2,132,404	2,060,437	71,967	3
Number of PLDT employees	9,992	11,237	(1,245)	(11)
Number of PLDT fixed lines in service per PLDT employee	213	183	30	16

Revenues from our local exchange service for the first half of 2004 decreased by Php86 million, or 1%, to Php10,379 million from Php10,465 million for the same period in 2003. The decrease was primarily due to the (1) shifting subscriber preference from postpaid to prepaid

services, which generate lower average revenue per subscriber, and (2) decline in installation revenues due to a promotion starting July 2003 which waived installation cost of subscribers in an effort to stimulate subscriber growth, partially offset by adjustments in our monthly local service rates. The percentage contribution of local exchange revenues to our total fixed line revenues also decreased for the first half of 2004 to 44% from 46% in the same period in 2003.

Gross additions to PLDT's fixed lines in service for the first half of 2004 totaled 350,490, an increase of 159,059 from the gross additions of 191,431 for the same period in 2003. On a net basis, PLDT’s fixed line additions for the first half of 2004 increased to 16,733 as against a decrease of 32,102 for the same period in 2003. While fixed line additions totaled 33,287 for PLDT’s prepaid fixed line services, PLDT’s postpaid fixed lines in service declined by 16,554 for the first half of 2004. As of June 30, 2004, PLDT’s postpaid and prepaid fixed line subscribers totaled 1,741,813 and 390,591, respectively, which accounted for approximately 82% and 18%, respectively, of PLDT’s total fixed lines in service.

Initially intended as an affordable alternative telephone service for consumers under difficult economic conditions, our prepaid fixed line services now form an important part of PLDT's overall churn and credit risk exposure management and subscriber retention strategy. Prepaid phone kits, each containing Php500 worth of pre-stored call credits, are sold for Php1,900 per unit. Prepaid subscribers are charged based on usage at a rate of Php1.00 per minute for local calls and the same rates are applicable to postpaid fixed line subscribers for national and international long distance calls.

A prepaid fixed line subscriber is recognized as an active subscriber when that subscriber activates and uses a prepaid call card. Prepaid fixed line subscribers can reload their accounts by purchasing call cards that are sold in denominations of Php500, Php300 and Php150. Reloads are valid for two months for the Php500 and Php300 card. The lower denominated Php150 card, launched in September 2003, has an account life of 15 days. A prepaid fixed line subscriber is disconnected if that subscriber does not reload within one month for the Php500 card, four months for the Php300 card, and 15 days for the Php150 card after the expiry of the last reload. All sales of prepaid cards, whether through dealers or through PLDT's business offices, are non-refundable.

Pursuant to a currency exchange rate adjustment mechanism authorized by the Philippine National Telecommunications Commission, or the NTC, we adjust our monthly local service rates upward or downward by 1% for every Php0.10 change in the peso-to-dollar exchange rate relative to a base rate of Php11.00 to US$1.00. During the first half of 2004, we implemented four upward and one downward adjustments in our monthly local service rates compared to four upward and three downward adjustments during the same period in 2003. The average peso-to-dollar rate for the first half of 2004 was Php55.952 to US$1.00, compared to the average of Php53.504 to US$1.00 for the same period in 2003. This change in the average peso-to-dollar rate translated to a peso depreciation of 5%, which resulted in an average net increase of 4% in our monthly local service rates for the first half of 2004.

The ratio of PLDT fixed lines in service per PLDT employee improved from 183 as of June 30, 2003 to 213 as of June 30, 2004. This improvement resulted from the net decrease in PLDT’s employee headcount. As of June 30, 2004, PLDT’s workforce was reduced by 11% to 9,992 employees from 11,237 employees as of June 30, 2003, mainly on account of PLDT’s manpower rightsizing program, or MRP.

International Long Distance Service

Our international long distance revenues, which we generate through our international gateway facilities, consist of:

- inbound call revenues representing settlements from foreign telecommunications carriers for inbound international calls, virtual transit and hubbing service and reverse charged calls such as received collect and home country direct service;

- access charges paid to us by other Philippine telecommunications carriers for terminating inbound international calls to our local exchange network; and

- outbound call revenues representing amounts billed to our customers (other than our cellular customers) for outbound international calls, net of amounts payable to foreign telecommunications carriers for terminating calls in their territories.

The following table shows information about our international fixed line long distance business for the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,			
			Increase (Decrease)	
	2004	2003	Amount	%
	(Unaudited)			
Consolidated international long distance revenues (in millions)	Php6,356	Php6,049	Php307	5
Inbound	5,218	5,052	166	3
Outbound	1,138	997	141	14
International call volumes (in million minutes, except call ratio)				
PLDT Group	1,159	1,196	(37)	(3)
Inbound	1,083	1,114	(31)	(3)
Outbound	76	82	(6)	(7)
Inbound-outbound call ratio	14.3:1	13.6:1	–	–
PLDT	1,146	1,117	29	3
Inbound	1,071	1,037	34	3
Outbound	75	80	(5)	(6)
Inbound-outbound call ratio	14.3:1	13.0:1	–	–

Our consolidated international long distance revenues increased by Php307 million, or 5%, to Php6,356 million in the first half of 2004 from Php6,049 million in the same period in 2003, primarily as a result of an increase in our inbound international long distance revenues principally driven by an increase in average inbound termination rates. Likewise, the percentage contribution of international long distance revenues to our total fixed line revenues slightly increased to 27% in the first half of 2004 from 26% in the same period in 2003.

Our revenues from inbound international long distance calls in the first half of 2004 increased by Php166 million, or 3%, to Php5,218 million from Php5,052 million in the same period in 2003 primarily due to the positive impact of the depreciation of the average value of the peso relative to the U.S. dollar and an increase in PLDT's average inbound termination rates, partially offset by the effect of lower inbound call volumes.

The depreciation of the peso contributed to the increase in our inbound international long distance revenues in peso terms since settlement charges for inbound calls are billed in U.S. dollars or in special drawing rights, an established method of settlement among international

telecommunications carriers using values based on a basket of foreign currencies, that are translated into pesos at the prevailing exchange rates at the time of billing. The average conversion rate was Php56.09 for the first half of 2004 and Php53.49 for the first half of 2003.

After lengthy negotiations commencing in May 2002 with carriers around the world, PLDT increased its average termination rates with carriers that account for a substantial portion of its international inbound traffic terminating on its fixed line network to approximately US$0.12 per minute effective February 1, 2003. Prior to the increase in termination rates, a substantial portion of PLDT's international inbound traffic terminating on its fixed line network was charged an average termination rate of approximately US$0.08 per minute. For further discussion, please see *Note 25 – Other Matters – U.S. Federal Communications Commission, or U.S. FCC, Ruling versus Philippine Telecommunications Companies* to the accompanying financial statements.

Our inbound international long distance call volumes in the first half of 2004 decreased by 3% to 1,083 million minutes from 1,114 million minutes in the same period in 2003, primarily due to increased competition from alternative means of long distance communications, particularly e-mailing, international text messaging and internet telephony and more inbound calls terminating directly to cellular subscribers.

Our revenues from outbound international long distance calls in the first half of 2004 increased by Php141 million, or 14%, to Php1,138 million from Php997 million in the same period in 2003. The depreciation of the peso contributed to the increase in outbound international long distance revenues in peso terms because outbound calls are charged at U.S. dollar rates and billed to our subscribers in pesos at the prevailing exchange rates at the time of billing. Average billing rates were Php55.85 and Php53.51 for the first half of 2004 and 2003, respectively.

Our outbound international long distance call volumes declined by 7% to 76 million minutes in the first half of 2004 from 82 million minutes in the same period in 2003, primarily due to cellular substitution (subscribers opting to use cellular for international outbound calls) and the popularity of alternative means of communications such as e-mailing, international text messaging and internet telephony.

National Long Distance Service

Our national long distance revenues consist of:

- per minute charges for calls made by our fixed line customers outside of the local service areas but within the Philippines, net of interconnection charges payable for calls carried through the backbone network of, and/or terminating to the customer of, another telecommunications carrier; and
- access charges received from other telecommunications carriers for calls carried through our backbone network and/or terminating to our customers.

The following table shows our national long distance revenues and call volumes for the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,			
			Increase (Decrease)	
	2004	2003	Amount	%
	(Unaudited)			
Consolidated national long distance revenues (in millions)	Php3,487	Php3,292	Php195	6
National long distance call volumes (in million minutes)				
PLDT Group	969	1,035	(66)	(6)
PLDT	943	1,023	(80)	(8)

Our national long distance revenues increased by Php195 million, or 6%, to Php3,487 million in the first half of 2004 from Php3,292 million in the same period in 2003 as a result of increased national direct dial, or NDD, rates and more beneficial interconnection agreements with cellular operators. Accordingly, the percentage contribution of national long distance revenues to our total fixed line revenues increased to 15% in the first half of 2004 from 14% in the same period in 2003.

Effective March 1, 2003, the rate for NDD calls originating from PLDT subscribers and terminating to other local exchange carriers increased to Php5.00 per minute from a flat rate of Php4.50 per minute. In addition, NDD calls originating from and terminating to PLDT was also adjusted to Php5.00 per minute from a flat rate of Php4.50 per minute effective June 8, 2003.

Further, we have entered into more beneficial interconnection agreements with cellular operators. Beginning January 2004, our settlement rate to cellular operators of Php4.50 per minute was reduced to Php4.00 per minute for calls terminating to cellular subscribers. At the same time, the cellular operators' settlement rate for calls terminating to PLDT subscribers increased from Php2.50 per minute to Php3.00 per minute. In 2003, certain local exchange carriers, previously under revenue sharing arrangements, entered into access charging agreements with PLDT. Under the revenue sharing agreements, charges are generally apportioned 30% for the originating entity, 40% for the backbone owner and another 30% for the terminating entity. Under these access charging agreements, the originating carrier generally pays access charges of (1) Php0.50 per minute for short haul traffic and Php1.25 per minute for long haul traffic to the carrier owning the backbone network; and (2) Php1.00 per minute to the terminating carrier. This change in interconnection charges resulted in a 7% decrease in average revenue per minute for calls originating from and terminating to other local exchange carriers.

Our national long distance call volumes, however, decreased by approximately 6% to 969 million minutes in the first half of 2004 from 1,035 million minutes in the same period in 2003. Cellular substitution and the widespread availability and growing popularity of alternative non-voice means of communications, particularly cellular text messaging and e-mailing, have negatively affected call volumes.

Data and Other Network Services

In the first half of 2004, our data and other network services posted a revenue of Php3,019 million, an increase of Php143 million, or 5%, from Php2,876 million in the same period in 2003. The revenue contribution of this service segment to our total fixed line revenues remained relatively flat at 13% in the first half of 2004 and 2003.

Data and other network services we currently provide include traditional bandwidth services, broadband/packet-based/internet-based services and other packet-based switching services.

The foregoing services are used for domestic and international communications, broadband data transmission services, internet exchange services, private networking services, switch-based services and international packet-based services.

Traditional bandwidth services accounted for 39% of the total revenues from PLDT's data and other network services in the first half of 2004, broadband/IP-based services accounted for 55%, and other services accounted for the remaining 6%, compared to 53%, 41% and 6%, respectively, in the same period in 2003. These percentage changes indicate a continuing shift in data and other network revenues from traditional bandwidth services to broadband/IP-based services. We expect this trend to continue given the growing demand for broadband transmission of voice, data and video due to the continued growth of the internet, e-commerce and other online services.

PLDT offers two residential internet service packages targeting separate markets: *PLDT Vibe* for light to medium internet users and *DSL* broadband for heavy internet users. As of June 30, 2004, the number of PLDT's fixed line subscribers for *PLDT Vibe* stood at 344,527, of which 181,168 were postpaid and 163,359 were prepaid subscribers, compared to 117,110 as of June 30, 2003, of which 84,566 were postpaid and 32,544 were prepaid subscribers, while the number of *DSL* subscribers reached 33,576 and 14,579 as of June 30, 2004 and 2003, respectively.

In April 2004, PLDT introduced additional enhanced IP-based solutions under an umbrella brand *IP-Plus*, namely, *Quality of Service*, or *QoS*, *IP Security*, or *IP Sec*, and *Voice over Virtual Private Network*, or *VoVPN*. With *QoS*, customers are given priority service for voice, premium and basic, with the highest priority given to voice since it requires error-free transmission. *IP Sec* optimizes the latest encryption technology to ensure utmost confidentiality of vital information. *VoVPN* gives customers toll-grade quality sans the cost of toll. All these *IP Plus* solutions translate to cost-efficiency, high reliability and increased security and flexibility.

In June 2004, PLDT established an Innovation Laboratory, or *Innolab*, in Cebu, a show and demo room where existing and potential clients as well as students can have a hands-on experience on various PLDT products and services designed for our corporate clientele. It also serves as a venue for testing software applications and computer programs and is expected to be the starting ground for innovative ideas where new products and cost-effective solutions unfold.

Miscellaneous

Miscellaneous revenues are derived mostly from directory advertising and facilities rental. In the first half of 2004, these revenues decreased by Php37 million, or 21%, to Php143 million from Php180 million in the same period in 2003. The decline was mainly due to a decrease in royalty fee on account of a change in revenue sharing agreement from collection rate to a fixed/flat rate. Miscellaneous revenues accounted approximately 1% of our total fixed line revenues in the first half of 2004 and 2003, respectively.

Information and Communications Technology

Our information and communications technology business is conducted by ePLDT, a wholly-owned subsidiary of PLDT. ePLDT's principal business is its operation of an internet data center under the brand name *Vitro*™. Granted pioneer status as an internet data center by the

Philippine Board of Investments, or BOI, *Vitro*™ provides co-location services, server hosting, hardware and software maintenance services, website development and maintenance services, webcasting and webhosting, shared applications, data disaster recovery and business continuity services, intrusion detection, and security services such as firewall and managed firewall.

ePLDT is focused on developing its call center business which capitalizes on the availability of English-speaking labor in the Philippines. The call center service business is being undertaken by the following wholly-owned subsidiaries:

- Vocativ Systems, Inc., or Vocativ, which owns and operates a 722-seat call center facility with 677 customer service representatives, or CSRs, exclusively for clients of a global provider of customer relationship management services. Vocativ is currently expanding its capacity by 369 seats which will become operational by the fourth quarter of 2004; and
- Parlance Systems, Inc., or Parlance, which owns and operates a 767-seat call center facility with 862 CSRs, exclusively for one of the largest direct-to-home satellite service providers in the United States for customer support and billing requirements. Parlance is further expanding its capacity by 274 seats to accommodate anticipated increased call volumes from its existing client.

ePLDT has also invested in a number of other e-commerce and internet-related businesses, which includes:

- 99.6% interest in Infocom, one of the country's leading internet service providers. Infocom offers consumer prepaid and postpaid internet access, corporate leased lines, dedicated dial-up, multi-user dial-up, broadband internet access thru *DSL* or *NOW* cable internet; web consulting, development and hosting; and
- 52.09% interest in Digital Paradise, Inc., or DigiPar, an internet café business which assumed the assets and brand of *Netopia*. *Netopia* is now one of the largest and fastest growing internet café chains in the country with over 85 branches and over 4,000 work stations. DigiPar offers high-speed internet services, including internet advertising, gaming, printing and sale of retail items.

Please refer to *Note 9 – Investments* to the accompanying notes to financial statements for further discussion on ePLDT's other information and communications technology services.

In the first half of 2004, our information and communications technology business generated total revenues of Php982 million, an increase of Php118 million, or 14%, from the Php864 million in the same period in 2003. These revenues accounted for 2% of our consolidated operating revenues for the first half of 2004 and 2003. ePLDT's call center business contributed revenues of Php519 million, internet service contributed revenues of Php256 million and *Vitro*™ and others contributed revenues of Php207 million, representing 53%, 26% and 21%, respectively, of the total revenues from our information and communications technology business in the first half of 2004, compared to 56%, 21% and 23% in the same period in 2003. Going forward, we expect revenues from our call center business to continue to contribute significantly to our information and communications technology revenues with the growing demand for call center services.

Consolidated Operating Expenses

Our consolidated operating expenses in the first half of 2004 increased by Php1,136 million, or 4%, to Php33,055 million from Php31,919 million in the same period in 2003. The increase was primarily due to higher non-cash expenses, mainly depreciation and amortization. As a percentage of our consolidated operating revenues, however, consolidated operating expenses decreased to 59% in the first half of 2004 from 69% in the same period in 2003.

Wireless

Consolidated operating expenses associated with our wireless business in the first half of 2004 amounted to Php15,841 million, an increase of Php1,231 million, or 8%, from Php14,610 million in the same period in 2003. A significant portion of this increase was attributable to non-cash expenses mainly depreciation and amortization coupled with an increase in certain cash expenses particularly professional and other service fees and compensation and benefits. As a percentage of our wireless operating revenues, operating expenses associated with our wireless business decreased to 51% in the first half of 2004 from 65% in the same period in 2003.

The following table summarizes our consolidated wireless-related operating expenses for the six months ended June 30, 2004 and 2003 and the percentage of each expense item to the total:

	Six Months Ended June 30,					
					Increase (Decrease)	
	2004	%	2003(1)	%	Amount	%
			(Unaudited)			
(in millions)						
Wireless services						
Depreciation and amortization(2)	Php6,117	39	Php4,944	34	Php1,173	24
Selling and promotions	3,366	21	4,161	29	(795)	(19)
Compensation and benefits	1,775	11	1,594	11	181	11
Maintenance	1,072	7	1,067	7	5	–
Rent	854	5	835	6	19	2
Provision for doubtful accounts	481	3	369	3	112	30
Professional and other service fees	466	3	271	2	195	72
Insurance and security services	439	3	349	2	90	26
Taxes and licenses	298	2	329	2	(31)	(9)
Provision for inventory obsolescence	128	1	46	–	82	178
Other operating expenses	845	5	645	4	200	31
Total	Php15,841	100	Php14,610	100	Php1,231	8

(1) As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.

(2) Includes depreciation of capitalized foreign exchange losses from the revaluation of net dollar liabilities of Php647 million in the first half of 2004 and Php548 million in the same period in 2003.

Depreciation and amortization charges increased by Php1,173 million, or 24%, to Php6,117 million substantially due to an increase in the depreciable asset base owing to continuing network expansion and upgrade and an increase in depreciation charges of capitalized foreign exchange losses from revaluation of net dollar liabilities.

Selling and promotion expenses decreased by Php795 million, or 19%, to Php3,366 million due to lower dealer discounts and advertising and promotions. Smart's average subscriber acquisition cost, or SAC, for prepaid subscribers in the first half of 2004 was Php463, a decrease of 35% from Php707 in the same period in 2003. Dealer discounts and advertising and

promotions per prepaid subscriber decreased by 60% and 28%, respectively, partially offset by a 24% increase in handset subsidy for prepaid subscribers. On the other hand, postpaid SAC in the first half of 2004 was Php20,822, an increase of 91% from Php10,883 in the same period in 2003. Handset subsidies increased by 79% and accounted for 78% and 83% of postpaid SAC in the first half of 2004 and 2003, respectively. Blended SAC declined by 39%, to Php659 in the first half of 2004 from Php1,075 in the same period in 2003.

Compensation and benefits increased by Php181 million, or 11%, to Php1,775 million primarily due to increased headcount and increased salaries, benefits and performance bonuses of Smart's employees. In addition, Smart accrued for an additional share under the enhanced employee retirement fund approved by Smart's Board of Directors in October 2003. Smart's employee headcount increased by 4% to 5,537 as of June 30, 2004 from 5,335 as of June 30, 2003.

Maintenance expenses increased by Php5 million to Php1,072 million mainly on account of higher repairs and maintenance costs, and higher site utility expenses due to the continued growth in the number of cell sites and other network facilities.

Rent expenses slightly increased by Php19 million, or 2%, to Php854 million on account of higher transmission links and higher office space rentals for the increased number of wireless centers and space requirements for increased personnel. As of June 30, 2004, Smart had 3,488 GSM cell sites and 4,565 base stations, compared with 2,389 GSM cell sites and 3,285 base stations as of June 30, 2003.

Provision for doubtful accounts increased by Php112 million, or 30%, to Php481 million to cover for possible uncollectible carrier accounts.

Professional and other service fees increased by Php195 million, or 72%, to Php466 million mainly as a result of increased legal, consultancy and bill collection service fees.

Insurance and security services increased by Php90 million, or 26%, to Php439 million mainly due to the increase in the number of Smart's cell sites and in the amount of network equipment insured as a result of the continued growth and expansion of its GSM network.

Taxes and licenses decreased by Php31 million, or 9%, to Php298 million mainly due to a decrease in Smart's business-related taxes and NTC supervision and regulation fees, partly offset by higher spectrum fees and disallowed input tax expense.

Provision for inventory obsolescence increased by Php82 million, or 178%, to Php128 million to cover for specifically identified slow moving handsets relating to ACeS Philippines.

Other operating expenses increased by Php200 million, or 31%, to Php845 million mainly due to increases in Smart's various business and operational-related expenses such as facility usage fees, training, travel, supplies, printing, communication and delivery expenses.

Fixed Line

Consolidated operating expenses related to our fixed line business in the first half of 2004 totaled Php16,241 million, a decrease of Php48 million, compared to Php16,289 million in the same period in 2003. The decrease was primarily due to PLDT's cost-containment initiatives, partially offset by higher non-cash expenses, mainly depreciation and amortization. As a percentage of our total fixed line operating revenues, fixed line-related operating expenses

decreased to 69% in the first half of 2004, compared to 71% in the same period in 2003.

The following table shows the breakdown of our total consolidated fixed line-related operating expenses for the six months ended June 30, 2004 and 2003 and the percentage of each expense item to the total:

	Six Months Ended June 30,					
					Increase (Decrease)	
	2004	**%**	**2003**(1)	**%**	**Amount**	**%**
			(Unaudited)			
(in millions)						
Fixed line services:						
Depreciation and amortization(2)	Php6,980	43	Php6,571	40	Php409	6
Compensation and benefits	3,516	22	3,709	23	(193)	(5)
Maintenance	1,535	9	1,498	9	37	2
Provision for doubtful accounts	1,393	9	1,522	9	(129)	(8)
Selling and promotions	631	4	633	4	(2)	–
Professional and other service fees	496	3	511	3	(15)	(3)
Rent	492	3	492	3	–	–
Insurance and security services	360	2	381	2	(21)	(6)
Taxes and licenses	333	2	292	2	41	14
Provision for inventory obsolescence	–	–	86	1	(86)	(100)
Other operating expenses	505	3	594	4	(89)	(15)
Total	Php16,241	100	Php16,289	100	Php(48)	–

(1) As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.

(2) Includes depreciation of capitalized foreign exchange losses from the revaluation of net dollar liabilities of Php2,319 million in the first half of 2004 and Php2,120 million in the same period in 2003.

Depreciation and amortization charges increased by Php409 million, or 6%, to Php6,980 million mainly due to higher depreciation of our regular asset base primarily resulting from additional completed projects and an increase in depreciation of capitalized foreign exchange losses from the revaluation of our net dollar liabilities, which were incurred in acquiring various telecommunications equipment.

Compensation and benefits decreased by Php193 million, or 5%, to Php3,516 million mainly due to a 11% reduction in headcount due to PLDT's MRP, partially offset by collective bargaining agreement-related increases in salaries and benefits of PLDT employees. See *Note 17 – Other Expenses – Net* to the accompanying financial statements for further discussion on PLDT's MRP.

Maintenance expenses increased by Php37 million, or 2%, to Php1,535 million primarily due to the expiration of warranty for certain plant facilities and higher maintenance costs of computer and peripherals in relation to charges for software support agreements for certain systems in the first half of 2004 as compared to the same period in 2003, partially offset by lower maintenance costs of the domestic fiber optic network primarily due to more remedial works done in 2003 than in 2004.

Provision for doubtful accounts decreased by Php129 million, or 8%, to Php1,393 million on account of lower provisions by PLDT for anticipated uncollectible accounts from various specifically identified domestic telecommunications carriers which have been provided for in 2003. PLDT's provision for doubtful accounts in the first half of 2004 and 2003 was equivalent to 6% and 6.2% of its operating revenues.

Selling and promotion expenses decreased by Php2 million to Php631 million mainly as a result of reduced corporate public relations expenses, partially offset by an increase in PLDT's promotional activities in relation to various products and services.

Professional and other service fees decreased by Php15 million, or 3%, to Php496 million as a result of lower advisory fees due to a decrease in number of consultants in line with PLDT's cost management efforts, coupled with a decrease in collection agency fees on account of lower final accounts subject for collection partially offset by payment of higher legal fees in the first half of 2004 for various services.

Insurance and security services decreased by Php21 million, or 6%, to Php360 million primarily due to a decrease in the number of contracted security guards.

Taxes and licenses increased by Php41 million, or 14%, to Php333 million mainly on account of higher business-related taxes paid in 2004 as compared to 2003.

Other operating costs decreased by Php89 million, or 15%, to Php505 million mainly due to lower office supplies consumption and printing costs resulting from PLDT's continuing cost-cutting activities, partially offset by higher contracted cost for technical and helpdesk resources and related computer and network maintenance and in-house systems development.

Information and Communications Technology

Consolidated operating expenses associated with our information and communications technology business totaled Php973 million in the first half of 2004, a decrease of Php47 million, or 5%, from Php1,020 million in the same period in 2003. The decline was due to the sale of our 51% interest in Contact World, a call center business, in June 2003. As a percentage of our information and communications technology operating revenues, operating expenses related to our information and communications technology business decreased to 99% in the first half of 2004 from 118% in the same period in 2003. The three largest expense items related to our information and communications technology business in the first half of 2004 were compensation and benefits, depreciation and amortization, and rent, representing 38%, 15% and 13%, respectively, of our total operating expenses related to this business. For the first half of 2003, compensation and benefits, maintenance, and depreciation and amortization registered the largest expenses representing 27%, 26% and 18%, respectively.

Net Operating Income

Our consolidated net operating income in the first half of 2004 was Php22,542 million, an increase of Php8,242 million, or 58%, from Php14,300 million in the same period in 2003. Accordingly, our consolidated operating margin (net operating income as a percentage of operating revenues) improved to 41% in the first half of 2004 from 31% in the same period in 2003.

Wireless

Our wireless business segment recorded an operating income of Php15,390 million in the first half of 2004, an increase of Php7,507 million, or 95%, over Php7,883 million registered in the same period in 2003. Smart's operating income contribution in the first half of 2004 increased by Php7,282 million to Php15,274 million from Php7,992 million due primarily to the growth in Smart's subscriber base.

Fixed Line

In the first half of 2004, our fixed line business segment contributed a net operating income of Php7,143 million, higher by Php570 million, or 9%, than Php6,573 million in the same period in 2003 mainly as a result of higher fixed line operating revenues coupled with lower fixed line-related expenses. PLDT's net operating income contribution to this business segment in the first half of 2004 was Php6,921 million, an increase of Php545 million, or 9%, compared to Php6,376 million in the same period in 2003.

Information and Communications Technology

In the first half of 2004, our information and communications technology business segment registered an operating income of Php9 million, an increase of Php165 million, compared to an operating loss of Php156 million posted in the same period in 2003. This improvement reflects the contribution of ePLDT's call center business which contributed 53% of information and communications technology business' operating income in the first half of 2004.

Interest Expense and Related Items - Net

Interest expense and related items – net increased by Php276 million, or 5%, to Php5,868 million in the first half of 2004 from Php5,592 million in the same period in 2003 mainly due to a net increase of Php462 million in PLDT's interest expense resulting from the peso depreciation that increased interest expense on foreign currency-denominated loans in peso terms and a decrease in interest charged to construction as more projects were completed. This increase was partially offset by a decrease in Smart's and Mabuhay Satellite's interest expenses by Php155 million and Php35 million, respectively, due to lower debt balances and lower interest rates mainly on foreign currency-denominated loans bearing floating interest rates.

Interest Income

Interest income increased by Php220 million, or 90%, to Php465 million in the first half of 2004 from Php245 million in the same period in 2003 mainly attributable to higher average cash balances.

Other Expenses – Net

In the first half of 2004, consolidated other expenses – net were Php1,050 million, a decrease of Php3,574 million, or 77%, compared to Php4,624 million in the same period in 2003 principally due to: (1) a decrease in asset impairment charge of Php1,144 million, or 93%, to Php85 million in the first half of 2004 from Php1,229 million in the same period in 2003; (2) recognition of provision for unrealizable assets of Php1,408 million in 2003; and (3) a decrease in manpower rightsizing cost by Php1,224 million, or 87%, to Php187 million in the first half of 2004 from Php1,411 million in the same period in 2003. The manpower rightsizing cost corresponded to 258 and 1,681 employees affected by PLDT's MRP in the first half of 2004 and 2003, respectively. See *Note 17 – Other Expenses – Net* to the accompanying financial statements for further discussion.

Income Before Income Tax and Minority Interest

Our income before income tax and minority interest in net income (losses) of consolidated subsidiaries in the first half of 2004 was Php16,046 million, representing an increase of Php13,333 million, or 491%, from Php2,713 million in the same period in 2003, mainly

attributable to a higher operating revenues generated in the first half of 2004 coupled with a substantial decline in other expenses - net during the same period. However, on a non-consolidated basis, income before income tax and equity share in net income of our subsidiaries improved by Php2,429 million, or 134%, to Php612 million in the first half of 2004 as against a net loss of Php1,817 million in the same period in 2003.

Our consolidated provision for income tax increased by Php2,874 million, or 251%, to Php4,020 million in the first half of 2004 from Php1,146 million in the same period in 2003. On a non-consolidated basis, our provision for income tax was Php215 million in the first half of 2004, from an income tax benefit of Php401 million in the same period in 2003.

In the first half of 2004, our effective corporate tax rates were lower than the 32% statutory corporate tax rate due to differences between our consolidated and non-consolidated income as shown in our financial statements and our taxable income. These differences arose from the following:

- the effect of a three-year income tax holiday granted to Smart by the BOI in connection with the pioneer status it awarded to Smart's GSM network expansion project;
- income already subjected to final tax or lower tax rate; and
- equity in net income of our associates, which has already been subjected to tax and therefore, as income to PLDT, is no longer subject to income tax.

Smart's three-year income tax holiday, which expired in May 2004, applied to the incremental income generated from its GSM network expansion. The income tax holiday was computed by applying the exemption rate against the income tax due on GSM operations. The exemption rate was computed by dividing the incremental GSM revenues by eligible GSM revenues (both gross of interconnection revenues) where the incremental GSM revenues were derived by deducting the BOI-prescribed base figure (Smart’s gross GSM revenue in 2000) from the total GSM revenues. After adjusting for non-deductible items and unrealized and realized foreign exchange losses, Smart’s net taxable income was multiplied by the statutory corporate income tax rate of 32% and the exemption rate. The resulting figure was the income tax holiday that will be deducted from the income tax due on GSM revenues with the difference being the income tax due for the period.

Net Income

As a result of the factors discussed above, our consolidated net income for the first half of 2004 was Php12,008 million, representing an increase of Php10,223 million, or 573%, over our restated consolidated net income of Php1,785 million in the same period in 2003. This increase was principally due to Smart’s net income contribution of Php11,635 million for the first half of 2004, a significant improvement of Php5,511 million, or 90%, over its net income contribution of Php6,124 million in the same period in 2003 and a substantial decline in other expenses – net of Php3,574 million due to the decrease in asset impairment charges and manpower rightsizing cost by Php1,144 million and Php1,224 million, respectively, and the recognition of provision for unrealizable assets of Php1,408 million in 2003. On a non-consolidated basis, PLDT's net income in the first half of 2004, before taking into account its equity share in net income of investees, was Php397 million, as against a net loss of Php1,416 million in the same period in 2003. The increase in net income was mainly attributable to lower manpower rightsizing cost by Php1,224 million.

Basic and diluted earnings per common share, or EPS, increased to Php65.62 and Php61.81, respectively, in the first half of 2004 from basic and diluted EPS of Php5.54 in the same period in 2003, after giving retroactive effect to common share equivalents. See *Note 19 – Earnings Per Common Share* to the accompanying financial statements for further discussion.

Liquidity and Capital Resources

The following table shows our consolidated and non-consolidated cash flows for the six months ended June 30, 2004 and 2003 as well as consolidated and non-consolidated capitalization and other selected financial data as of June 30, 2004 and 2003:

	Consolidated		Non-Consolidated	
	Six Months Ended June 30,		Six Months Ended June 30,	
	2004	2003(1)	2004	2003(1)
	(Unaudited)			
(in millions)				
Cash Flows				
Net cash provided by operating activities	Php35,010	Php23,081	Php14,721	Php10,262
Net cash (used in) provided by investing activities	(11,496)	(5,699)	8,655	2,671
Capital expenditures	11,576	5,340	2,667	1,496
Net cash used in financing activities	20,352	17,090	16,687	13,112
Net increase (decrease) in cash and cash equivalents	3,110	240	6,735	(199)

	Consolidated		Non-Consolidated	
	June 30, 2004	December 31, 2003(1)	June 30, 2004	December 31, 2003(1)
	(Unaudited)	(Audited)	(Unaudited)	(Audited)
(in millions)				
Capitalization				
Notes payable	Php150	Php2,133	Php–	Php1,933
Current portion of long-term debt	22,273	23,742	13,918	15,850
Long-term debt – net of current portion	123,840	133,939	108,799	116,392
Total debt	146,263	159,814	122,717	134,175
Stockholders' equity	104,830	93,578	104,830	93,578
	Php251,093	Php253,392	Php227,547	Php227,753
Other Financial Data				
Cash and cash equivalents	Php22,373	Php19,263	Php12,013	Php5,278
Property, plant and equipment – net	243,444	244,427	184,571	188,152
Total assets	300,899	297,626	263,047	261,184
Net debt(2)	123,890	140,551	110,704	128,897

(1) *As restated to reflect the change in accounting policy on leases, as described in Note 3 – Accounting Changes to the accompanying financial statements.*

(2) *Total debt less cash and cash equivalents.*

As of June 30, 2004, our consolidated cash and cash equivalents totaled Php22,373 million. Principal sources of consolidated cash and cash equivalents in the first half of 2004 were cash flows from operations amounting to Php35,010 million and drawings from long-term credit facilities aggregating Php4,824 million. These funds were used principally for capital outlays of Php11,576 million, including capitalized interest of Php302 million; total debt principal payments of Php19,413 million; and interest payments of Php5,908 million.

Operating Activities

On a consolidated basis, net cash flows from operating activities in the first half of 2004 increased by Php11,929 million, or 52%, to Php35,010 million from Php23,081 million in the same period in 2003.

A growing portion of our consolidated cash flow is generated by our wireless business, which accounted for 56% of our consolidated operating revenues in the first half of 2004, compared to 49% in the same period in 2003. Revenues from our fixed line and information and communications technology services accounted for 42 and 2%, respectively, of our consolidated operating revenues in the first half of 2004 and 49% and 2%, respectively, for the first half of 2003.

PLDT's contribution to our consolidated cash flows from operations in the first half of 2004 was Php14,721 million, representing an increase of Php4,459 million, or 43%, from Php10,262 million in the same period in 2003. The increase was primarily due to higher level of settlements of current liabilities in the first half of 2003.

Our subsidiaries, particularly Smart, made significant contributions to our cash from operations. In the first half of 2004, Smart generated cash from operations of Php19,701 million, or 56% of our consolidated cash flows from operations, representing an increase of Php7,797 million, or 65%, compared to Php11,904 million, or 52%, of our consolidated operating cash flows in the same period in 2003. Smart’s strong cash flows reflect the continuing strong performance of its cellular business. However, Smart is subject to loan covenants that restrict its ability to pay dividends, redeem preferred shares, make distributions to PLDT or otherwise provide funds to PLDT or any associate without the consent of its lenders. On May 26, 2004, after obtaining the relevant waivers from Finnvera and certain of its lenders prior to actual payment, Smart paid a dividend of Php11,280 million to PLDT, equivalent to 70% of Smart’s 2003 net income. In June 2003, after receiving similar approvals from Finnvera and certain lenders, Smart paid dividends in the amount of Php4,300 million to PLDT, representing 70% of Smart’s 2002 net income and in the amount of Php1,866 million to PLDT in November 2003, equivalent to the remaining 30% of its 2002 net income. Smart made its first dividend payment of Php1,540 million to PLDT in December 2002, representing 40% of Smart’s net income in 2001. We cannot assure you that Smart will be able to obtain such waivers or any other waivers in the future, or what amount, if any, Smart would be permitted or financially able to distribute. We expect that we will have difficulty meeting our debt payment obligations if we do not continue to receive cash dividends from Smart.

As of June 30, 2004, related party liabilities included (1) PLDT’s payables to Smart amounting to Php4,186 million, representing interconnection fees; (2) Smart’s liabilities to Piltel totaling Php1,907 million, relating mostly to prepaid air time reloads for *Talk ‘N Text* subscribers through *Smart Load*, and (3) Piltel’s liabilities to PLDT amounting to Php1,050 million, representing interconnection charges. See “Related Party Transactions” in this report and *Note 15 – Related Party Transactions* to the accompanying financial statements for further discussion.

Investing Activities

On a consolidated basis, net cash used in investing activities in the first half of 2004 of Php11,496 million increased by Php5,797 million, or 102%, compared to Php5,699 million in the same period in 2003. This increase was primarily the result of higher aggregate capital spending.

Our consolidated capital expenditures in the first half of 2004 totaled Php11,576 million, an increase of Php6,236 million, or 117%, from Php5,340 million in the same period of 2003 primarily due to PLDT's and Smart's increased capital spending. Smart's capital spending of Php8,813 million in the first half of 2004 was used to further expand and upgrade its GSM and transmission network facilities to increase capacity and coverage in respect of basic and advanced cellular services. PLDT's capital spending of Php2,667 million was principally used to finance the expansion of its fixed line data and network services. ePLDT and its subsidiaries' capital spending of Php75 million was used to primarily fund its *Vitro*™, Infocom and call center business operations. Consolidated capital expenditures in the first half of 2003 amounted to Php5,340 million, of which Php1,496 million, Php3,740 million, Php51 million and Php38 million were attributable to PLDT, Smart, ePLDT and PLDT Global, respectively. The balance represented other subsidiaries' capital spending.

Under the terms of Piltel's debt restructuring plan, PLDT issued a Letter of Support for the benefit of Piltel and its creditors under which PLDT has agreed to cover any funding shortfalls of Piltel up to a maximum amount of US$150 million. Under the Letter of Support, PLDT provided to Piltel Php2,317 million (US$48 million) in 2000, Php2,039 million (US$41 million) in 2001, and Php571 million (US$11 million) in 2002. There was no drawdown under the Letter of Support in 2003 nor in the first half of 2004. Drawings under the PLDT Letter of Support are converted into U.S. dollars at the prevailing exchange rates at the time of drawdown. As of June 30, 2004, the remaining undrawn balance under the Letter of Support was US$50 million (approximately Php2,823 million). If, among other things, Piltel's financial and operating performance were to deteriorate or any amounts were required to be paid to Piltel's unrestructured creditors in cash to settle their claims (aggregate principal of US$1 million as of December 31, 2003), additional drawings under the Letter of Support would likely be required to provide all or a portion of the funds needed by Piltel. We cannot assure that additional amounts will not have to be drawn under the Letter of Support nor can we predict when the remaining undrawn balance under the Letter of Support will be exhausted. See *Note 9 – Investments* to the accompanying financial statements for further discussion.

Financing Activities

On a consolidated basis, we used net cash of Php20,352 million for financing activities in the first half of 2004, compared to Php17,090 million in the same period in 2003. On a non-consolidated basis, net cash used in financing activities in the first half of 2004 was Php16,687 million, compared to Php13,112 million in the same period in 2003. The net cash used in financing activities in the first half of 2004 was mainly attributable to debt repayments by PLDT in line with its ongoing debt reduction program.

Debt Financing

Additions to our consolidated long-term debt in the first half of 2004 totaled Php4,824 million, of which Php2,522 million came from PLDT's drawings, primarily from long-term loan facilities used to finance capital expenditures and refinancing facilities used to repay maturing debts. Payments in respect of principal and interest amounted to Php19,413 million and Php5,908 million, respectively, in the first half of 2004, of which Php14,760 million and Php5,320 million were attributable to PLDT, respectively.

Our consolidated indebtedness as of June 30, 2004 was Php146,263 million, representing a decrease of Php13,551 million, or 8%, compared to Php159,814 million as of December 31, 2003. This decrease was mainly due to the reductions of Php11,458 million and Php1,796 million in PLDT's and Smart's indebtedness, respectively. PLDT's indebtedness decreased by

9% to Php122,717 million as of June 30, 2004 from Php134,175 million as of December 31, 2003, due to PLDT's debt repayments in line with PLDT's efforts to reduce overall indebtedness. Smart's indebtedness as of June 30, 2004 was Php18,790 million, a decrease of 9% from Php20,586 million as of December 31, 2003.

As of June 30, 2004, PLDT had undrawn committed dollar-denominated long-term credit facilities in the aggregate amount of US$68 million, inclusive of the remaining US$25 million undrawn portion of the US$149 million Kreditanstalt für Wiederaufbau refinancing facility, US$4 million undrawn portion of the US$12 million term loan facility extended by DEG-Deutsche Investitions-und Entwicklungsgesellschaft mbH under an agreement dated May 29, 2003 and the JP¥4,055 million undrawn portion of the JP¥5,615 million syndicated term loan facility supported by Nippon Export and Investment Insurance of Japan under an agreement dated June 11, 2003. As of June 30, 2004, Smart still had available facilities under its €50 million Framework Agreement with HypoVereinsbank up to a maximum aggregate amount of €44 million. Smart availed of the US$40 million remaining balance of its US$100 million NEXI-supported loan facility in April 2004.

After giving effect to the anticipated application of existing refinancing facilities, the scheduled maturities of our outstanding long-term debt as of June 30, 2004 are as follows:

Year	US$ Loans(2)		JP¥ Loans(3)		Peso Loans	Total
Consolidated			**(in millions)**			
2004(1)	US$150	Php8,407	JP¥2,014	Php1,040	Php839	Php10,286
2005	469	26,349	6,818	3,522	880	30,751
2006	441	24,766	6,816	3,521	826	29,113
2007	476	26,740	3,178	1,642	–	28,382
2008	69	3,898	1,589	821	–	4,719
2009 and onwards	813	42,052	–	–	810	42,862
Non-Consolidated						
2004(1)	US$76	Php4,297	JP¥2,014	Php1,040	Php802	Php6,139
2005	322	18,068	6,818	3,522	780	22,370
2006	305	17,159	6,816	3,521	770	21,450
2007	419	23,540	3,178	1,642	–	25,182
2008	69	3,893	1,589	821	–	4,714
2009 and onwards	813	42,052	–	–	810	42,862

(1) July 1, 2004 through December 31, 2004.
(2) The exchange rate used was Php56.176 to US$1.00.
(3) The exchange rate used was Php0.5166 to JP¥1.00.

Approximately Php103,251 million principal amount of our consolidated outstanding long-term debt as of June 30, 2004 is scheduled to mature over the period from 2004 to 2008. Of this amount, approximately Php79,855 million is attributable to PLDT, Php18,790 million to Smart, and the remainder to Mabuhay Satellite, Maratel and ePLDT.

Covenants

Our debt instruments contain restrictive covenants, including covenants that prohibit us from paying common dividends, and require us to comply with specified financial ratios and other financial tests, calculated in conformity with accounting principles generally accepted in the Philippines, at relevant measurement dates, principally at the end of each quarterly period.

The financial tests under our debt instruments, as amended, include maintaining a positive tangible net worth and compliance with the following ratios:

- interest coverage ratio, calculated on a non-consolidated basis and excluding PLDT's equity share in net earnings or losses of investees, of not less than 180% or 200%;
- total debt to EBITDA on a non-consolidated basis of not more than 5.0:1 from March 31, 2004 to June 30, 2004, not more than 4.5:1 from September 30, 2004 to December 31, 2004 and not more than 4.0:1 from March 31, 2005 and thereafter;
- long-term indebtedness to appraised value of equity/tangible net worth on a non-consolidated basis ranging from not more than 1.1:1 to not more than 3.0:1;
- current ratio on a non-consolidated basis, ranging from not less than 0.9:1 to not less than 1.2:1;
- debt service coverage ratio on a non-consolidated basis of at least 1.1:1; and
- debt to free cash flow ratio on a non-consolidated basis of not more than 5.5:1 from March 31, 2004 to June 30, 2004, not more than 5.0:1 from September 30, 2004 to June 30, 2005, not more than 4.5:1 from September 30, 2005 to June 30, 2006, and not more than 4.0:1 from September 30, 2006 onwards.

In addition, some of PLDT's debt instruments contain covenants requiring PLDT to comply with specified financial tests on a consolidated basis calculated in conformity with accounting principles generally accepted in the Philippines. These include:

- long-term debt to appraised value of equity/tangible net worth of not more than 2.33:1;
- total debt to EBITDA of not more than 4.5:1 in 2004 and not more than 4.0:1 in 2005 and thereafter;
- current ratio ranging from not less than 0.75:1 to 0.9:1; and
- interest coverage ratio of not less than 200%.

The principal factors that can negatively affect our ability to comply with these financial ratios and other financial tests are depreciation of the peso relative to the U.S. dollar, poor operating performance of PLDT and its consolidated subsidiaries, impairment or similar charges in respect of investments or other long-lived assets that may be recognized by PLDT and its consolidated subsidiaries and increases in our interest expenses. Since approximately 97% of PLDT's total debt is denominated in foreign currencies, principally in U.S. dollars, many of these financial ratios and other tests are negatively affected by any weakening of the peso. As of June 30, 2004, the peso depreciated by 1% to Php56.176 to US$1.00, from Php55.586 to US$1.00 as of December 31, 2003. The peso has been subjected to significant fluctuations. In 2003, the peso depreciated to Php55.075 to US$1.00 on March 12, 2003 then recovered to a high of Php52.021 to US$1.00 on May 8, 2003 only to depreciate again to a low of Php55.767 to US$1.00 on November 27, 2003. During the first half of 2004, the peso appreciated to a high of Php55.142 on January 6, 2004 but depreciated to a low of Php56.429 on March 22, 2004.

PLDT's ability to maintain compliance with financial covenant requirements measured on a non-consolidated basis is principally affected by the performance of its fixed line business. PLDT cannot be assured of the benefit of net revenues and cash flows generated by Smart and PLDT's other investees in assisting in complying with non-consolidated covenants.

We have maintained compliance with all of our financial ratios and covenants as measured under our loan agreements and other debt instruments. However, if negative factors adversely affect our financial ratios, we may be unable to maintain compliance with these ratios and covenants or be unable to incur new debt. Under some of our loan agreements, certain of our financial ratios will continue to become more restrictive as the loans near maturity. Inability to comply with our financial ratios and covenants could result in a declaration of default and acceleration of some or all of our indebtedness. The terms of some of our debt instruments have no minimum amount for cross-default.

Please see *Note 12 – Long-term Debt* for a detailed discussion of our covenants.

Financing Requirements

We believe that our available cash, including cash flow from operations and drawings from existing and anticipated credit facilities, will provide sufficient liquidity to fund our projected operating, investment, capital expenditures and debt service requirements for the next 12 months.

We continue to pursue various initiatives and financing transactions with the objective of further improving the balance between our cash flows and debt service requirements and reducing our overall indebtedness. In addition, PLDT has managed its capital expenditures, reduced its investments, suspended dividend payments to common shareholders and increased its application of available cash to reduce its indebtedness. Further, we are benefiting from increasing revenue and cash flow contributions from our subsidiaries, particularly Smart. Smart, however, will be required to obtain further waivers from Finnvera and certain lenders to pay additional dividends in future periods. See "— Operating Activities" for further details.

Credit Ratings

Our credit ratings may significantly affect the terms of our prospective financings, particularly financing costs. None of our existing indebtedness contains provisions under which credit rating downgrades would trigger a default, changes in applicable interest rates or other similar terms and conditions.

On June 24, 2004 and March 23, 2004, Standard and Poor's Ratings Group affirmed its "BB" rating and stable outlook on PLDT.

On April 8, 2004, Fitch Ratings upgraded PLDT's long-term foreign currency and local currency ratings to "BB" from "BB-" (BB minus) while the rating of PLDT's convertible preferred stock was similarly upgraded to "B+" (B plus) from "B". The rating action follows a sustained period of improvement in PLDT's operating and financial profile mainly due to the growth of Smart. The stable outlook also reflects Fitch's view that neither the existing competitive landscape nor the planned resumption of common share dividends by PLDT would materially disrupt our deleveraging efforts.

On March 23, 2004, Moody's affirmed PLDT's "Ba2" senior unsecured debt rating with a negative outlook and its "B1" preferred rating with a stable outlook. On January 27, 2004, PLDT's foreign currency senior unsecured debt rating was upgraded by Moody's Investors Service to "Ba2" from a recent "Ba3" as of July 29, 2003 and preferred stock rating moved up to "B1" from "B2." The rating reflects continued improvements in the operating performance of Smart and the expectation of on-going free cash flow to help repay debt maturities in the coming years. The negative outlook on PLDT's rating is constrained, reflecting Moody's decision to

downgrade the Philippine Government's long-term foreign currency bond rating to "Ba2" with a negative outlook also on January 27, 2004.

Off-Balance Sheet Arrangement

On October 10, 2002, PLDT entered into a Receivables Purchase Deed, or RPD, with a foreign financial institution, or the Purchaser, under which PLDT agreed (1) to sell its receivables from certain eligible foreign carriers for an advance payment of US$50 million, with a balance of US$33 million as of June 30, 2004, and (2) to service, administer and collect the receivables on behalf of the Purchaser. Under the RPD, the Purchaser has no recourse to PLDT should an eligible carrier fail or refuse to settle the assigned/purchased receivables, except if PLDT commits a breach on its representations and warranties. For the six months ended June 30, 2004 and 2003, receivables sold under the RPD amounted to US$5 million (Php297 million) and US$5 million (Php272 million), respectively. Loss on sale of receivables under the RPD amounted to US$0.65 million (Php37 million) and US$0.84 million (Php45 million) for the six months ended June 30, 2004 and 2003, respectively.

Equity Financing

Through our subscriber investment plan, or SIP, which provides postpaid fixed line subscribers the opportunity to buy shares of our 10% cumulative convertible preferred shares as part of the upfront payments collected from subscribers, PLDT was able to raise Php68 million in the first half of 2004 and Php43 million in the same period in 2003. As approved by the NTC, the SIP was made optional in 2003 from being compulsory in earlier years.

Cash dividend payments in the first half of 2004 amounted to Php718 million, compared to Php694 million in the same period in 2003, all of which were paid solely to preferred shareholders of PLDT. The most recent cash dividend paid by PLDT to its common shareholders was in April 2001 (dividends declared in March 2001); since then, no dividends have been paid to common shareholders.

Contractual Obligations and Commercial Commitments

Contractual Obligations

The following table discloses our contractual obligations outstanding as of June 30, 2004:

	Payments Due by Period				
	Total	**Within 1 year**	**2–3 years**	**4–5 years**	**After 5 years**
			(Unaudited)		
(in millions)					
Long-term debt obligations	Php146,113	Php22,236	Php70,734	Php20,885	Php32,258
Long-term lease obligations:					
Operating Lease	5,433	1,304	2,362	924	843
Capital Lease	1,354	532	657	165	–
Unconditional purchase obligations[(1)]	12,587	3,615	2,256	2,784	3,932
Other long-term obligations	22,131	–	–	14,049	8,082
Total contractual cash obligations	Php187,618	Php27,687	Php76,009	Php38,807	Php45,115

(1) The amounts disclosed in the table above are based on the original Air Time Purchase Agreement with ACeS International Limited, or AIL. In 2003, a Standstill Agreement was executed to cover, among other matters, the amended minimum and supplemental air time payment provisions for the year 2003.

Long-term Debt Obligations

For a discussion of our long-term debt obligations, see *Note 12 – Long-term Debt* to the accompanying financial statements.

Long-term Operating Lease Obligations

Transponder Lease Agreement. On December 28, 1995, PLDT and Mabuhay Satellite entered into a Transponder Lease Agreement, which was amended on May 10, 2000. This agreement has a term of ten years commencing on December 18, 1997, unless earlier terminated in accordance with the terms thereof. The annual basic rent for the transponders was US$13 million as of June 30, 2004, and PLDT's aggregate remaining obligation under this agreement was approximately Php2,477 million as of that date.

Domestic Fiber Optic Network Submerged Plant Agreement. On July 4, 2000, PLDT entered into an agreement with NTT World Engineering Marine Corporation for submarine cable repair and related services for the maintenance of PLDT's domestic fiber optic network submerged plant for a period of five years up to July 4, 2005. Under this agreement, PLDT is required to pay NTT World Engineering Marine Corporation a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely-operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair. As of June 30, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php128 million.

Digital Passage Service Contracts. PLDT has existing Digital Passage Service Contracts with foreign telecommunication administrations for several dedicated circuits to various destinations for ten to 25 years expiring at various dates. As of June 30, 2004, PLDT's aggregate remaining obligation under these contracts amounted to approximately Php36 million.

License Agreement with Mobius Management Systems (Australia) Pty Ltd., or Mobius. PLDT entered into a license agreement with Mobius pursuant to which Mobius has granted PLDT a non-exclusive, non-assignable and non-transferable license for the use of computer software components. Under this agreement, Mobius is also required to provide maintenance services for a period of one year at no additional maintenance charge. PLDT may purchase maintenance services upon expiration of the first year for a fee of 15% of the current published license fee. As of June 30, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php55 million.

Other Long-term Operating Lease Obligations. We have various long-term lease contracts for periods ranging from two to ten years covering certain offices, warehouses, cell sites, telecommunication equipment locations and various office equipment. In particular, Smart has lease obligations aggregating Php2,666 million as of June 30, 2004 in respect of office and cell site rentals with over 2,000 lessors nationwide.

Long-term Capital Lease Obligations

Municipal Telephone Projects. In 1993, PLDT entered into two lease agreements with the Philippine Department of Transportation and Communications, or DOTC, covering telecommunications facilities in Bohol and Batangas established under the Municipal Telephone Act. Under these agreements, PLDT was granted the exclusive right to perform telecommunications management services, to expand services, and to promote the use of the DOTC-contracted facilities in certain covered areas for a period of 15 years. Title to the properties shall be transferred to PLDT upon expiration of the lease term. As of June 30, 2004, the aggregate remaining obligation under this agreement was approximately Php914 million. In

case of cancellation, PLDT is liable to pay Php100 million under each of the two contracts as liquidated damages.

On June 1, 2004, PLDT served the DOTC a notice of termination of the lease agreement in respect of the telecommunications system in Bohol which state of deterioration, obsolescence and disrepair have made it impossible for PLDT to continue managing, operating, and maintaining the system. Since 2002, PLDT has been advising the DOTC of the need to review the viability of the system as it has infused more than Php200 million for upgrades and maintenance to keep the system operable. Further, the enactment of R.A. 7925, which negated the DOTC's warranty to grant PLDT the exclusive right to provide telecommunication services in the areas stipulated, prevented PLDT from achieving the originally projected profitability thereby rendering it impossible for PLDT to continue fulfilling its obligation under the lease agreement. Although several discussions have been held since then to seek a mutually acceptable agreement, no amenable arrangement has been reached. On June 30, 2004, the DOTC advised PLDT that the request for termination of the lease agreement in Bohol has been referred to the Department of Justice, or DOJ, as government agencies are required to refer all interpretation of contracts and agreements to the DOJ secretary as attorney-general of the national government. As of the date of this report, the DOJ has not yet responded to the DOTC's referral. As of June 30, 2004, the net book value of the telecommunications system in Bohol, including PLDT's additional capital expenditure relating to the telecommunications system, and corresponding capital lease obligation amounted to Php144 million and Php508 million, respectively.

Other Long-term Capital Lease Obligations. The PLDT Group has various long-term lease contracts for a period of three years covering various office equipment. In particular, Smart has capital lease obligations aggregating Php436 million in respect of office equipment.

Unconditional Purchase Obligations

Air Time Purchase Agreement with AIL. PLDT is a party to a Founder NSP, or National Service Provider, Air Time Purchase Agreement with AIL in March 1997, which was amended in December 1998, under which PLDT is granted the exclusive right to sell ACeS services in the Philippines. In exchange, the Air Time Purchase Agreement states that PLDT has to purchase from AIL a minimum of US$5 million worth of air time annually over ten years commencing on the date of commercial operations of the Garuda I satellite. In the event AIL's aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement also states that PLDT has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term.

As of June 30, 2004, PLDT's aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php12,030 million. See *Note 15 – Related Party Transactions* and *Note 21 – Provisions and Contingencies* to the accompanying financial statements for further details relating to the Air Time Purchase Agreement with AIL.

International Affiliate Agreement with VeriSign, Inc., or VeriSign. On September 15, 2000, ePLDT entered into an agreement with VeriSign for the non-exclusive, non-transferable right and license to use the VeriSign software, brand and Certification Practice Statement for the purpose of approving, issuing, suspending or revoking digital certificates for users of the internet or similar open systems in the Philippines for a period of seven years. Under this agreement, ePLDT is required to pay VeriSign a certain percentage of the revenue derived from the services subject to minimum annual royalty payments aggregating to US$11 million, which was subsequently reduced to US$1 million, for the seven-year contract period. In addition, ePLDT was required to pay an annual support fee totaling US$0.5 million during the first year and US$0.3 million in each year thereafter.

Effective July 1, 2003, VeriSign has agreed to amend the agreement and issued Addendum 6 to write-off all past due invoices and payments owed to VeriSign, which were invoiced or scheduled to be invoiced under the agreement prior to this Addendum 6. All royalty payments and annual support fees due through June 2003 will be part of the write-off in the amount of US$0.8 million. For contract year 4 (September 2003-August 2004), the annual support fee will be reduced from US$0.3 million to US$ 40,000 and for contract years 5-7 (September 2004-August 2007) from US$0.3 million to US$0.16 million. In addition, VeriSign agreed to reduce the affiliate revenue sharing rates from 50% of suggested retail price to 25% of suggested retail price for both enterprise and internet products for 12 months starting July 2003 and negotiable thereafter. As of June 30, 2004, ePLDT's aggregate remaining minimum obligation under this agreement was approximately Php18 million pertaining to annual support fee.

Effective July 1, 2004, VeriSign has agreed to amend the Agreement and issued Addendum 8 as extension of Addendum 6. Annual support fee for year 5 (September 2004 to August 2005) will remain at US$40,000 and affiliate revenue sharing rates will remain at 25%.

License Purchase Agreement with I-Contact Solutions Pte. Ltd. On April 2, 2003, iPlus Intelligent Network Inc., or iPlus, a wholly-owned subsidiary of ePLDT and the Philippines' pioneer in IP-based IT response center, entered into an Application Services Provider, or ASP, and Reseller Contract with I-Contact Solutions Pte. Ltd., or I-Contact, of Singapore. Under the agreement, iPlus will purchase licenses of the CosmoCall Universe™ IP-based contact center solution. CosmoCall Universe supports multi-channel customer interactions including telephone, web chat, web voice, web video, web collaboration, e-mail and voicemail in one high capacity, high availability, multi-tenant platform. CosmoCall Universe is a complete, unified contact center suite that includes ACD, IVR, CTI, predictive dialing, multimedia recording and a complement of other powerful management applications. The aggregate value of these licenses is US$2.1 million and these licenses will be delivered quarterly over a two-year period. Further to the agreement, I-Contact will appoint iPlus as the exclusive reseller and ASP for the Philippine market and will provide iPlus with all the necessary support in terms of sales, marketing, and technical services. Effective March 30, 2004, I-Contact has agreed to amend the Contract and waived all financial obligations and committed seats requirement over the two-year period. iPlus will pay all its remaining obligations pertaining only to the 300 seats delivered by I-Contact. As of June 30, 2004, iPlus' aggregate remaining obligation under this agreement was US$0.45 million (approximately Php25 million).

Other Unconditional Purchase Obligations. The PLDT group has various purchase contracts for periods ranging from two to three years covering the use of fraud management system and satellite hub and remote VSAT network systems.

Other Long-term Obligations

Mandatory Conversion and Purchase of Shares. As of June 30, 2004, PLDT had issued a total of 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for a total of 59 million shares of Series K, Class I Convertible Preferred Stock of Piltel pursuant to the debt restructuring of Piltel.

Each share of Series V, VI and VII Convertible Preferred Stock is convertible at any time at the option of the holder into one PLDT common share. On the date immediately following the seventh anniversary of the issue date of the Series V and Series VI Convertible Preferred Stocks

and on the eighth anniversary of the issue date of the Series VII Convertible Preferred Stock, the remaining outstanding shares under these series will be mandatorily converted to shares of PLDT's common stock. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JP¥4,071.89 per share for Series V, VI and VII, respectively.

As of June 30, 2004, 145,320 shares of Series V Convertible Preferred Stock and 531,251 shares of Series VI Convertible Preferred Stock had been converted to PLDT's common shares. The aggregate value of the put option based on outstanding shares as of June 30, 2004 was Php22,131 million, of which Php14,049 million is payable on June 4, 2008 and Php8,082 million on June 4, 2009, if all of the outstanding shares of Series V, VI and VII Convertible Preferred Stocks were mandatorily converted and all the underlying shares of common stock were put to PLDT. The market value of the underlying shares of common stock was Php12,859 million, based on the market price of PLDT's common stock of Php1,150 per share as of June 30, 2004.

Commercial Commitments

As of June 30, 2004, our outstanding commercial commitments, in the form of letters of credit, amounted to Php5,099 million. These commitments will expire within one year.

In October 1998, Smart entered into a Frame Supply Contract with Nokia Telecommunications OY for the supply of hardware, software and documentation for its GSM cellular network. In the same month, Smart and Nokia (Philippines), Inc., or Nokia, signed a Frame Services Contract that covers the design, planning, installation, commissioning, integration, acceptance testing, training and handling of the network. In August 2001, Smart issued Master Purchase Orders, or MPOs, in the amount of US$200 million in favor of Nokia for the purchase of additional equipment to expand Smart's GSM network. The US$200 million MPO was completed in November 2003. On May 30, 2003, Smart entered into a Technical Support Services Agreement, or TSSA, with Nokia in the amount of US$8 million. This TSSA has been fully served as of December 31, 2003.

In January 2004, Smart signed a new MPO in favor of Nokia amounting to US$117 million (Phase 7 under the Frame Supply Contract between Smart and Nokia). Smart is, however, under no legal obligation to incur these expenditures.

On June 23, 2004, Smart signed a TSSA with Nokia in the amount of US$10 million which is valid until December 31, 2004.

As of June 30, 2004, Smart had no guarantee obligations, standby repurchase obligations or other commercial commitments.

Quantitative and Qualitative Disclosures about Market Risks

Our operations are exposed to various risks, including liquidity risk, foreign exchange risk and interest rate risk. The importance of managing these risks has significantly increased in light of considerable change and continuing volatility in the Philippine and international financial markets. With a view to managing these risks, we have incorporated financial risk management functions in our organization, particularly in our treasury operations.

Liquidity Risk Management

We seek to manage our liquidity profile to be able to finance our capital expenditures and service our maturing debts. To cover our financing requirements, we intend to use internally

generated funds and proceeds from debt and equity issues and sales of certain assets.

As part of our liquidity risk management program, we regularly evaluate our projected and actual cash flow information and continuously assess conditions in the financial markets for opportunities to pursue fund-raising initiatives. These initiatives may include bank loans, export credit agency-guaranteed facilities, and debt capital and equity market issues.

Foreign Exchange Risk Management

As of June 30, 2004, the Philippine peso had depreciated against the U.S. dollar to Php56.176 to US$1.00 from Php53.522 to US$1.00 as of June 30, 2003, which in turn represented a depreciation against the U.S. dollar from Php50.541 to US$1.00 at June 30, 2002. In the first half of 2004, PLDT capitalized net foreign exchange losses of Php772 million, as compared to Php356 million in the same period in 2003. Of these capitalized net foreign exchange losses, Php709 million in the first half of 2004 and Php103 million in the same period in 2003, were attributable to foreign currency-denominated liabilities used to finance our capital investments and were therefore recorded as additions to the carrying value of the related property accounts.

The following table shows our consolidated and non-consolidated foreign currency-denominated monetary assets and liabilities and their peso equivalents as of June 30, 2004 and as of December 31, 2003:

	June 30, 2004(1)		December 31, 2003(2)	
	U.S. dollars	Pesos	U.S. dollars	Pesos
	(Unaudited)	(in millions)	(Audited)	
Consolidated				
Assets				
Cash and cash equivalents	US$294	Php16,503	US$146	Php8,098
Receivables-net	176	9,871	195	10,855
Other current assets	–	9	–	–
	470	26,383	341	18,953
Liabilities				
Notes payable	–	–	3	150
Accounts payable	87	4,863	60	3,322
Accrued expenses and other current liabilities	74	4,086	25	1,342
Long-term debt	2,606	142,758	2,819	153,542
Deferred credits and other noncurrent liabilities	217	12,228	209	11,613
	2,984	163,935	3,116	169,969
Net foreign currency-denominated liabilities	US$2,514	Php137,552	US$2,775	Php151,016
Non-Consolidated				
Assets				
Cash and cash equivalents	US$199	Php11,198	US$54	Php3,014
Receivables-net	123	6,892	134	7,463
Other current assets	–	9	–	–
	322	18,099	188	10,477
Liabilities				
Accounts payable	10	572	16	874
Accrued expenses and other current liabilities	59	3,346	7	386
Long-term debt	2,193	119,555	2,373	128,757
Deferred credits and other noncurrent liabilities	218	12,228	209	11,613
	2,480	135,701	2,605	141,630
Net foreign currency-denominated liabilities	US$2,158	Php117,602	US$2,417	Php131,153

(1) The exchange rate used was Php56.176 to US$1.00.
(2) The exchange rate used was Php55.586 to US$1.00.

While a certain percentage of our revenues is either linked to or denominated in U.S. dollars, substantially all of our indebtedness, a substantial portion of our capital expenditures and a portion of our operating expenses are denominated in foreign currencies, mostly in U.S. dollars.

As of June 30, 2004, approximately 98% and 97% of our total consolidated and non-consolidated debts, respectively, were denominated in foreign currencies. Of our foreign currency-denominated debts, 7% and 8% are in Japanese yen, on a consolidated and non-consolidated basis, respectively, and the balance in U.S. dollars. Thus, a weakening of the peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 62% and 59% of our consolidated and non-consolidated debts, respectively), and interest expense on our debt in peso terms. In addition, many of our financial ratios and other financial tests will be negatively affected. If, among other things, the value of the peso against the U.S. dollar drops from its current level, we may be unable to maintain compliance with these ratios, which could result in acceleration of some or all of our indebtedness. For further information on our loan covenants, see "Liquidity and Capital Resources — Financing Activities — Covenants" above and *Note 12 – Long-term Debt* to the accompanying financial statements.

To manage our foreign exchange risks, stabilize cash flows, and improve investment and cash flow planning, we enter into forward foreign exchange contracts, foreign currency swap contracts, currency options and other hedging products aimed at reducing and/or managing the adverse impact of changes in foreign exchange rates on our operating results and cash flows. However, these hedges do not cover all of our exposure to foreign exchange risks, and hedges to cover all of our exposure are not currently or readily available.

Specifically, we use forward foreign exchange contracts, foreign currency swap contracts and currency option contracts to manage the foreign exchange risk associated with our foreign currency-denominated loans. As of June 30, 2004, PLDT's outstanding forward foreign exchange contracts, principal-only long-term cross-currency swap contracts and currency option contracts amounted to US$76 million, US$725 million, and US$73 million and JP¥863 million, respectively.

Smart's outstanding forward foreign exchange contracts amounted to US$121 million as of June 30, 2004. Also, Smart had a long-term cross-currency swap contract which matured on April 30, 2003. The final exchange has been made and the contract has been terminated.

For further discussions of these contracts, see *Note 12 – Long-term Debt* to the accompanying financial statements.

Interest Rate Risk Management

From time to time and on a limited basis, we enter into interest rate swap agreements in order to manage our exposure to interest rate fluctuations.

We make use of hedging instruments and structures solely for reducing or eliminating financial risks associated with our liabilities and not for trading or speculative purposes.

Effect of Peso Depreciation

In the first half of 2004 and 2003, our operating revenues, which have been received in U.S. dollars or in respect of which we have been able to adjust our service fees to reflect changes in the peso-to-dollar exchange rate exceeded our U.S. dollar-linked operating expenses. As a result, the depreciation of the peso against the dollar over this period had a positive net impact on

our operating profit. However, since substantially all of our indebtedness is denominated in U.S. dollars, such depreciation has also increased our interest expense in peso terms and increased the peso amounts of our U.S. dollar-denominated indebtedness. We have capitalized foreign exchange losses in respect of U.S. dollar-denominated indebtedness, and net income in future periods is expected to be negatively affected as a result of higher depreciation expense resulting from such capitalization. Our cash flows are negatively affected by the higher peso cost of repaying U.S. dollar-denominated debts, and our ability to comply with financial covenants and ratios is negatively affected by the increase in the amount of our debts and our interest expenses in peso terms.

Impact of Inflation and Changing Prices

Inflation can be a significant factor in the Philippine economy, and we are continually seeking ways to minimize its impact. In recent periods, while decreases in the relative value of the peso have had a significant effect on us, we do not believe inflation has had a material impact on our operations. The average inflation rate in the Philippines in the first half of 2004 was 5.1%, compared to 2.9% in the same period in 2003.

OTHER INFORMATION

Piltel Debt Exchange Transaction

On July 2, 2004, Smart announced that it had successfully closed the Piltel debt exchange transaction. This concluded the process begun in March this year when Smart invited various creditors of Piltel to exchange their indebtedness for various types of Smart debt and/or cash, as follows:

- Cash settlement, at a maximum exchange price of US$0.40 for each US$1.00 equivalent of Piltel debt exchanged;
- US$ Smart debt maturing in December 2007 at the rate of US$0.525 for each US$1.00 equivalent of Piltel debt exchanged, with interest at US$ LIBOR plus 1% per annum, payable quarterly;
- US$ Smart debt maturing in December 2008 at the rate of US$0.575 for each US$1.00 equivalent of Piltel debt exchanged, with interest at US$ LIBOR plus 1% per annum, payable quarterly;
- US$ Smart 10-year debt maturing in June 2014, at par by reference to the US$1.00 equivalent of Piltel debt exchanged, with fixed interest at 2.25% per annum, payable quarterly; and
- For Yen Trade creditor, US$ Smart 10-year debt maturing in June 2014, at par by reference to the US$1.00 equivalent of Piltel debt exchanged, with fixed interest at 2.25% per annum, payable quarterly and with an option to elect, by not less than 15 months' prior notice, for an early repayment at a discount either on December 2007 at 52.5% of the relevant debt amount or on December 2008 at 57.5% of the relevant debt amount.

By the end of the offer period on May 31, 2004, Smart had received offers from Piltel's creditors representing approximately 69.4% in aggregate of the outstanding restructured Piltel debt. In addition, it had received, from a significant portion of the Piltel creditors who did not participate in the transaction, waivers to certain provisions of the agreements governing Piltel's restructured indebtedness, allowing Smart to close the transaction. Given the high level of

acceptance from the Piltel creditors, the Board of Directors of PLDT and Smart endorsed Smart's decision to proceed with the Piltel debt exchange transaction.

As a result, Smart became Piltel's largest creditor, holding US$289 million of Piltel's US$417 million restructured debt. Based on the options chosen by the participating creditors, Smart has issued to them US$283.2 million in new debt and paid US$1.5 million in cash.

Option	Allocation		Exchange	New Debt/Cash
	Amount	%	Ratio (%)	Outlay of Smart
	(in millions, except percentage)			
2014 Smart Debt	US$280.1	67.2	100.0	US$280.1
2008 Smart Debt	5.0	1.2	57.5	2.9
2007 Smart Debt	0.4	0.1	52.5	0.2
Subtotal	285.5	68.5	210.0	283.2
Cash	3.8	0.9	40.0	1.5
Total	**US$289.3**	**69.4**	**250.0**	**US$284.7**

Further, in line with the previously announced intention of Smart to acquire PLDT's equity holdings in Piltel, also on July 2, 2004, Smart entered into a Sale and Purchase Agreement with PLDT to acquire the latter's 59.3 million shares of Piltel Series K, Class I Convertible Preferred Stock for Php2,066 million. The payment was settled through an offset of amounts owed to Smart by PLDT arising primarily from interconnection charges. At a later stage, Smart intends to acquire the common shares held by PLDT in Piltel, thereby consolidating PLDT's wireless holdings.

On July 9, 2004, Smart converted a total of 4.8 million shares of Piltel Series K, Class I Convertible Preferred Stock into 820.3 million shares of Piltel common stock, equivalent to 32.7% of the total outstanding shares of common stock of Piltel after such conversion. Such initial conversion resulted in diluting PLDT's ownership in Piltel to 30.5%. Smart intends to convert its remaining 54.5 million shares of Piltel Series K, Class I Convertible Preferred Stock into 9,260 million shares of common stock from the increase in authorized capital stock of Piltel. Piltel has scheduled a special stockholders' meeting on September 3, 2004 to approve this increase. Once all the outstanding shares of Piltel Series K, Class I Convertible Preferred Stock are fully converted, Smart will hold a total of 10,080 million shares of common stock of Piltel, equivalent to 85.6% of the resulting total outstanding shares of common stock after such conversion. In aggregate therefore, ownership of Piltel by PLDT and Smart will be 92.1%.

On July 19, 2004, Smart received confirmation from the Philippines' Securities and Exchange Commission, or SEC, that the issuance of 820.3 million shares of common stock of Piltel, equivalent to 32.7% of total outstanding shares of common stock of Piltel after the initial conversion will not trigger a mandatory tender offer requirement under Section 19 of the Securities Regulation Code. The SEC also confirmed that the conversion of the remaining preferred stocks made through an increase in Piltel's capital stock is also exempt from mandatory tender offer requirement.

U.S. Federal Communications Commission, or U.S. FCC, Ruling versus Philippine Telecommunications Companies

Effective as of February 1, 2003, PLDT stopped terminating traffic sent directly by each of AT&T and MCI, because PLDT's termination rate agreements with AT&T and MCI lapsed in December 2002 without either agreeing with PLDT on any provisional arrangement or final agreement on new termination rates. In separate orders dated February 7 and 26, 2003, the

National Telecommunications Commission, or NTC, confirmed that "absent any provisional or interim agreement" with U.S. carriers, there would be no provision of termination services between the parties "who are thereby encouraged to seek other routes or options to terminate traffic to the Philippines." Upon petitions of AT&T and MCI, on March 10, 2003, the International Bureau of the U.S. FCC issued an Order which directed all facilities-based carriers subject to U.S. FCC jurisdiction to suspend payments for termination services to Philippine carriers, including PLDT, Smart and Subic Telecom, until such time as the U.S. FCC issues a Public Notice that AT&T's and MCI's circuits on the U.S.–Philippine route were fully restored. The Order also removed the Philippines from the list of U.S.–international routes approved for the provision of International Simple Resale, or ISR. In response to the International Bureau's Order, the NTC issued a Memorandum Order dated March 12, 2003, directing all affected Philippine carriers "(1) not to accept terminating traffic via direct circuits from U.S. facilities-based carriers who do not pay Philippine carriers for services rendered; and (2) to take all measures necessary to collect payments for services rendered in order to preserve the viability, efficiency, sustained growth and development and continued competitiveness of the Philippine telecommunications industry."

On October 17, 2003, based on negotiations between the NTC and the U.S. FCC to resolve the issue regarding termination rates, the NTC, in the expectation that the U.S. FCC would fully lift the March 10, 2003 Order, lifted its March 12, 2003 Order and directed all Philippine carriers to immediately accept terminating traffic via direct circuits from U.S. facilities-based carriers at mutually acceptable final or interim termination rates and other terms and conditions agreed upon by the parties.

On November 17, 2003, after Smart reached interim agreements with each of AT&T and MCI on September 30 and November 12, 2003, respectively, the International Bureau of the U.S. FCC lifted its March 10, 2003 Order with respect to Smart and ordered the U.S. carriers to resume making payments to Smart.

On January 15, 2004, after PLDT reached interim agreements with each of MCI and AT&T and reopened its circuits with these carriers on November 12, 2003 and January 9, 2004, respectively, the International Bureau of the U.S. FCC lifted its March 10, 2003 Order also with respect to PLDT and ordered the U.S. carriers to resume making payments to PLDT.

On May 13, 2004, the U.S. FCC partially dismissed and partially denied applications by Philippine carriers, including PLDT, and certain U.S. carriers for review of the March 10, 2003 Order of the International Bureau of the U.S. FCC. In particular, the U.S. FCC affirmed the March 10, 2003 Order's finding that "Philippine carriers engaged in collective action to "whipsaw" AT&T and MCI." The U.S. FCC stated, however, that the findings of the March 10, 2003 Order were not findings under the U.S. anti-trust laws and that the U.S. Department of Justice is independently "investigating the possibility of anticompetitive practices among Philippine carriers under its authority pursuant to U.S. anti-trust laws." The U.S. FCC also upheld the March 10, 2003 Order in respect of the suspension of payments for termination services to the Philippine carriers pending restoration of the circuits. In addition, the U.S. FCC denied a request to modify the March 10, 2003 Order of the International Bureau of the U.S. FCC to restore the Philippines to the list of U.S.-international routes approved for the provision of ISR. The U.S. FCC stated that it was dismissing this request as moot because of the U.S. FCC's recently adopted International Settlements Policy Reform which eliminated International Settlements Policy, or ISP.

Although not included in the initial list of countries exempted from the U.S. FCC's ISP, the U.S. FCC identified the U.S.-Philippines route as eligible for being removed from the ISP in

accordance with its newly established procedures for doing so. Under this procedure, the U.S. FCC asked for public comment on the removal of the Philippines from the ISP. In comments filed in June and July, 2004, removal was supported by several Philippine and U.S. carriers, including AT&T and MCI, and was opposed by one U.S. carrier, International Access, Inc.

On July 6, 2004, PLDT filed with the U.S. FCC a Petition for Reconsideration of the Commission's May 13, 2004 Order on the grounds that the Order should have vacated as moot the International Bureau's March 10, 2003 Order.

Investigation by U.S. Department of Justice

In January 2004, PLDT received grand jury subpoena seeking documents and a PLDT employee was subpoenaed to testify before the grand jury in connection with a criminal investigation being conducted by the U.S. Department of Justice with respect to alleged antitrust violations relating to the provision of international termination services in the Philippines. The U.S. Department of Justice has also requested testimony and documents from Smart in connection with this investigation. Further, in March 2004, PLDT (U.S.) Ltd., a subsidiary of PLDT Global, received a grand jury subpoena seeking documents, in response to which PLDT (U.S.) Ltd. is currently producing documents. In addition, in March 2004, a PLDT (U.S.) Ltd. employee received a subpoena to testify before the grand jury in connection with this investigation. This employee has not yet been asked to appear before the grand jury. At this time, the PLDT Group cannot predict the outcome of this investigation.

Adoption of International Accounting Standards, or IAS

In recent years, the Philippine Accounting Standards Council, or ASC, has been adopting the International Accounting Standards, or IAS, issued by the International Accounting Standards Council, or IASC with no local equivalent standards and has been replacing existing local standards.

The International Accounting Standards Board, or IASB, assumed from the IASC the responsibility for setting the international accounting standards. The standards issued by the IASB are designated as International Financial Reporting Standards, or IFRS. Upon its inception, the IASB also adopted the IAS issued by the IASC. The IASB carried on improvements on certain IAS in preparation for the full adoption of IFRS in 2005. In line with this initiative, the IASB has recently issued revised IAS, IFRS and exposure drafts, or EDs, most of which are to be effective in 2005.

We are currently in the process of evaluating the impact of the new and revised standards on our financial statements. See *Note 3 – Accounting Changes* to the accompanying financial statements for further discussion.

Related Party Transactions

In the ordinary course of business, companies belonging to the PLDT Group are engaged in arm's-length intercompany transactions. We believe that the terms of these transactions are comparable with those available from unrelated parties.

- *Telecommunications services provided within the PLDT Group* — interconnection agreements and connectivity service agreements for leased lines, under terms similar with those agreed with other telecommunications providers outside the PLDT Group.

- *Transponder Lease Agreement between PLDT and Mabuhay Satellite* — an agreement pursuant to which Mabuhay Satellite leases to PLDT C-band transponders on board the Agila II satellite. Total fees under this agreement totaled Php341 million and Php385 million for the six months ended June 30, 2004 and 2003, respectively. PLDT's outstanding obligations under this agreement amounted to Php26 million as of June 30, 2004 and December 31, 2003.

- *Facilities Management Agreement between PLDT and Piltel* — an agreement under which PLDT undertakes the management, operation and maintenance of Piltel's regional telecommunications facilities as well as Executive Order No. 109, network operations and services, including E.O. 109 fixed line build-out installations, public calling offices, payphone facilities, and the systems required to support these services. Total management fees under this agreement totaled Php35 million and Php41 million for the six months ended June 30, 2004 and 2003, respectively. PLDT's outstanding receivables under this agreement amounted to Php367 million and Php329 million as of June 30, 2004 and December 31, 2003, respectively.

- *Facilities Management Agreement between Piltel and Subic Telecom* — an agreement under which Subic Telecom manages the regional telephone network, customer operations, network operations and payphones of Piltel in Subic and Olongapo City. Total management fees under this agreement totaled Php11 million for the six months ended June 30, 2004 and 2003. This new agreement is effective for three years until September 2004. Subic Telecom's outstanding receivables under this agreement amounted to Php51 million and Php11 million as of June 30, 2004 and December 31, 2003, respectively.

- *Agreements between Smart and Piltel* — agreements relating to the integration of Smart's and Piltel's operations under which Smart undertakes to manage Piltel's facilities, customer services, administrative support and management services and billing services. Total fees under these service agreements totaled Php463 million and Php348 million for the six months ended June 30, 2004 and 2003, respectively. Smart's outstanding receivables under these agreements amounted to Php221 million and Php906 million as of June 30, 2004 and December 31, 2003, respectively. In addition, Smart also entered into a facilities service agreement with Piltel under which Piltel accesses Smart's existing GSM network and facilities to enable Piltel to offer prepaid cellular service using GSM technology in exchange for approximately 50% of Piltel's revenues, net of interconnection expenses. Total facility fees under this agreement amounted to Php2,814 million and Php1,823 million for the six months ended June 30, 2004 and 2003, respectively. Under this agreement, outstanding receivables of Smart amounted to Php1,219 million and Php633 million as of June 30, 2004 and December 31, 2003, respectively.

- *Air Time Purchase Agreement between PLDT and AIL and Related Agreements* — an agreement under which PLDT has been granted the exclusive right to sell ACeS services in the Philippines. In March 2003, PLDT, together with the other founder shareholders, entered into a Standstill Agreement in respect of the Air Time Purchase Agreement. On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement following the lapse of the November 15, 2003 deadline set for the negotiation of a revised Air Time Purchase Agreement. On June 21, 2004, AIL also sent PLDT a letter citing PLDT in default under the Air Time Purchase Agreement for non-

payment of outstanding amounts and for repudiation of its obligations thereunder. See *Note 21 – Provisions and Contingencies* to the accompanying financial statements for further discussion.

- *Agreements between Smart and Mabuhay Satellite* — Smart entered into transponder lease agreement with Mabuhay Satellite for the use of the transponders aboard its satellite, Agila II. The monthly rent for the transponders is on a tiered-pricing scheme per megahertz based on the actual usage of Smart. Total fees under this agreement amounted to Php49 million and Php24 million for the six months ended June 30, 2004 and 2003, respectively. Outstanding obligations of Smart under this agreement amounted to Php10 million and Php13 million as of June 30, 2004 and December 31, 2003, respectively.

- *Agreements between Smart and ACeS Philippines* — agreements under which Smart (1) provides ACeS Global Mobile Personal Communications by Satellite, or GMPCS, services, in the Philippines under a revenue-sharing agreement, (2) undertakes the management, maintenance and operations of GMPCS, and (3) provides certain administrative support and services in certain aspects of ACeS Philippines' business operations. Total fees under these agreements, net of ACeS' share, totaled Php41 million and Php36 million for the six months ended June 30, 2004 and 2003, respectively. Under these agreements, Smart's outstanding obligation to ACeS amounted to Php36 million as of June 30, 2004 while Smart had no outstanding obligation as of December 31, 2003.

In addition, transactions to which PLDT or its subsidiary is a party, in which a director or key officer or owner of more than 10% of the common shares of PLDT, or any member of the immediate family of a director or key officer or owner of more than 10% of the common shares of PLDT had a direct or indirect material interest as of June 30, 2004 and December 31, 2003 and for the six months ended June 30, 2004 and 2003 are as follows:

- *Agreements with NTT Communications and/or its Affiliates* — agreements under which (1) NTT Communications provides advisory services for various business areas of PLDT; (2) NTT World Engineering Marine Corporation provides maintenance services to PLDT's domestic fiber optic network; (3) PLDT is licensed to market managed data and other services using NTT Communications' Arcstar brand; and (4) PLDT and NTT Communications agreed to cooperative arrangements for international telecommunication services. Total fees under these agreements totaled Php146 million and Php147 million for the six months ended June 30, 2004 and 2003, respectively. PLDT's outstanding obligations under these agreements amounted to Php31 million and Php40 million as of June 30, 2004 and December 31, 2003, respectively.

- *Agreements between Smart and Asia Link B.V.* — agreements under which Asia Link undertakes to provide technical support services for the operations and maintenance of Smart's CMTS. Total fees under these agreements totaled Php214 million and Php147 million for the six months ended June 30, 2004 and 2003, respectively. Under these agreements, Smart had outstanding payables of Php119 million and Php228 million as of June 30, 2004 and December 31, 2003, respectively. Asia Link is a subsidiary of theFirst Pacific Group.

- *Agreements relating to insurance companies* — Gotuaco del Rosario and Associates, or Gotuaco, acts as the broker for certain insurance companies to cover certain insurable properties of the PLDT Group. Insurance premiums are remitted

to Gotuaco and the broker's fees are settled between Gotuaco and the insurance companies. In addition, PLDT has signed an insurance policy with Malayan Insurance Co. Inc., or Malayan, wherein premiums are paid directly to Malayan. Premium payments to Gotuaco and Malayan covering the 12-month period ending July 31, 2004 totaled Php324 million. Two directors of PLDT have a direct/indirect interest in or serve as director/officer of Gotuaco and Malayan.

For a more detailed discussion of the related party transactions enumerated above, see *Note 15 – Related Party Transactions* to the accompanying financial statements.