



**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
For the Year Ended December 31, 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 – Summary of Significant Accounting Policies to the accompanying consolidated 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 consolidated 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 consolidated 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 consolidated financial statements were made based on the exchange rate of Php56.341 to US\$1.00, the volume weighted average exchange rate at December 31, 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.

Our consolidated financial statements as of and for the year ended December 31, 2004 incorporate certain changes in accounting policies which have affected our financial position and



results of operations retrospectively. For further discussion please see Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

Financial Highlights and Key Performance Indicators

(in millions)	December 31,		Increase (Decrease)	
	2004 (Audited)	2003(1) (As restated)	Amount	%
Consolidated Balance Sheets				
Total assets	Php265,473	Php255,647	Php9,826	4
Cash and cash equivalents and short-term investment	31,194	21,034	10,160	48
Property, plant and equipment	194,525	194,790	(265)	–
Interest-bearing financial liabilities	164,489	192,348	(27,859)	(14)
Long-term debt	149,030	176,456	(27,426)	(16)
Total equity	48,515	21,449	27,066	126
Net debt to equity ratio(2)	2.43x	7.25x	–	–
Years Ended December 31,				
	2004 (Audited)	2003(1) (As restated)	Amount	%
Consolidated Statements of Income				
Revenues and other income	Php126,252	Php112,283	Php13,969	12
Expenses	93,332	110,607	(17,275)	(16)
Income before income tax	32,920	1,676	31,244	1,864
Net income attributable to equity holders	28,044	2,123	25,921	1,221
Net income margin	22%	2%	–	–
Consolidated Statements of Cash Flows				
Net cash provided by operating activities	Php73,514	Php55,972	Php17,542	31
Net cash used in investing activities	23,939	19,610	4,329	22
Capital expenditures	21,162	18,019	3,143	17
Net cash used in financing activities	41,557	27,937	13,620	49
Operational Data				
Number of cellular subscribers	19,208,232	12,947,197	6,261,035	48
Number of fixed lines in service	2,152,027	2,185,951	(33,924)	(2)
Number of employees	19,099	18,191	908	5

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

(2) Net debt is derived by deducting cash and cash equivalents and short-term investment from long-term debt.

In line with the accounting changes we adopted as discussed below, our results of operations discussion was changed to reflect our revised financial statement presentation. Following Philippine Accounting Standards, or PAS, No. 1 “Presentation of Financial Statements” (equivalent to IAS 1), the results of operating activities on the face of our statements of income was removed. Instead, all inflow activities are discussed under “Revenues and Other Income” and all outflow activities are grouped together under “Expenses”. Accordingly, our business segment discussion is based on this presentation.

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 Smart Communications, Inc., or Smart, and Pilipino Telephone Corporation, or Piltel, our cellular service providers, 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 Clark Telecom, Inc., Subic Telecommunications Company, Inc., PLDT-Maratel, Inc., Piltel and Bonifacio Communications Corporation, which together account for approximately 3% 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.; call center services provided by ePLDT's subsidiaries Parlance Systems, Inc., Vocativ Systems, Inc. and ePLDT Ventus, Inc.; internet access and gaming services provided by ePLDT's subsidiaries, Infocom Technologies, Inc., Digital Paradise, Inc. and netGames, Inc.; and e-commerce and IT-related services provided by other investees of ePLDT, as discussed in *Note 9 – Investments in Associates* to the accompanying consolidated financial statements.

Driven by the continued growth of our wireless business segment, particularly our cellular business, we registered total revenues and other income of Php126,252 million, an increase of Php13,969 million or 12%, as compared to Php112,283 million in 2003.

Expenses decreased by Php17,275 million or 16% from Php110,607 million in 2003 to Php93,332 million in 2004 largely resulting from decreases in financing costs, cost of sales, asset impairment, and compensation and benefits .

With the expiration of Smart's income tax holiday in May 2004, we recognized a provision for income tax of Php4,948 million for 2004 as compared to a benefit from income tax of Php545 million for 2003.

As a result of the foregoing, our net income attributable to equity holders increased by Php25,921 million, or 1,221%, from Php2,123 million in 2003 to Php28,044 million in 2004.

Accounting Changes

The accounting policies adopted are consistent with those of the previous financial year except that we have adopted the following new accounting standards effective for financial years beginning January 1, 2004 and accounting standards intended to be mandatory for financial years beginning on or after January 1, 2005.

Adoption of the new standards involved the following changes in accounting policies and we have accordingly restated our comparative consolidated financial statements retroactively in accordance with the transitional rules detailed in these standards.

PAS effective January 1, 2004:

- **PAS 12 "Income Taxes"**. PAS 12 prescribes the accounting treatment for current and noncurrent deferred income taxes. This standard requires the use of the balance sheet liability method in accounting for deferred income taxes. It requires the recognition of a deferred tax liability and, subject to certain conditions, a deferred tax

asset, for all temporary differences with certain exceptions. This standard provides for the recognition of a deferred tax asset when it is probable that taxable income will be available against which the deferred tax asset can be used. It also provides for the recognition of a deferred tax liability with respect to asset revaluations and fair value adjustments arising from business combinations.

- **PAS 17 “Leases”.** PAS 17 requires the capitalization of finance leases, which transfer substantially all the risks and benefits incidental to ownership of leased item, at the inception of the lease at the fair value of leased property or, if lower, at the present value of the minimum lease payments. PAS 17 also requires that a lease, where the lessor retains substantially all the risks and benefits of ownership of the asset, be classified as operating lease, which should be recognized as an expense in the income statement on a straight-line basis over the lease term.

PAS effective January 1, 2005:

- **PAS 19 “Employee Benefits”.** PAS 19 requires the use of the projected unit credit method in measuring retirement benefit expense and a change in the manner of computing benefit expense relating to past service cost and actuarial gains and losses. Past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. On the initial adoption of this standard, the effect of the change in accounting policy includes all actuarial gains and losses that arose in earlier periods even if they fall inside the 10% corridor. In subsequent periods, portion of actuarial gains or losses is recognized as income or expense if the cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceeded the greater of: (i) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and (ii) 10% of the fair value of any planned assets at that date by dividing the excess determined by the expected average remaining working lives of the employees participating in that plan is recognized immediately as income or expense.
- **PAS 21 “The Effects of Changes in Foreign Exchange Rates”.** PAS 21 requires the recognition of foreign exchange gains and losses in the period they are incurred. Upon the adoption of PAS 21, we adjusted previously recorded undepreciated capitalized foreign exchange losses, net of exchange losses that qualify as borrowing cost and income tax effect, against beginning retained earnings, to the extent that such capitalized amounts do not meet the conditions for capitalization under the new accounting standard, and restated prior years’ consolidated financial statements. Further, PAS 21 requires the determination of the functional currency of an entity. Exchange differences arising from any retranslation are taken directly to a separate component of equity. On disposal of an entity with a functional currency other than the Philippine peso, the deferred cumulative amount recognized in equity relating to that particular operation shall be recognized in the consolidated income statement.
- **PAS 27 “Consolidated and Separate Financial Statements”.** PAS 27 supersedes SFAS 27/IAS 27, “Consolidated Financial Statements and Accounting for Investments in Subsidiaries.” Under PAS 27, the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that significantly impair a subsidiary’s ability to transfer funds to the parent company was removed.

Consequently, Piltel was required to be included in our consolidated financial statements retrospectively.

- **PAS 32 “Financial Instruments: Disclosure and Presentation”.** PAS 32 covers the disclosure and presentation of all financial instruments. This standard requires more comprehensive disclosures about a company’s financial instruments, whether recognized or unrecognized in the consolidated financial statements. New disclosure requirements include terms and conditions of financial instruments used, types of risks associated with both recognized and unrecognized financial instruments (market risk, price risk, credit risk, liquidity risk, and cash flow risk), fair value information of both recognized and unrecognized financial assets and financial liabilities, and our financial risk management policies and objectives. This standard also requires financial instruments to be classified as liabilities or equity in accordance with their substance and not their legal form. Consequently, we have designated PLDT’s Convertible Preferred Stock Series V, VI and VII as compound instruments consisting of liability and equity components. The total fair value of the Convertible Preferred Stock Series V, VI and VII was determined at issue date, of which the aggregate fair value of the liability component of the Series V, VI and VII Convertible Preferred Stock as of date of issuance is included as a financial liability under *Note 18 – Interest-bearing Financial Liabilities* account in the consolidated balance sheets. The residual amount was assigned as the equity component.
- **PAS 39 “Financial Instruments: Recognition and Measurement”.** PAS 39 establishes the accounting and reporting standards for recognizing and measuring our financial assets and financial liabilities. This standard requires a financial asset or financial liability to be recognized initially at cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability) for it. Subsequent to initial recognition, we are to continue to measure financial assets at their fair values, except for loans and receivables originated by the enterprise and not held for trading and held-to-maturity investments, which are measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as “at fair value through profit and loss” and derivatives, which are measured at fair value.

PAS 39 also covers the accounting for derivative instruments. This standard has expanded the definition of a derivative instrument to include derivatives (derivative-like provisions) embedded in non-derivative contracts. Under this standard, every derivative instrument is recorded in the balance sheet as either an asset or liability measured at its fair value. Derivatives that are not designated and do not qualify as hedges are adjusted to fair value through income. If the derivative is designated and qualifies as a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in equity until the hedged item is recognized in earnings.

- **PAS 40 “Investment Property”.** PAS 40 prescribes the accounting treatment for investment property which is defined as land and/or building held to earn rentals or for capital appreciation or both. An investment property is initially recognized at cost. Subsequent to initial recognition, investment property is either carried at (i) cost, less accumulated depreciation or any accumulated impairment losses, or (ii) fair

value, wherein fair value movements are recognized as income or expense. Transfers to or from investment property classification are made only when there is evidence of a change in use.

- **PFRS 2 “Share-Based Payment”.** PFRS 2 requires an entity to recognize goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. In line with our adoption of PFRS 2, we recognized in our consolidated statements of income the costs of employees’ and directors’ share options and other share-based incentives by using an option-pricing model, further details of which are given in *Note 22 – Employee Benefits*.
- **PFRS 3 “Business Combinations”, PAS 36 “Impairment of Assets” and PAS 38 “Intangible Assets”.** PFRS 3 requires all business combinations within its scope to be accounted for by applying the purchase method. In addition, this standard requires the acquirer to initially measure separately the identifiable assets, liabilities and contingent liabilities at their fair values, at acquisition date, irrespective of the extent of any minority interest.

PFRS 3 also requires goodwill in a business combination to be recognized by an acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer’s interest in the net fair value of the acquiree’s identifiable assets and liabilities. Further, the amortization of goodwill acquired in a business combination is prohibited; instead, goodwill is to be tested annually, or more frequently, if events or changes in circumstances indicate that the asset might be impaired.

- **PFRS 5 “Disposal of Non-Current Assets and Presentation of Discontinued Operations”.** Under the superseded PAS 35, we would have previously recognized a discontinued operation at the earlier of when (a) we enter into a binding agreement; and (b) the board of directors have approved and announced a formal disposal plan. PFRS 5 now requires an operation to be classified as discontinued when the criteria to be classified as held for sale have been met or we have disposed of the operation.

Following additional guidelines from PAS 16 “Property, Plant and Equipment”, we have recognized the initial settlement of the net present value of legal and constructive obligations associated with the retirement of a tangible long-lived asset that resulted from the acquisition, construction or development and the normal operation of a long-lived asset in the period in which it is incurred. The asset retirement obligations were recognized in the period in which they are incurred if a reasonable estimate of fair values can be made. The related asset retirement costs are capitalized as part of the carrying amount of the corresponding property, plant and equipment which are being depreciated on a straight-line basis over the useful lives of the related assets or the contract periods, whichever is lower.



The following is the reconciliation from net income and equity as previously reported to net income and equity as restated, including the effect of these restatements on per share amounts:

	Equity			Net Income		
	December 31,			For the years ended December 31,		
	2003	2002	2001	2003	2002	2001
<i>(in millions, except per share amounts)</i>						
As previously reported	Php94,929	Php88,936	Php87,302	Php11,182	Php3,003	Php2,699
PAS 16 – Property, Plant and Equipment	(143)	(70)	(43)	(73)	(28)	(18)
PAS 17 – Leases	(562)	(547)	(458)	(15)	(88)	(90)
PAS 19 – Employee Benefits	(3,059)	(1,946)	(1,645)	(1,112)	(301)	(179)
PAS 21 – The Effects of Changes in Foreign Exchange Rates	(37,111)	(36,590)	(37,592)	(596)	946	8,369
PAS 27 – Consolidated and Separate Financial Statements	(19,446)	(16,424)	952	(3,445)	(17,581)	(8,321)
PAS 32 – Financial Instruments: Disclosure and Presentation	(14,481)	(12,811)	(11,792)	(1,775)	(1,353)	(3,590)
PAS 39 – Financial Instruments: Recognition and Measurement	1,045	3,078	3,943	(2,034)	(865)	3,988
PAS 40 – Investment Property	236	254	265	(18)	(10)	49
PFRS 2 – Share-Based Payment	–	–	–	10	(76)	(119)
PFRS 3 – Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets	41	–	–	(1)	–	–
As restated	Php21,449	Php23,880	Php40,932	Php2,123	Php(16,353)	Php2,788
Earnings per common share, as previously reported				Php55.74	Php8.03	Php7.10
Earnings per share impact of restated items:						
PAS 16 – Property, Plant and Equipment				(0.43)	(0.16)	(0.11)
PAS 17 – Leases				(0.09)	(0.52)	(0.54)
PAS 19 – Employee Benefits				(6.57)	(1.78)	(1.06)
PAS 21 – The Effects of Changes in Foreign Exchange Rates				(3.52)	7.06	49.62
PAS 27 – Consolidated and Separate Financial Statements				(20.34)	(103.98)	(49.34)
PAS 32 – Financial Instruments: Disclosure and Presentation				(10.40)	(8.36)	(19.81)
PAS 39 – Financial Instruments: Recognition and Measurement				(10.57)	(5.12)	23.65
PAS 40 – Investment Property				(0.11)	0.10	6.69
PFRS 2 – Share-Based Payment				0.06	(0.45)	(0.71)
PFRS 3 – Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets				(0.01)	–	–
Earnings per common share, as restated				Php3.76	Php(105.18)	Php15.49

For a detailed discussion regarding changes in accounting policies, please refer to *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

Results of Operations

The table below shows the contribution by each of our business segments to our revenues and other income, expenses and net income (losses) for the years ended December 31, 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.

	<u>Wireless</u>	<u>Fixed Line</u>	<u>ICT</u>	<u>Inter-segment Transactions</u>	<u>Total</u>				
(in millions)									
For the year ended December 31, 2004									
Revenues and Other Income	Php80,057	Php48,810	Php2,415	Php(5,030)	Php126,252				
Service	69,349	48,486	2,080	(4,661)	115,254				
Non-service	6,111	–	321	(163)	6,269				
Other income	4,597	324	14	(206)	4,729				
Expenses	48,381	46,943	3,038	(5,030)	93,332				
Net Income (Loss) attributable to equity holders	27,354	1,383	(693)	–	28,044				
For the year ended December 31, 2003(1)									
Revenues and Other Income	65,780	47,175	1,893	(2,565)	112,283				
Service	54,653	46,920	1,467	(2,436)	100,604				
Non-service	10,548	–	316	(150)	10,714				
Other income	579	255	110	21	965				
Expenses	54,503	56,315	2,354	(2,565)	110,607				
Net Income (Loss) attributable to equity holders	9,625	(7,118)	(384)	–	2,123				
	<u>Amount</u>	<u>%(1)</u>	<u>Amount</u>	<u>%(1)</u>	<u>Amount</u>	<u>%(1)</u>	<u>Amount</u>	<u>Amount</u>	<u>%</u>
Increase (Decrease)									
Revenues and Other Income	Php14,277	22	Php1,635	3	Php522	28	Php(2,465)	Php13,969	12
Service	14,696	27	1,566	3	613	42	(2,225)	14,650	15
Non-service	(4,437)	(42)	–	–	5	2	(13)	(4,445)	(41)
Other income	4,018	694	69	27	(96)	(87)	(227)	3,764	390
Expenses	(6,122)	(11)	(9,372)	(17)	684	29	(2,465)	(17,275)	(16)
Net Income (Loss) attributable to equity holders	17,729	184	8,501	119	(309)	80	–	25,921	1,221

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

Wireless

Revenues and Other Income

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



The following table summarizes our service and non-service revenues and other income from our wireless business for the years ended December 31, 2004 and 2003 by service segment:

(in millions)	Years Ended December 31,					
	2004		2003(1)		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
Wireless services:						
Service Revenues						
Cellular	Php67,391	84	Php52,950	80	Php14,441	27
Satellite, VSAT and others	1,958	2	1,703	3	255	15
	<u>69,349</u>	<u>86</u>	<u>54,653</u>	<u>83</u>	<u>14,696</u>	<u>27</u>
Non-service Revenues						
Sale of handsets and SIM-packs	6,111	8	10,548	16	(4,437)	(42)
Other Income						
Gain on debt exchange transactions	4,419	6	80	–	4,339	5,424
Others	178	–	499	1	(321)	(64)
	<u>4,597</u>	<u>6</u>	<u>579</u>	<u>1</u>	<u>4,018</u>	<u>694</u>
Total Wireless Revenues and Other Income	<u>Php80,057</u>	<u>100</u>	<u>Php65,780</u>	<u>100</u>	<u>Php14,277</u>	<u>22</u>

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

Service Revenues

Our wireless service revenues increased by Php14,696 million, or 27%, to Php69,349 million in 2004 compared to Php54,653 million in 2003 mainly as a result of the continued growth of Smart's and Piltel's subscriber base. Accordingly, as a percentage of our total wireless revenues and other income, service revenues increased to 86% in 2004 from 83% in 2003.

Cellular Service

Unless otherwise indicated, the financial data and operating metrics cited in the cellular service section reflect the consolidated results of our cellular subsidiary, Smart and its subsidiary, Piltel.

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 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 service; and
- other charges, including those for reconnection and migration.

Our cellular service revenues in 2004 amounted to Php67,391 million, an increase of Php14,441 million, or 27%, from Php52,950 million in 2003. Cellular service revenues accounted for 84% and 80% of our total wireless revenues and other income in 2004 and 2003, respectively.

As of December 31, 2004, the combined cellular subscribers of Smart and Piltel reached 19,208,232, an increase of 6,261,035, or 48%, over their combined cellular subscriber base of 12,947,197 as of December 31, 2003. Prepaid and postpaid net subscriber activations totaled 6,235,518 and 25,517, respectively, in 2004, or a quarterly average addition of 1,558,880 prepaid and 6,379 postpaid subscribers.

Smart markets nationwide cellular communications services under the brand names *Smart Buddy*, *Smart Gold*, *addict mobile*, *Smart Infinity* and *Smart Kid*. *Smart Buddy*, *addict mobile prepaid*, or *amp*, and *Smart Kid prepaid* are prepaid services while *Smart Gold*, *addict mobile*, *Smart Infinity* and *Smart Kid* are postpaid services, which are all provided through Smart's digital network. *Smart Gold* was launched in April 1999 and remains Smart's most broadbased postpaid brand. Introduced in April 2003, *addict mobile* is aimed primarily at the 18-35 year olds in the higher and middle income markets. It 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, targeting affluent individuals 35 years and above who are highly mobile locally and internationally. It offers 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 prepaid versions of *addict mobile* and *Smart Kid* were introduced in October 2004.

Piltel markets its cellular prepaid service under the brand name *Talk 'N Text* and is provided through Smart's network. Piltel's and Smart's revenue sharing arrangement of 50-50 was changed to 80-20 in favor of Piltel for the year 2004 as approved by Piltel's and Smart's board of directors on December 22, 2004. Please see "Other Information" for further discussion.

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, Php15 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 700,000 retail agents, approximately 90% of which are micro businesses. As of December 31, 2004, approximately 97% of Smart Buddy subscribers and 93% of *Talk 'N Text* subscribers were using *Smart Load* as their reloading mechanism. In 2004, *Smart Load* has accounted for approximately 71% of sales derived from reloads.

In December 2003, Smart introduced *Pasa Load* (literally meaning "transfer load"), a derivative service of *Smart Load* that allowed for Php10 load transfers to other *Smart Buddy* and *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* encourage subscribers to stay within our cellular network instead of churning and re-subscribing at a later time. *Pasa Load* was also made available to Smart

postpaid subscribers beginning April 18, 2004 with identical denominations to those offered to prepaid subscribers. The denominations have a similar one-day load expiry. The sender is billed the amount of the load and a Php1.00 transaction fee which is added on top of the monthly service fee.

On August 1, 2004, Smart launched *Smart Padala*, a service intended for overseas Filipino workers. *Smart Padala* is the first cash remittance service through text and is faster and cheaper than traditional remittance centers. It is ideally suited for the lower income market where cash remittances have the highest need and appreciation. *Smart Padala* is coursed through Banco de Oro, a Philippine financial institution, as well as partnerships with several internationally-licensed remittance companies (e.g., CBN, Travelex) and domestic encashment centers (e.g., McDonald's, 7-11, Seaoil and Tambunting Pawnshops.) *Smart Padala* is one of the latest innovative services by Smart emanating from its *Smart Money* platform. Launched in October 2000, *Smart Money* is the foundation for Smart's mobile commerce initiatives and makes possible Smart's electronic loading services such as *Smart Load*, *Pasa Load* and *Smart Padala*. Working with Banco de Oro and MasterCard, one of the world's leading payment services providers, *Smart Money* is a reloadable electronic cash card that works with mobile phones, and can be used worldwide as a result of the MasterCard partnership. *Smart Money* has won international recognition, most notably as the Most Innovative GSM Wireless Service for Customers in the 2001 GSM Association annual assembly in Cannes. As of December 31, 2004, there were approximately 1,000,000 active *Smart Money* cards in use.

The following table summarizes key measures of our cellular business as of and for the years ended December 31, 2004 and 2003:

(in millions)	Years Ended December 31,			
	2004	2003(1)	Increase	
			Amount	%
Cellular service revenues	Php67,391	Php52,950	Php14,441	27
Mobile	67,084	52,768	14,316	27
<i>By component</i>	65,535	51,718	13,817	27
Voice	33,570	29,594	3,976	13
Data	31,965	22,124	9,841	44
<i>By service type</i>	65,535	51,718	13,817	27
Prepaid	61,340	48,226	13,114	27
Postpaid	4,195	3,492	703	20
<i>Others</i> (2)	1,549	1,050	499	48
Satellite-based PCOs (3)	307	182	125	69

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

(2) Refers to other non-subscriber-related revenues, such as inbound international roaming fees.

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

	As of December 31,			
	2004	2003	Increase	
			Amount	%
Cellular subscriber base	19,208,232	12,947,197	6,261,035	48
Prepaid	18,933,738	12,698,220	6,235,518	49
Smart	14,321,288	9,831,135	4,490,153	46
Piltel	4,612,450	2,867,085	1,745,365	61
Postpaid	274,494	248,977	25,517	10
	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Systemwide traffic volumes (in millions)				
Calls (in minutes)	5,037	4,330	707	16
Domestic	3,576	3,021	555	18
International	1,461	1,309	152	12
Inbound	1,292	1,150	142	12
Outbound	169	159	10	6
Text messages	40,953	28,825	12,128	42
Smart	33,622	24,085	9,537	40
Piltel	7,331	4,740	2,591	55

Voice Services

Cellular revenues from voice services, which include all voice traffic and voice value-added services such as voice mail and international roaming, increased by Php3,976 million, or 13%, to Php33,570 million in 2004 from Php29,594 million in 2003 mainly due to the increase in subscriber base.

Prior to January 2004, our prepaid 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 our network or to other mobile operators' networks. Beginning January 2004, we implemented all-day flat air time rates for calls made by our prepaid subscribers. *Smart Buddy* subscribers' calls terminating to subscribers within our network 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. *Talk 'N Text* subscribers, on the other hand, are charged Php5.50 for calls made to subscribers within our network, while an all-day flat rate of Php6.50 are 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 the 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

Cellular revenues from data services, which include all text messaging-related services as well as value-added services, increased by Php9,841 million, or 44%, to Php31,965 million in 2004 from Php22,124 million in 2003. Cellular data services accounted for 48% of mobile cellular revenues in 2004, compared to 42% in 2003. Text messaging-related services contributed revenues of Php28,364 million in 2004, compared to Php20,426 million in 2003, and accounted for 89% and 92% of the total cellular data revenues for 2004 and 2003, respectively. The increase in revenues from text messaging-related services resulted mainly from a 42% increase in the volume of text



messages to 40,953 million outbound messages in 2004 from the 28,825 million outbound messages handled in 2003. Value-added services contributed revenues of Php3,601 million in 2004, increasing by Php1,903 million, or 112%, from Php1,698 million in 2003.

The following table shows the breakdown of cellular data revenues for the years ended December 31, 2004 and 2003:

(in millions)	Years Ended December 31,			
	2004	2003(1)	Increase (Decrease)	
			Amount	%
Text messaging				
Domestic	Php26,502	Php18,392	Php8,110	44
International	1,862	2,034	(172)	(8)
	<u>28,364</u>	<u>20,426</u>	<u>7,938</u>	<u>39</u>
Value-added services				
Non-Zed(2)	Php1,942	Php767	Php1,175	153
Smart Zed™	617	665	(48)	(7)
Mobile Banking, Roaming SMS, WAP, Smart Money	1,042	266	776	292
	<u>3,601</u>	<u>1,698</u>	<u>1,903</u>	<u>112</u>
Total	<u>Php31,965</u>	<u>Php22,124</u>	<u>Php9,841</u>	<u>44</u>

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

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

Subscriber Base, ARPU and Churn Rates

Of our 19,208,232 subscribers as of December 31, 2004, prepaid subscribers accounted for approximately 99% while postpaid subscribers accounted for the remaining 1%. Cellular prepaid subscriber base grew by 49% to 18,933,738 as of December 31, 2004 from 12,698,220 as of December 31, 2003, whereas postpaid subscriber base increased by 10% to 274,494 as of December 31, 2004 from 248,977 as of December 31, 2003.

Our quarterly net subscriber activations over the last eight quarters are as follows:

	Prepaid		Postpaid	Total
	Smart	Piltel	Smart	
2004				
First Quarter	1,162,301	218,038	16,866	1,397,205
Second Quarter	1,207,542	468,772	7,691	1,684,005
Third Quarter	797,686	635,978	10,445	1,444,109
Fourth Quarter	1,322,624	422,577	(9,485)	1,735,716
2003				
First Quarter	527,158	205,086	36,963	769,207
Second Quarter	744,251	241,630	9,331	995,212
Third Quarter	858,723	319,528	8,816	1,187,067
Fourth Quarter	1,051,965	327,221	17,219	1,396,405

Revenues attributable to our cellular prepaid service amounted to Php61,340 million in 2004, a 27% increase over the Php48,226 million earned in 2003. Prepaid service revenues in 2004 and 2003 accounted for 94% and 93%, respectively, of voice and data revenues. Revenues attributable to Smart's postpaid service amounted to Php4,195 million in 2004, a 20% increase over



the Php3,492 million earned in 2003. Postpaid service revenues in 2004 and 2003 accounted for 6% and 7%, respectively, of voice and data revenues.

The following table summarizes our cellular monthly ARPUs for the years ended December 31, 2004 and 2003:

	Years Ended December 31,							
	Gross		(Decrease)		Net		(Decrease)	
	2004	2003	Amount	%	2004	2003	Amount	%
Prepaid								
Smart	Php428	Php521	Php(93)	(18)	Php355	Php425	Php(70)	(16)
Piltel	311	354	(43)	(12)	259	292	(33)	(11)
Prepaid – Blended	401	485	(84)	(17)	333	396	(63)	(16)
Postpaid – Smart	1,741	1,756	(15)	(1)	1,286	1,331	(45)	(3)
Prepaid and Postpaid Blended	424	512	(88)	(17)	349	416	(67)	(16)

Our quarterly prepaid and postpaid ARPUs over the last eight quarters are as follows:

	Prepaid				Postpaid	
	Smart		Piltel		Smart	
	Gross	Net	Gross	Net	Gross	Net
2004						
First Quarter	Php463	Php383	Php341	Php287	Php1,736	Php1,326
Second Quarter	455	380	341	289	1,683	1,239
Third Quarter	399	329	287	241	1,780	1,176
Fourth Quarter	395	328	275	220	1,763	1,402
2003						
First Quarter	533	416	351	273	1,716	1,268
Second Quarter	527	426	362	299	1,751	1,336
Third Quarter	490	404	345	292	1,756	1,332
Fourth Quarter	535	454	359	303	1,800	1,385

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.

Prepaid service revenues consist mainly of charges for subscribers' actual usage of their loads. Gross monthly ARPU for *Smart Buddy* subscribers in 2004 was Php428, a decrease of 18%, compared to Php521 in 2003. The decline was attributable mainly to a decrease in the average outbound local voice revenue per subscriber in 2004. On a net basis, ARPU in 2004 decreased by 16% to Php355 from Php425 in 2003. The lower rate of decrease in net ARPU compared to the decrease in gross ARPU resulted mainly from a decrease in the average interconnection expense per subscriber on the back of the increasing percentage of Smart-to-Smart traffic to local voice traffic, to 64% in 2004 from 61% in 2003. In addition, the introduction of *Smart Load* helped mitigate the decline in net ARPU due to a lower dealer discount of 5% applied to over-the-air loading compared to 10% for prepaid cards. 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 income bracket of the market. Gross monthly ARPU for *Talk 'N Text* subscribers in 2004 was Php311, a decrease of 12% compared to Php354 in 2003. The decline was attributable mainly to a decrease in the average outbound local voice revenue per subscriber in 2004. On a net basis, ARPU in 2004 decreased by 11% to Php259 from Php292 in 2003.

Monthly ARPU for Smart's postpaid services 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.

Gross monthly ARPUs for postpaid subscribers in 2004 decreased by 1% to Php1,741 while net monthly ARPUs decreased by 3% to Php1,286 compared to the ARPU levels in 2003. Prepaid and postpaid monthly gross blended ARPU was Php424 in 2004, a decrease of 17% compared to Php512 in 2003. Monthly net blended ARPU decreased by 16% to Php349 in 2004 from Php416 in 2003.

Churn, or the rate at which existing subscribers have their service cancelled 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 at 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; and 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 prepaid cellular subscriber 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 "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, may have led, based on the approach used in the past, to an overstatement of our prepaid subscriber base.

For *Smart Buddy*, the average monthly churn rate for 2004 was 2.7%, compared to 2.9% in 2003 while the average monthly churn rate for *Talk 'N Text* subscribers was 3.5% compared to 4.2% in 2003.

The average monthly churn rate for Smart's postpaid subscribers for 2004 was 1.4%, compared to 3.0% 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. Gross revenues from these services for 2004 amounted to Php1,958 million, an increase of Php255 million, or 15%, from Php1,703 million in 2003.

Non-Service Revenues

Our wireless non-service revenues consist of:

- Proceeds from sale of cellular handsets; and
- Proceeds from sale of cellular SIM-packs.

Our wireless non-service revenues decreased by Php4,437 million, or 42%, to Php6,111 million in 2004 as compared to Php10,548 million in 2003 mainly attributable to lower handset sales. In 2004, activations were driven by more SIM-pack sales and SIM-swap activities.

Other Income

Our wireless business segment generated other income of Php4,597 million in 2004, an increase of Php4,018 million, or 694%, from Php579 million in 2003. This increase was primarily a result of a Php4,419 million gain on the debt exchange transaction in 2004 pertaining to our wireless business which arose from the exchange of 69.4% of Piltel's total outstanding restructured debt for cash and new debt instruments issued to Piltel's creditors. The gain represents the difference between the fair value of Piltel's debt cancelled and/or exchanged to Smart's debt amounting to Php12,893 million (net of debt discount of Php3,359 million) and Smart's consideration for the debt exchange including cash of Php84 million (US\$1.5 million) and fair value of newly issued debt amounting to Php8,390 million (net of debt discount of Php7,464 million).

Expenses

Expenses associated with our wireless business in 2004 amounted to Php48,381 million, a decrease of Php6,122 million, or 11%, from Php54,503 million in 2003. A significant portion of this decrease was attributable mainly to costs of sales, depreciation and amortization, and lower asset impairment. As a percentage of our wireless revenues and other income, expenses associated with our wireless business decreased to 60% in 2004 from 83% in 2003.

Cellular business expenses accounted for 95% and 92%, while satellite, VSAT and other business expenses accounted for 5% and 8% of our wireless business expenses in 2004 and 2003, respectively.



The following table summarizes our wireless-related expenses for the years ended December 31, 2004 and 2003 and the percentage of each expense item to the total:

(in millions)	Years Ended December 31,					
	2004		2003(1)		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
Wireless services						
Costs of sales	Php11,122	23	Php16,094	30	Php(4,972)	(31)
Depreciation and amortization	10,940	23	13,526	25	(2,586)	(19)
Financing costs	5,166	11	6,551	12	(1,385)	(21)
Selling and promotions	4,260	9	3,310	6	950	29
Rent	3,962	8	2,262	4	1,700	75
Compensation and benefits(2)	3,341	7	3,802	7	(461)	(12)
Maintenance	2,596	5	2,051	4	545	27
Taxes and licenses	1,214	2	1,174	2	40	3
Professional and other service fees	1,059	2	675	1	384	57
Insurance and security services	937	2	756	1	181	24
Asset impairment	430	1	2,589	5	(2,159)	(83)
Provisions	417	1	160	-	257	161
Miscellaneous expense	2,937	6	1,553	3	1,384	89
Total	Php48,381	100	Php54,503	100	Php(6,122)	(11)

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

(2) Includes salaries and benefits, incentive plan, pension and MRP costs.

Costs of sales decreased by Php4,972 million, or 31% to Php11,122 million as activations in 2004 were driven more by SIM-pack sales and SIM-swap activities compared to handset sales in 2003. In addition, satellite airtime cost decreased by Php76 million, or 37%, to Php283 million due to the change in basis of recognizing airtime cost. In 2003, satellite air time cost was accrued at a fixed amount per month based on the payment schedule in a standstill agreement in consideration for unlimited airtime access. In 2004, upon the termination of the moratorium, airtime cost was reverted to the original charging rate on a per minute basis. This was agreed to be the basis of airtime cost until a new agreement is finalized. Please see Note 5 – Revenues and Expenses to the accompanying consolidated financial statements for further discussion. The breakdown of cost of sales for our wireless business for the year 2004 and 2003 are as follows:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
	Amount	Amount	Amount	%
Cost of cellular handsets and SIM-packs sold	Php10,839	Php15,887	Php(5,048)	(32)
Cost of satellite air time	283	207	76	37
	Php11,122	Php16,094	Php(4,972)	(31)

Depreciation and amortization charges decreased by Php2,586 million, or 19%, to Php10,940 million substantially due to a decrease in the depreciable asset base as certain of our wireless assets were fully depreciated by the end of 2003.

Financing costs decreased by Php1,385 million, or 21%, to Php5,166 million primarily due to lower foreign exchange losses as the level of depreciation of the peso was higher in 2003 compared to 2004 and lower interest expense on loans with lower debt balances in 2004 as compared to 2003. The breakdown of our financing costs for the wireless business for the years ended December 31, 2004 and 2003 is as follows:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Accretion on financial liabilities	Php3,217	Php2,387	Php830	35
Interest on loans and related items	1,754	2,062	(308)	(15)
Financing charges	1	32	(31)	(97)
Foreign exchange losses	746	2,116	(1,370)	(65)
Dividends on preferred stock subject to mandatory redemption	284	254	30	12
Capitalized foreign exchange losses	(6)	(70)	64	(91)
Loss on derivative transactions – net	(8)	165	(173)	(105)
Capitalized interest	(98)	(27)	(71)	263
Interest income	(724)	(368)	(356)	97
	Php5,166	Php6,551	Php(1,385)	(21)

Selling and promotion expenses increased by Php950 million, or 29%, to Php4,260 million due to advertising and promotions costs incurred to attract new subscriptions, as well as to retain the existing subscriber base.

Rent expenses increased by Php1,700 million, or 75%, to Php3,962 million on account of an increase in the number of transmission links and higher cell site and office space rentals for the increased number of cell sites wireless centers and space requirements for increased personnel. As of December 31, 2004, we had 3,957 cell sites and 5,303 base stations, compared with 2,920 cell sites and 3,904 base stations as of December 31, 2003.

Compensation and benefits decreased by Php461 million, or 12%, to Php3,341 million primarily due to a higher accrual in 2003 of a long-term incentive benefits of managers and executives of Smart covering the period 2000 to 2004, partially offset by an increase in headcount and increased salaries, benefits and performance bonuses of Smart's employees. Smart's employee headcount increased by 9% to 5,905 as of December 31, 2004 from 5,408 as of December 31, 2003.

Maintenance expenses increased by Php545 million, or 27%, to Php2,596 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.

Taxes and licenses increased by Php40 million, or 3%, to Php1,214 million mainly due to an increase in Smart's business-related permits and licenses.

Professional and other service fees increased by Php384 million, or 57%, to Php1,059 million mainly as a result of increased legal, consultancy and bill collection service fees.

Insurance and security services increased by Php181 million, or 24%, to Php937 million mainly due to the increase in our number of cell sites and in the amount of network equipment insured as a result of the continued growth and expansion of our network.

Asset impairment decreased by Php2,159 million, or 83%, to Php430 million due to impairment losses recognized in respect of our investment in ACeS International Limited (AIL) and of certain equipment related to its business in 2003 aggregating Php2,589 million.



Provisions increased by Php257 million, or 161%, to Php417 million to cover for specifically identified subscriber accounts of Smart and slow moving handsets relating to ACeS Philippines in 2004. The breakdown of provisions for the year ended 2004 and 2003 is as follows:

	Years Ended December 31,		Increase	
	2004	2003	Amount	%
Provision for doubtful accounts	Php204	Php72	Php132	183
Provision for inventory obsolescence	213	88	125	142
	<u>Php417</u>	<u>Php160</u>	<u>Php257</u>	<u>161</u>

Miscellaneous expenses increased by Php1,384 million, or 89%, to Php2,937 million due to various business and operational-related expenses such as facility usage fees, travel, supplies, communication and delivery expenses.

Provision for income tax

Provision for income tax increased by Php2,655 million, or 161%, to Php4,307 million in 2004 from Php1,652 million in 2003 as Smart's income tax holiday expired in 2004.

Smart's three-year income tax holiday, which expired in May 2004, applied to the incremental income generated from its network expansion. The income tax holiday was computed by applying the exemption rate against the income tax derived from operations. The exemption rate was computed by dividing the incremental revenues by eligible revenues (both gross of interconnection revenues) where the incremental revenues were derived by deducting the BOI-prescribed base figure (Smart's gross revenue in 2000) from the total 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 was deducted from the income tax due on revenues with the difference being the income tax due for the period.

Net Income

Our wireless business segment recorded a net income of Php27,354 million in 2004, an increase of Php17,729 million, or 184%, over Php9,625 million registered in 2003 due primarily to the growth in our cellular subscriber base, complemented by a 11% decrease in wireless expenses.

Fixed Line

Revenues and Other Income

Our fixed line business provides local exchange service, international and national long distance services, data and other network services, and miscellaneous services. Revenues and other income generated from our fixed line business for 2004 totaled Php48,810 million, an increase of Php1,635 million, or 3%, from Php47,175 million in 2003.



The following table summarizes revenues from our fixed line business for the years ended December 31, 2004 and 2003 by service segment:

(in millions)	Years Ended December 31,					
	2004		2003(1)		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
Fixed line services:						
Service Revenues						
Local exchange	Php20,458	42	Php20,837	44	Php(379)	(2)
International long distance	12,803	26	12,735	27	68	1
National long distance	7,076	14	6,561	14	515	8
Data and other network	7,114	15	5,978	13	1,136	19
Miscellaneous	1,035	2	809	2	226	28
	<u>48,486</u>	<u>99</u>	<u>46,920</u>	<u>100</u>	<u>1,566</u>	<u>3</u>
Other Income	324	1	255	—	69	27
Total Fixed Line Revenues	<u>Php48,810</u>	<u>100</u>	<u>Php47,175</u>	<u>100</u>	<u>Php1,635</u>	<u>3</u>

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

Service Revenues

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; 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 years ended December 31, 2004 and 2003:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Consolidated local exchange service revenues (in millions)	Php20,458	Php20,837	Php(379)	(2)
Number of fixed lines in service	2,152,027	2,185,951	(33,924)	(2)
Number of fixed line employees	9,692	10,518	(826)	(8)
Number of fixed lines in service per employee	222	208	14	7

Revenues from our local exchange service in 2004 decreased by Php379 million, or 2%, to Php20,458 million from Php20,837 million 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 decreased to 42% in 2004 from 44% in 2003.

Fixed line net deductions in 2004 were 33,924 as compared to 2,661 in 2003. While fixed line additions totaled 11,532 for prepaid fixed line services, postpaid fixed lines in service declined by 45,456 in 2004. As of December 31, 2004, postpaid and prepaid fixed line subscribers totaled 1,783,191 and 368,836, respectively, which accounted for approximately 83% and 17%, respectively, of 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 our 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 but the rates for prepaid and postpaid fixed line subscribers for national and international long distance calls are the same.

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 cards. 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 2004, we implemented six upward and one downward adjustments in our monthly local service rates compared to 11 upward and three downward adjustments in 2003. The average peso-to-dollar rate in 2004 was Php56.044 to US\$1.00, compared to the average of Php54.215 to US\$1.00 in 2003. This change in the average

peso-to-dollar rate translated to a peso depreciation of 3%, which resulted in an average net increase of 1.5% in our monthly local service rates in 2004.

International Long Distance Service

Our international long distance service 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 years ended December 31, 2004 and 2003:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Consolidated international long distance service revenues (in millions)	Php12,803	Php12,735	Php68	1
Inbound	10,452	10,581	(129)	(1)
Outbound	2,351	2,154	197	9
International call volumes (in million minutes, except call ratio)	2,348	2,286	62	3
Inbound	2,192	2,128	64	3
Outbound	156	158	(2)	(1)
Inbound-outbound call ratio	14.1:1	13.5:1	-	-

Our consolidated international long distance service revenues increased by Php68 million, or 1%, to Php12,803 million in 2004 from Php12,735 million in 2003. The percentage contribution of international long distance service revenues to our total fixed line revenues decreased to 26% in 2004 from 27% in 2003.

Our revenues from inbound international long distance calls in 2004 decreased by Php129 million to Php10,452 million from Php10,581 million in 2003 primarily due to the change in call mix in favor of transit calls with lower hubbing rates.

Our inbound international long distance call volumes in 2004 increased by 3% to 2,192 million minutes from 2,128 million minutes in 2003, largely due to an increase in transit calls.

Our revenues from outbound international long distance calls in 2004 increased by Php197 million, or 9%, to Php2,351 million from Php2,154 million in 2003. The increase resulted from higher conversion rates used as average billing rates were Php55.98 and Php54.04 in 2004 and 2003, respectively, and a change in call mix in favor of traffic utilizing least cost routes.

Our outbound international long distance call volumes declined by 1% to 156 million minutes in 2004 from 158 million minutes 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 service 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 service revenues and call volumes for the years ended December 31, 2004 and 2003:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Consolidated national long distance service revenues (in millions)	Php7,076	Php6,561	Php515	8
National long distance call volumes (in million minutes)	1,853	2,016	(163)	(8)

Our national long distance service revenues increased by Php515 million, or 8%, to Php7,076 million in 2004 from Php6,561 million 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 was 14% for 2004 and 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 8% to 1,853 million minutes in 2004 from 2,016 million minutes 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 2004, our data and other network services posted revenues of Php7,114 million, an increase of Php1,136 million, or 19%, from Php5,978 million in 2003. The revenue contribution of this service segment to our total fixed line service revenues increased to 15% in 2004 from 13% in 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.

Broadband/IP-based services accounted for 51%, traditional bandwidth services accounted for 44% and other services accounted for the remaining 5% of the total revenues from PLDT's data and other network services in 2004, compared to 44%, 50% and 6%, respectively, 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 December 31, 2004, the number of PLDT's fixed line subscribers for *PLDT Vibe* stood at 369,435, of which 146,909 are exclusive postpaid users, 163,585 are exclusive prepaid users, and 58,941 are both postpaid and prepaid users, compared to 188,034 as of December 31, 2003, of which 110,502 were exclusive postpaid users, 58,939 were exclusive prepaid users, and 18,593 were both postpaid and prepaid users, while the number of *DSL* subscribers reached 49,476 and 23,884 as of December 31, 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 without the cost of toll charges. 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 service revenues are derived mostly from directory advertising and facilities rental. In 2004, these revenues increased by Php226 million, or 28%, to Php1,035 million from Php809 million in 2003. The improvement was mainly due to an increase in co-location charges from more co-location sites coupled with an increase in rent income on duct utilization and cable restoration. Miscellaneous service revenues accounted for approximately 2% of our total fixed line revenues in 2004 and 2003, respectively.

Other Income

All other income/gains such as rental income, gain on disposal of property, which do not fall under service and non-service revenues are included under this classification. In 2004, our fixed line business segment registered an increase in other income of Php69 million, or 27%, to Php324 million in 2004 from Php255 million in 2003 mainly due to higher service and facilities fees.

Expenses

Expenses related to our fixed line business in 2004 totaled Php46,943 million, a decrease of Php9,372 million, or 17%, compared to Php56,315 million in 2003. The decrease was primarily due to lower financing costs, compensation and benefits as a result of the MRP and asset impairment. As a percentage of our total fixed line revenues, fixed line-related expenses decreased to 96% in 2004, compared to 119% in 2003.

The following table shows the breakdown of our total consolidated fixed line-related expenses for the years ended December 31, 2004 and 2003 and the percentage of each expense item to the total:

	Years Ended December 31,					
	2004		2003(1)		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
(in millions)						
Fixed line services:						
Financing costs	Php14,232	30	Php18,782	34	Php(4,550)	(24)
Depreciation and amortization	10,125	21	9,767	17	358	4
Compensation and benefits(2)	7,792	17	10,507	19	(2,715)	(26)
Provisions	4,431	9	4,597	8	(166)	(4)
Maintenance	3,211	7	3,081	6	130	4
Rent	1,700	4	1,915	3	(215)	(11)
Professional and other service fees	1,181	3	1,129	2	52	5
Selling and promotions	1,160	2	1,054	2	106	10
Taxes and licenses	762	2	595	1	167	28
Insurance and security services	700	1	762	1	(62)	(8)
Asset impairment	366	1	2,846	5	(2,480)	(87)
Miscellaneous expense	1,283	3	1,280	2	3	—
Total	Php46,943	100	Php56,315	100	Php(9,372)	(17)

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

(2) Includes salaries and benefits, incentive plan, pension and MRP costs.

Financing costs decreased by Php4,550 million, or 24%, to Php14,232 million due to lower interest expense and related items owing to lower debt balances in 2004 compared with 2003 and

lower foreign exchange losses pertaining to: (1) the foreign exchange revaluation of the carrying values of financial liabilities as the level of peso depreciation was higher in 2003 as compared to 2004 and (2) designation and documentation of certain hedged items as hedged instruments to qualify for hedge accounting from July 2004 onwards. The breakdown of our financing costs for our fixed line business for the years ended December 31, 2004 and 2003 is as follows:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Interest on loans and related items	Php10,699	Php10,895	Php(196)	(2)
Hedge cost	1,011	1,054	(43)	(4)
Financing charges	145	231	(86)	(37)
Foreign exchange losses	1,956	7,235	(5,279)	(73)
Accretion on financial liabilities	235	280	(45)	(16)
Capitalized foreign exchange losses	(68)	(275)	207	75
Loss on derivative transactions – net	999	360	639	178
Capitalized interest	(497)	(860)	363	42
Interest income	(248)	(138)	(110)	80
	<u>Php14,232</u>	<u>Php18,782</u>	<u>Php(4,550)</u>	<u>(24)</u>

Depreciation and amortization charges increased by Php358 million, or 4%, to Php10,125 million mainly due to higher depreciation of our regular asset base primarily resulting from additional completed projects.

Compensation and benefits decreased by Php2,715 million, or 26%, to Php7,792 million mainly due to a 7% reduction in headcount due to PLDT's MRP in 2003, where MRP cost of Php1,885 million was recognized consequently; in 2004, MRP cost amounted to Php553 million. This decreasing effect was partially offset by collective bargaining agreement-related increases in salaries and benefits of PLDT employees. See *Note 5 – Revenues and Expenses* to the accompanying consolidated financial statements for further discussion on PLDT's MRP.

Provisions decreased by Php166 million, or 4%, to Php4,431 million primarily on account of lower provisions by PLDT for anticipated uncollectible accounts from various specifically identified domestic telecommunications carriers which were provided for in 2003. In 2004, PLDT made provisions for anticipated uncollectible accounts based on the aging profile of its accounts receivables. PLDT's provision for doubtful accounts in 2004 and 2003 was equivalent to 8% of its service revenues. The breakdown of provisions for our fixed line business for the year ended 2004 and 2003 is as follows:

	Years Ended December 31,			
	2004	2003	Increase (Decrease)	
			Amount	%
Provision for doubtful accounts	Php3,751	Php3,949	Php(198)	(5)
Provision for inventory obsolescence	361	238	123	52
Provision for onerous contracts	319	410	(91)	(22)
	<u>Php4,431</u>	<u>Php4,597</u>	<u>Php(166)</u>	<u>(4)</u>

Maintenance expenses increased by Php130 million, or 4%, to Php3,211 million primarily owing to the expiration of warranties for certain plant facilities and higher maintenance costs of computer and peripherals in relation to charges for software support agreements for certain systems in 2004 as compared in 2003, partially offset by lower maintenance costs of the domestic fiber optic network due to more remedial works done in 2003 than in 2004.

Rent expenses decreased by Php215 million, or 11%, to Php1,700 million due to a decrease in international leased circuits and rental for bundled sales/Value Added Service Units expense.

Professional and other service fees increased by Php52 million, or 5%, to Php1,181 million as a result of higher legal fees in 2004 for various services, partially offset by 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.

Selling and promotion expenses increased by Php106 million, or 10%, to Php1,160 million mainly as a result of an increase in PLDT's promotional activities in relation to various products and services, partially offset by reduced corporate public relations expenses.

Taxes and licenses increased by Php167 million, or 28%, to Php762 million mainly on account of higher business-related taxes paid in 2004 as compared to 2003.

Insurance and security services decreased by Php62 million, or 8%, to Php700 million primarily due to lower premiums on property all-risk, industrial all-risk and industrial fire insurance and lower number of contracted security guards.

Asset impairment decreased by Php2,480 million, or 87% to Php366 million due to impairment of Piltel's E.O. 109 facilities amounting to Php1,438 million and an unrealizable asset of Php1,408 million in 2003.

Miscellaneous expenses increased by Php3 million to Php1,283 million due to higher contracted costs for technical and helpdesk resources and related computer and maintenance and in-house systems development, partially offset by lower office supplies consumption and printing costs resulting from PLDT's continuing cost-containing activities.

Provision for (benefit from) income tax

Provision for income tax amounted to Php569 million in 2004 as compared to benefit from income tax of Php2,130 million in 2003 due to a tax loss position in 2003 as non-tax deductible charges were higher in 2003.

Net Income (Loss)

In 2004, our fixed line business segment contributed a net income of Php1,383 million, compared to a loss of Php7,118 million in 2003 mainly as a result of a 3% increase in fixed line revenues and other income complemented by a decrease in fixed line-related expenses by 17% particularly financing costs, compensation and benefits and asset impairment.

Information and Communications Technology

Revenues and Other Income

Our information and communications technology business is conducted by ePLDT, a wholly-owned subsidiary of PLDT.

In 2004, our information and communications technology business generated revenues of Php2,415 million, an increase of Php522 million, or 28%, from Php1,893 million in 2003. Going

forward, we expect revenues from our call center and Internet and gaming businesses to continue to contribute significantly to our information and communications technology revenues with the growing demand for call center services.

The following table summarizes revenues from our information and communications technology business for the years ended December 31, 2004 and 2003 by service segment:

	Years Ended December 31,					
	2004		2003		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
Service Revenues						
Call center	Php1,213	50	Php927	49	Php286	31
Internet and gaming business	569	24	380	20	189	50
<i>Vitro</i> TM data center	243	10	120	6	123	103
Others	55	2	40	2	15	38
	<u>2,080</u>	<u>86</u>	<u>1,467</u>	<u>77</u>	<u>613</u>	<u>42</u>
Non-service Revenues						
Point of Product Sales	321	13	316	17	5	2
Other Income	14	1	110	6	(96)	(87)
Total ICT Revenues	<u>Php2,415</u>	<u>100</u>	<u>Php1,893</u>	<u>100</u>	<u>Php522</u>	<u>28</u>

Service Revenues

Service revenues generated by our information and communications technology business amounted to Php2,080 million in 2004, an increase of Php613 million, or 42%, from Php1,467 million in 2003. This was primarily a result of the continued growth of our call center and Internet and gaming businesses.

Call Center

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

- Vocativ Systems, Inc., or Vocativ, which owns and operates a 998-seat call center facility with 749 customer service representatives, or CSRs, exclusively for clients of a global provider of customer relationship management services;
- Parlance Systems, Inc., or Parlance, which owns and operates a 1,177-seat call center facility with 1,109 CSRs, exclusively for one of the largest direct-to-home satellite service providers in the United States for customer support and billing requirements; and
- ePLDT Ventus, Inc, or Ventus, which owns a 400-seat call center facility located in Iloilo province expected to commence full commercial operations in April 2005. Ventus will be expanding in Metro Manila with a 678-seat facility to accommodate current and new client requirements. This facility is expected to be completed by May 2005.

Call center revenues consist of:

- inbound calls for customer care, product inquiries, sales and technical support based on active minutes;
- outbound calls for sales and collections based on active minutes; and
- service income for e-mail handling, web chat, web co-browsing, data entry and business process outsourcing based on transaction volume.

Revenues related to our call center business in 2004 increased by Php286 million, or 31%, to Php1,213 million from Php927 million in 2003 due to the combined effects of the following:

- Vocativ's upward price adjustment for voice and voice over internet protocol, or VoIP, and an increase in programs being handled; and
- an upward price adjustment by Parlance for its inbound and outbound projects, coupled with an increase in the number of registered minutes.

Call center revenues accounted for 50% and 49% of our total information and communications technology revenues in 2004 and 2003, respectively.

Internet business

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

- a 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;
- a 67.79% 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 100 branches and over 4,000 work stations. DigiPar offers high-speed internet services, including internet advertising, gaming and printing; and
- a 63% interest in netGames, Inc., a publisher for Massively Multi-player Online Game, or MMOG, in the Philippines. netGames, which was incorporated on June 21, 2004, is the Philippine licensee of Khan Online, the country's first full 3D online game. netGames is expected to commence full commercial operations by February 2005.

Internet Service revenues consist of:

- revenues derived from actual usage of internet access network by prepaid subscribers and any unused peso value of expired prepaid cards or electronic internet time loads, net of discounts given to dealers;

-
- monthly service fees from postpaid corporate and consumer subscribers, including (1) charges for internet usage in excess of allocated free plan internet hours; (2) one-time installation and activation fees; and (3) fees for value added services such as additional mailbox accounts;
 - monthly service fees on value added services, including e-mail and web hosting services;
 - one-time fees generated from resellership of internet-related solutions such as security solutions and domain registration; and
 - share in revenues of text, voice and internet messages for cellular, landline and internet-based content and applications.

Revenues from our internet business for 2004 increased by Php189 million, or 50%, to Php569 million from Php380 million in 2003 primarily due to the consolidation of DigiPar in June 2004. Our internet business revenues accounted for 24% and 20% of total revenues from information and communications technology business in 2004 and 2003, respectively.

Vitro™ data center

ePLDT operates 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.

Vitro™ revenues consist of:

- monthly service fees derived from co-location services, server hosting, hardware and software maintenance services, website development and maintenance services, web hosting, data recovery security services and other value added services;
- installation charges and other one-time fees associated with the set-up; and
- monthly service fees or one-time fees generated from professional services of Vitro's certified professionals.

In 2004, *Vitro™* contributed revenues of Php243 million, an increase of Php123 million, or 103%, from Php120 million in 2003, primarily due to an increase in co-location revenues, server hosting and other services. *Vitro™* revenues accounted for 10% and 6% of total revenues from information and communications technology business in 2004 and 2003, respectively.

Others

Other revenues consist of:

- fees generated for issuance of digital certificates; and

- revenues derived from IT helpdesk/contact center solutions and terminals for credit, debit and credit card transactions.

Revenues from other businesses related to our information and communications technology segment in 2004 increased by Php15 million, or 38%, to Php55 million from Php40 million in 2003 largely due to IT helpdesk/contact center services rendered coupled with an increase in number of digital certificates sold.

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

Non-Service Revenues

Non-service revenues consist of sales generated from resellership of Microsoft software licenses and Cisco hardware equipment. In 2004, non-service revenues generated by our information and communications technology business increased by Php5 million, or 2%, to Php321 million prompted by higher point of product sales of Cisco equipment and Microsoft licenses.

Other Income

All other income/gains which do not fall under service and non-service revenues are included under this classification. Other income generated from our information and communications technology business segment declined by 87% to Php14 million in 2004 from Php110 million in 2003 due to a gain on the divestment of Contact World, Inc., a call center facility, in 2003.

Expenses

Expenses associated with our information and communications technology business totaled Php3,038 million in 2004, an increase of Php684 million, or 29%, from Php2,354 million in 2003. As a percentage of our information and communications technology revenues, expenses related to our information and communications technology business was at 126% and 124% for 2004 and 2003, respectively.



The following table shows the breakdown of our total consolidated information and communications technology-related expenses for the years ended December 31, 2004 and 2003 and the percentage of each expense item to the total:

	Years Ended December 31,					
	2004	%	2003(1)	%	Increase (Decrease)	
(in millions)					Amount	%
Information and communications technology services:						
Compensation and benefits(2)	Php892	29	Php551	23	Php341	62
Asset impairment	616	20	387	16	229	59
Rent	353	12	339	14	14	4
Depreciation and amortization	340	11	313	13	27	9
Maintenance	316	10	184	8	132	72
Selling and promotions	291	10	35	2	256	731
Professional and other service fees	64	2	65	3	(1)	(2)
Financing costs	22	1	53	2	(31)	(58)
Taxes and licenses	21	1	18	1	3	17
Insurance and security services	7	–	10	–	(3)	(30)
Provisions	(3)	–	82	4	(85)	(104)
Miscellaneous expense	119	4	317	14	(198)	(62)
Total	Php3,038	100	Php2,354	100	Php684	29

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

(2) Includes salaries and benefits, incentive plan, pension and MRP costs.

Compensation and benefits increased by Php341 million, or 62%, to Php892 million mainly due to the expansion of our call center facilities and consolidation of DigiPar which resulted in an increase in headcount coupled with an increase in salaries, bonuses and various incentives of employees.

Asset impairment increased by Php229 million, or 59%, to Php616 million due to an impairment provision recognized in 2004 in relation to an investee company. In 2003, we retired certain equipment with net book values aggregating Php387 million primarily as a result of the abandonment of a reloadable chip-based cash card project.

Rent expense increased by Php14 million, or 4%, to Php353 million due to the consolidation of DigiPar with the opening of several *Netopia* branches countrywide and abroad in 2004.

Depreciation and amortization charges increased by Php27 million, or 9%, to Php340 million primarily due to an increase in depreciable asset base in relation to the expansion of our call center business segment.

Maintenance expenses increased by Php132 million, or 72%, to Php316 million primarily due to a change in maintenance agreement for higher annual maintenance in respect of our digital certificate business.

Selling and promotion expenses increased by Php256 million, or 731%, to Php291 million mainly as a result of increased advertising and promotions expense by *Netopia*.

Professional and other service fees decreased by Php1 million, or 2%, to Php64 million primarily due to lower training and shuttling expenses relating to our call center representatives.

Financing costs decreased by Php31 million, or 58%, to Php22 million due to lower interest expense on loans as debt balances declined in 2004 as compared to 2003.

Taxes and licenses increased by Php3 million, or 17%, to Php21 million mainly on account of higher business-related taxes paid in 2004 as compared to 2003.

Insurance and security services decreased by Php3 million, or 30%, to Php7 million primarily due to the divestment of Contact World, with high insurance and security costs in 2003.

Provisions decreased by Php85 million, or 104%, owing to specifically identified subscriber accounts of Infocom already provided for in 2003.

Miscellaneous expenses decreased by Php198 million, or 62%, to Php119 million in line with our over-all cost containment initiatives.

Provision for (benefit from) income tax

Provision for income tax amounted to Php72 million in 2004 an increase of Php139 million, or 207%, as compared to the benefit from income tax of Php67 million recognized in 2003. This was principally due to Infocom's reversal of recorded deferred income tax asset of Php64 million in 2004.

Net Income (Loss)

In 2004, our information and communications technology business segment registered a net loss of Php693 million, a decrease of Php309 million, or 80%, compared to a net loss of Php384 million posted in 2003. This reflects the recorded increase in net income contribution of our call center business, partially offset by (1) a net increase in asset impairment charges and (2) a reported net loss of Php116 million by Infocom in 2004 compared to a net income of Php20 million in 2003.

Liquidity and Capital Resources

The following table shows our consolidated cash flows for the years ended December 31, 2004 and 2003 as well as consolidated capitalization and other selected financial data as of December 31, 2004 and 2003:

	Years Ended December 31,	
	2004	2003(1)
(in millions)		
Cash Flows		
Net cash provided by operating activities	Php73,514	Php55,972
Net cash used in investing activities	23,939	19,610
Capital expenditures	21,162	18,019
Net cash used in financing activities	41,557	27,937
Net increase in cash and cash equivalents	7,949	8,397
	December 31,	
	2004	2003(1)
(in millions)		
Capitalization		
Interest-bearing financial liabilities:		
Long-term financial liabilities:		
Long-term debt	Php121,012	Php152,646
Obligations under capital lease	601	729
Preferred stock subject to mandatory redemption	14,375	12,735
	<u>135,988</u>	<u>166,110</u>
Interest-bearing financial liabilities maturing within one year:		
Notes payable	58	2,133
Obligation under capital lease maturing within one year	425	295
Long-term debt maturing within one year	28,018	23,810
	<u>28,501</u>	<u>26,238</u>
Total interest-bearing financial liabilities	164,489	192,348
Total equity	48,515	21,449
	<u>Php213,004</u>	<u>Php213,797</u>
Other Financial Data		
Total assets	Php265,473	Php255,647
Property, plant and equipment – net	194,525	194,790
Cash and cash equivalents	27,321	19,372

(1) As restated to reflect the changes in accounting policies, as discussed in Note 2 – Summary of Significant Accounting Policies to the accompanying consolidated financial statements.

As of December 31, 2004, our consolidated cash and cash equivalents totaled Php27,321 million. Principal sources of consolidated cash and cash equivalents in 2004 were cash flows from operations amounting to Php73,514 million and drawings from long-term credit facilities aggregating Php12,131 million. These funds were used principally for capital outlays of Php21,162 million, total debt principal payments of Php41,960 million and interest payments of Php12,310 million.

Operating Activities

Our consolidated net cash flows from operating activities in 2004 increased by Php17,542 million, or 31%, to Php73,514 million from Php55,972 million in 2003.

A growing portion of our cash flow is generated by our wireless business, which accounted for 58% and 53% of our service revenues in 2004 and 2003, respectively. Revenues from our fixed line and information and communications technology services accounted for 40% and 2%, respectively, of our service revenues in 2004 and 46% and 1%, respectively, in 2003.

Wireless' cash flows from operating activities accounted for 57% of our consolidated cash flows from operations owing to the sustained growth of our cellular subscriber base and service usage. Our fixed line business contributed 41% to our consolidated cash flows from operations in 2004 with improved collection efficiency and lower cash expenses in line with our cost-containment efforts. We believe that our continuing strong cash flows on a consolidated basis will allow us to defray our current liabilities despite our current ratio being less than 1:1 as of December 31, 2004.

While 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, Smart has been able to obtain waivers from Finnvera and certain of its lenders for each of the dividend payments made by Smart to PLDT in 2004, 2003 and 2002. In 2004, Smart paid an aggregate of Php16,100 million in dividends to PLDT, of which Php11,280 million was paid in May 2004 and the balance of Php4,820 million paid in December 2004. In June and November 2003, Smart paid dividends in the amount of Php4,300 million and Php1,866 million, respectively. Smart made its first dividend payment of Php1,540 million to PLDT in December 2002.

Investing Activities

Net cash used in investing activities in 2004 amounted to Php23,939 million, an increase of Php4,329 million, or 22%, compared to Php19,610 million in 2003. This increase was primarily the result of higher aggregate capital spending.

Our consolidated capital expenditures in 2004 totaled Php21,162 million, an increase of Php3,143 million, or 17%, from Php18,019 million in 2003 primarily due to Smart's increased capital spending. Smart's capital spending of Php14,721 million in 2004 was used to further expand and upgrade its transmission network facilities to increase capacity and coverage in respect of basic and advanced cellular services. PLDT's capital spending of Php5,794 million was principally used to finance the expansion of its fixed line data and network services. ePLDT and its subsidiaries' capital spending of Php517 million was used to primarily fund its *Vitro*TM, Infocom and call center business operations. Consolidated capital expenditures in 2003 amounted to Php18,019 million, of which Php6,083 million, Php11,265 million, Php53 million and Php266 million were attributable to PLDT, Smart, ePLDT and PLDT Global, respectively. The balance represented other subsidiaries' capital spending.

During 2004, we made certain strategic investments aggregating Php1,366 million to strengthen our position in the wireless and information and communications technology segments. Of the Php1,366 million investment, Php1,141 million represented Smart's partial payment of its investment in a wireless broadband and data service company, and Php225 million pertained to ePLDT's investment in convertible debt securities of a company engaged in a systems integration of internet and mobile telephone gaming project.

Financing Activities

On a consolidated basis, we used net cash of Php41,557 million for financing activities in 2004, compared to Php27,937 million in 2003. The net cash used in financing activities in 2004 was mainly attributable to interest payments and debt repayments by PLDT in line with its ongoing debt reduction program.

Debt Financing

Additions to our consolidated long-term debt in 2004 totaled Php12,131 million, of which Php3,976 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 of our total debt amounted to Php41,960 million and Php12,310 million, respectively, in 2004, of which Php32,518 million and Php10,539 million were attributable to PLDT, respectively.

The following table shows our long-term debt, including current portion as of December 31, 2004 and 2003:

(in millions)	December 31,		Increase (Decrease)	
	2004	2003 (As restated)	Amount	%
U.S. Dollars:				
Export Credit Agencies-Supported Loans	Php41,266	Php50,504	Php(9,238)	(18)
Fixed Rate Notes	68,795	77,880	(9,085)	(12)
Term Loans	20,492	11,079	9,413	85
Restructured Loans	4,815	7,310	(2,495)	(34)
Satellite Acquisition Loans	4,064	4,722	(658)	(14)
	<u>139,432</u>	<u>151,495</u>	<u>(12,063)</u>	<u>(8)</u>
Japanese Yen:				
Overseas Investment Loan	5,363	5,068	295	6
Export Credit Agency-Supported Loan	1,212	–	1,212	100
Multicurrency Term Loan	–	5,487	(5,487)	(100)
Restructured Loans	–	6,963	(6,963)	(100)
	<u>6,575</u>	<u>17,518</u>	<u>(10,943)</u>	<u>(62)</u>
Philippine Pesos:				
Peso Fixed Rate Corporate Notes	1,675	2,173	(498)	(23)
Term Loans	1,348	5,270	(3,922)	(74)
	<u>3,023</u>	<u>7,443</u>	<u>(4,420)</u>	<u>(59)</u>
	<u>Php149,030</u>	<u>Php176,456</u>	<u>Php(27,426)</u>	<u>(16)</u>

For a complete discussion of long-term debt, see *Note 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements.

Our long-term debt decreased by Php27,426 million, or 16%, to Php149,030 million as of December 31, 2004 largely due to debt repayments in line with PLDT's efforts to reduce overall debt level. PLDT's long-term debt was reduced by 18% to Php110,077 million by the end of 2004. On the other hand, Smart's indebtedness increased by 50% to Php29,355 million at the end of 2004 on account of the debt exchange transaction with Piltel's creditors in July 2004 where Smart issued new debt of US\$283.3 million booked at fair value of Php8,390 million, net of debt discount amounting to Php7,464 million; Smart's unamortized discount amounted to Php7,239 million as of December 31, 2004. Similarly, Piltel's debt balance owed to third parties as of December 31, 2004 was reduced to Php5,230 million, net of unamortized discount of Php2,006 million. Mabuhay

Satellite's debt level decreased by 14% to Php4,064 million owing to debt amortizations during the year. Other subsidiaries' indebtedness increased by Php173 million primarily from Vocativ's full availment of a 5-year Php149 million term loan facility.

As of December 31, 2004, PLDT had no undrawn committed long-term credit facilities. The JP¥3,095 million undrawn portion of the JP¥5,615 million syndicated term loan facility supported by Nippon Export and Investment Insurance of Japan and US\$4 million undrawn portion of the US\$12 million term loan facility extended by DEG-Deutsche Investitions-und Entwicklungsgesellschaft mbH were cancelled on December 3, 2004 and September 26, 2004, respectively. In addition, PLDT also waived further disbursements from the US\$149 million Kreditanstalt fur Wiederaufbau refinancing facility effective September 1, 2004, thus, canceling the undrawn portion of US\$9 million. As of December 31, 2004, Smart still had available facilities under its €50 million Framework Agreement with Bayerische Hypo-und Vereinsbank Aktiengesellschaft up to a maximum aggregate amount of €44 million.

The scheduled maturities of our outstanding long-term debt at nominal values as of December 31, 2004 are as follows:

Year	US\$ Loans(1)		JP¥ Loans(2) (in millions)		Peso Loans	Total
2005	US\$448	Php25,282	JP¥3,420	Php1,879	Php870	Php28,031
2006	410	23,131	3,418	1,878	852	25,861
2007	487	27,439	3,418	1,879	78	29,396
2008	100	5,583	1,709	939	67	6,589
2009	251	14,137	-	-	56	14,193
2010 and onwards	962	54,186	-	-	1,214	55,400

(1) The exchange rate used was Php56.341 to US\$1.00.

(2) The exchange rate used was Php0.5495 to JP¥1.00.

Approximately Php104,070 million principal amount of our consolidated outstanding long-term debt as of December 31, 2004 is scheduled to mature over the period from 2005 to 2009. Of this amount, approximately Php77,408 million is attributable to PLDT, Php22,294 million to Smart, and the remainder to Mabuhay Satellite, Maratel and ePLDT.

Covenants

Our debt instruments contain restrictive covenants, including covenants that could prohibit us from paying common dividends under certain circumstances, 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. We have complied with all of our maintenance ratios as required under our loan covenants and other debt instruments.

Please see *Note 18 – Interest-bearing Financial Liabilities* for a detailed discussion of our covenants.

Financing Requirements

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

Since 2002, we have been utilizing internally generated cash particularly from our cellular business to reduce our overall level of indebtedness. In line with this objective, we have managed our capital expenditures, reduced our investments and suspended dividend payments to common shareholders from April 2001 to 2004. As a result of our improving cash flows and reduced debt levels, we intend to restore the payment of common dividends in 2005 and gradually increase our dividend payout ratio in succeeding years as we improve our leverage ratios.

Credit Ratings

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 February 16, 2005, Moody's Investor Service, or Moody's, downgraded the foreign currency senior unsecured debt rating of PLDT by one-notch to Ba3 from Ba2 with a stable outlook. The rating action was taken as part of Moody's two-notch downgrade of the Republic of the Philippines' foreign currency country ceiling to B1 from Ba2. On the same date, Moody's affirmed PLDT's B1 preferred stock rating with a stable outlook. Moody's views that there is a differential between PLDT's foreign currency rating and the sovereign rating. According to Moody's, PLDT's foreign currency bond rating is a function of its own risk of default and is less likely to be subject to a debt moratorium which the Philippine government may declare in case of an event of default by government.

On January 17, 2005, Standard and Poor's Ratings Group, or Standard and Poor's, revised its long-term foreign currency rating on PLDT from "BB" to "BB-" (BB minus) with a stable outlook. The rating action was taken immediately after Standard and Poor's downgraded the foreign currency rating on the Republic of the Philippines to "BB-" (BB minus).

On December 15, 2004, Fitch Ratings, or Fitch, revised the outlook on PLDT's long-term foreign currency rating to negative from stable while affirming PLDT's long-term foreign currency rating at "BB". The rating action reflects Fitch's decision to revise its outlook on the Republic of the Philippines' long-term ratings to negative from stable as PLDT's foreign currency ratings are constrained by the sovereign.

Equity Financing

PLDT raised Php281 million from the exercise by certain officers and executives of stock options in 2004. In addition, through our subscriber investment plan, or SIP, which provides postpaid fixed line subscribers the opportunity to buy shares of our 10% cumulative convertible preferred stock as part of the upfront payments collected from subscribers, PLDT was able to raise Php1 million in 2004 and Php5 million in 2003. As approved by the NTC, the SIP was made optional in 2003 from being compulsory in earlier years.

Cash dividend payments in 2004 amounted to Php1,456 million, compared to Php1,349 million in 2003, all of which were paid 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. We intend to restore the payment of dividends to common shareholders in 2005.

Contractual Obligations and Commercial Commitments

Contractual Obligations

The following table discloses our contractual obligations outstanding as of December 31, 2004:

	Payments Due by Period				
	Total	Within 1 year	2–3 years	4–5 years	After 5 years
(in millions)					
Long-term debt (1)	Php159,470	Php28,031	Php55,257	Php20,782	Php55,400
Long-term lease obligations:					
Operating Lease	5,712	1,435	2,439	723	1,115
Capital Lease	1,766	673	637	13	443
Unconditional purchase obligations(2)	12,302	4,405	2,263	2,253	3,381
Other long-term obligations	22,016	–	–	22,016	–
Total contractual cash obligations	<u>Php201,266</u>	<u>Php34,544</u>	<u>Php60,596</u>	<u>Php45,787</u>	<u>Php60,339</u>

(1) Before deducting unamortized debt discount and debt issuance cost.

(2) Based on the original Air Time Purchase Agreement with ALL.

Long-term Debt

For a discussion of our long-term debt, see *Note 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements.

Long-term Operating Lease Obligations

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 December 31, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php69 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 December 31, 2004, PLDT's aggregate remaining obligation under these contracts amounted to approximately Php30 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 December 31, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php45 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 Php3,185 million as of December 31, 2004 in respect of office and cell site rentals with over 2,000 lessors nationwide.

Long-term Capital Lease Obligations

For a discussion of our long-term capital lease obligations, see *Note 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements.

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 and Piltel has capital lease obligations aggregating Php906 million as of December 31, 2004 in respect of office equipment and facilities.

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 December 31, 2004, PLDT's aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,962 million. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. See *Note 21 – Related Party Transactions* and *Note 24 – Provisions and Contingencies* to the accompanying consolidated 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 to 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 to 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.

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%. As of December 31, 2004, ePLDT's aggregate remaining minimum obligation under this agreement was approximately Php18 million pertaining to annual support fee.

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 December 31, 2004, iPlus has paid all its obligations to I-Contact.

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

Other Long-term Obligations

Mandatory Conversion and Purchase of Shares. As of December 31, 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 Series K, Class I Convertible Preferred Stock of Piltel pursuant to the debt restructuring plan 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 JPY4,071.89 per share for Series V, VI and VII, respectively.

As of December 31, 2004, 515,818 shares of Series V Convertible Preferred Stock and 545,122 shares of Series VI Convertible Preferred Stock had been converted to PLDT common shares. The aggregate value of the put option based on outstanding shares as of December 31, 2004 was Php22,016 million, of which Php13,419 million is payable on June 4, 2008 and Php8,597 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 Php14,685 million, based on the market price of PLDT's common stock of Php1,360 per share as of December 31, 2004.

Please refer to *Note 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements for further discussion.

Commercial Commitments

As of December 31, 2004, our outstanding commercial commitments, in the form of letters of credit, amounted to Php1,504 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 over of the GSM network. In August 2001, Smart issued a Master Purchase Order, or MPO, in the amount of US\$200 million in favor of Nokia for the purchase of additional equipment to expand Smart's GSM cellular 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). This MPO has been completed as of December 31, 2004.

On June 23, 2004 and May 30, 2004, Smart signed a TSSA with Nokia in the amount of US\$10 million and US\$8 million, respectively, which was valid until December 31, 2004.

On December 14, 2004, Smart signed another MPO in favor of Nokia for US\$70 million (Phase 8 for GSM 900/1800 and WCDMA equipment under the same Frame Supply Contract). Smart, however, is under no legal obligation to incur these expenditures.

As of December 31, 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 December 31, 2004, the Philippine peso had depreciated against the U.S. dollar to Php56.341 to US\$1.00 from Php55.586 to US\$1.00 as of December 31, 2003, which in turn represented a depreciation against the U.S. dollar from Php53.254 to US\$1.00 at December 31, 2002. In 2004, consolidated capitalized net foreign exchange losses which qualified as borrowing costs were Php74 million, as compared to Php345 million in 2003. These capitalized net foreign exchange losses which qualified as borrowing costs 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.

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 December 31, 2004, approximately 98% of our total consolidated debts were denominated in foreign currencies. Of our foreign currency-denominated debts, 4% are in Japanese yen on a consolidated basis 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 64% of our consolidated foreign-currency debts), 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 substantially 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 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated 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.

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. In order to manage hedge costs of these contracts, we utilize structures that include credit - linkage with PLDT as the reference entity, combination of currency option contracts, and fixed to floating coupon only swap agreements. Accounted as either cash flow hedges or transactions not designated as hedges, changes in the fair value of these instruments are recognized as cumulative translation adjustments in equity until the hedged item is recognized in earnings or directly to income for the period. As of December 31, 2004, PLDT's outstanding forward foreign exchange contracts, principal-only long-term cross-currency swap contracts and currency option contracts amounted to US\$87 million and JP¥14 million; US\$550 million; and US\$251 million, respectively. Smart's outstanding forward foreign exchange contracts amounted to US\$69 million as of December 31, 2004.

For further discussions of these contracts, see *Note 25 – Financial Assets and Liabilities – Derivative Financial Instruments* to the accompanying consolidated financial statements.

Interest Rate Risk Management

On a limited basis, we enter into interest rate swap agreements in order to manage our exposure to interest rate fluctuations. As of December 31, 2004, PLDT's outstanding interest rate swap contracts amounted to US\$125 million. For further discussions of these contracts, see *Note 25 – Financial Assets and Liabilities – Derivative Financial Instruments* to the accompanying consolidated financial statements.

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 2004 and 2003, our service 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 business expenses.

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 our recognition of foreign exchange losses as we revalue our U.S. dollar-denominated indebtedness. 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 2004 was 6.0%, compared to 3.1% in 2003.

OTHER INFORMATION

Changes in Management Agreements between Piltel and Smart

On December 22, 2004, Piltel and Smart entered into a new omnibus agreement which superseded and replaced their existing Facilities Management Agreement, Customer Service Management Agreement, Administrative Support and Management Services Agreement as well as the Facilities Service Agreement. The original agreements were entered into in 2000 to cover services outsourced by Piltel to Smart covering such areas as network management, customer care and general administration as well as its 50-50 revenue sharing arrangement to compensate Smart for Piltel's use of Smart's network for Piltel's *Talk 'N Text* service.

Pursuant to the terms of the original agreements, which call for a periodic review of the various terms and conditions contained therein, Piltel and Smart undertook a review of the revenue sharing arrangement as well as other relevant fee structures after *Talk 'N Text* surpassed the 3.5 million subscriber mark in June 2004. In August 2004, both companies approved the joint engagement of an international, external telecommunications consultant to provide a framework for considering the extent and timing of any changes in the various agreements.

In its review, the consultant noted that the combined subscriber base of Smart and Piltel has reached such a level that the benefits of the resulting economies of scale should be reflected in the revenue sharing agreement. The consultant also noted that declining network and operating costs per subscriber derived from improvements in productivity and technology should also be taken into consideration in the sharing of revenues.

The new omnibus agreement took effect from January 1, 2004 and covers the provision of all the services under the original agreements, in consideration of a revenue sharing agreement of 80-20 in favor of Piltel. In addition, Smart also recompensed Piltel for Php3.7 billion representing Piltel's equitable share of revenues as a result of Piltel having achieved a critical mass of subscribers and the resultant "economies of scale" earlier than anticipated.

Acquisition of Meridian Telekoms, Inc.

On September 2, 2004, Smart entered into a Sale and Purchase Agreement to acquire 100% of Meridian Telekoms, Inc., a company primarily engaged in providing wireless broadband and data services to small and medium-scale enterprises in the Philippines, for a total consideration of US\$45 million of which payments of US\$11 million and US\$7 million were made in 2004 and US\$4 million in January 2005; the balance of US\$23 million is payable on December 31, 2005. The acquisition aims to strengthen Smart's position in the wireless data segment and is in line with Smart's overall strategy of providing the widest range of innovative wireless services.

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 issued 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. DOJ 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 Order 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. In November 2004, the U.S. FCC exempted a number of additional countries from the ISP, but not the Philippines. Instead, the U.S. FCC stated that it would rule separately regarding the Philippines after reviewing the issues raised by International Access, Inc. These issues are still pending before the U.S. FCC.

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 a 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 (U.S. DOJ) with respect to alleged antitrust violations relating to the provision of international termination services in the Philippines. The U.S. DOJ 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. produced documents. In February 2005, two former employees of PLDT U.S. Ltd testified before the grand jury in the U.S. DOJ matter. A PLDT employee was also scheduled to reappear for testimony in February, but his appearance has been postponed. At this time, the PLDT Group cannot predict the outcome of this investigation.

Related Party Transactions

In the ordinary course of business, companies related to but are outside of the consolidated 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.

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 December 31, 2004 and 2003 and for the years ended December 31, 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 Php336 million and Php288 million for 2004 and 2003, respectively. PLDT's outstanding obligations under these agreements amounted to Php49 million and Php40 million as of December 31, 2004 and 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 cellular business. Total fees under these agreements totaled Php507

million and Php429 million for 2004 and 2003, respectively. Under these agreements, Smart had outstanding payables of Php267 million and Php228 million as of December 31, 2004 and 2003, respectively. Asia Link is a subsidiary of the First 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 an insurance policy with Malayan Co., Inc., or Malayan, wherein premiums are directly paid to Malayan. Total payments to Gotuaco and Malayan covering the 12-month period ending July 31, 2005 amounted to Php440 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 21 – Related Party Transactions* to the accompanying consolidated financial statements.