



**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
For the Year Ended December 31, 2005**

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 and Practices to the accompanying audited 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 audited 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 differ in certain significant respects from generally accepted accounting principles in the United States.

The financial information appearing in this report and in the accompanying audited 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 audited consolidated financial statements were made based on the exchange rate of Php53.062 to US\$1.00, the volume weighted average exchange rate at December 31, 2005 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 at the date on which we made it. New risks and uncertainties come up from time to time, and it is impossible for us to predict these events or how they may affect us. We have no duty to, and do not intend to, update or revise the forward-looking statements in this report after the date hereof. In light of these risks and uncertainties, any forward-looking statement made in this report or elsewhere might not occur.

Financial Highlights and Key Performance Indicators

	December 31,		Increase (Decrease)	
	2005	2004	Amount	%
(in millions, except for operational data, exchange rates and earnings per common share)				
Consolidated Balance Sheets				
Total assets	Php251,984	Php264,751	(Php12,767)	(5)
Property, plant and equipment	176,974	194,525	(17,551)	(9)
Cash and cash equivalents and short-term investments	32,810	31,194	1,616	5
Total equity	74,369	47,187	27,182	58
Interest-bearing financial liabilities	116,616	164,729	(48,113)	(29)
Notes payable and long-term debt	103,544	149,088	(45,544)	(31)
Net debt to equity ratio ⁽¹⁾	0.95x	2.50x	-	-
	Years ended December 31,		Increase (Decrease)	
	2005	2004	Amount	%
Consolidated Statements of Income				
Revenues and other income	Php125,721	Php126,204	(Php483)	-
Service income	121,060	115,206	5,854	5
Expenses	87,106	93,272	(6,166)	(7)
Income before income tax	38,615	32,932	5,683	17
Net income attributable to equity holders	34,112	28,031	6,081	22
Net income	34,479	27,959	6,520	23
Net income margin	27%	22%	-	-
Earnings per common share – basic	189.96	156.14	33.82	22
Consolidated Statements of Cash Flows				
Net cash provided by operating activities	74,903	74,287	616	1
Net cash used in investing activities	11,690	23,939	(12,249)	(51)
Capital expenditures	14,990	21,162	(6,172)	(29)
Net cash used in financing activities	59,484	42,330	17,154	41
Operational Data				
Number of cellular subscribers	20,408,621	19,208,232	1,200,389	6
Number of fixed lines in service	2,113,799	2,152,027	(38,228)	(2)
Number of employees	18,926	18,433	493	3
Exchange Rates				
	Php per US\$	Php per JP¥		
December 31, 2005	Php53.062	Php0.4504		
December 31, 2004	56.341	0.5495		
December 31, 2003	55.586	0.5193		

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

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; Meridian Telekoms, Inc., or Meridian, our wireless broadband provider; Wolfpac Mobile, Inc., or Wolfpac, our wireless content operator, Mabuhay Satellite Corporation, or Mabuhay Satellite, ACeS Philippines Cellular Satellite Corporation, or ACeS Philippines, and Telesat, Inc., or Telesat, our satellite and very small aperture terminal, or VSAT, operators;

- *Fixed Line* — fixed line telecommunications services are primarily provided through PLDT. We also provide fixed line services through PLDT's subsidiaries 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., or Parlance, Vocativ Systems, Inc., or Vocativ, and ePLDT Ventus, Inc., or Ventus; internet access and gaming services provided by ePLDT's subsidiaries, Infocom Technologies, Inc. or Infocom, Digital Paradise, Inc., or Digital Paradise, Digital Paradise Thailand, Ltd., or Digital Paradise Thailand, netGames, Inc., or netGames, and Airborne Access Corporation, or Airborne Access; and e-commerce, and IT-related services provided by other investees of ePLDT, as discussed in *Note 9 – Investments in Associates* to the accompanying audited consolidated financial statements.

We registered total revenues and other income of Php125,721 million in 2005, a decrease of Php483 million as compared to Php126,204 million in 2004, primarily due to the decline in our non-service revenues and other income with the Php4,419 million gain recognized in relation to Piltel's debt exchange transaction in 2004, partially offset by a Php5,854 million, or 5%, net increase in our service revenues.

Expenses decreased by Php6,166 million, or 7%, to Php87,106 million in 2005 from Php93,272 million in 2004, largely resulting from decreases in financing costs which were mostly driven by the appreciation of the Philippine peso against the U.S. dollar and Japanese yen and lower cost of sales, partly offset by an increase in depreciation and amortization expense.

As a result of the foregoing, our net income increased by Php6,520 million, or 23%, to Php34,479 million in 2005 from Php27,959 million in 2004. Consequently, basic earnings per common share increased by 22% from Php156.14 in 2004 to Php189.96 in 2005.



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, 2005 and 2004. Most of our revenues are derived from our operations within the Philippines.

(in millions)	Wireless	Fixed Line	ICT	Inter-segment Transactions	Total				
For the year ended December 31, 2005									
Revenues and other income	Php78,835	Php49,990	Php3,438	(Php6,542)	Php125,721				
Service	74,675	49,663	2,953	(6,231)	121,060				
Non-service	2,711	41	351	(116)	2,987				
Equity share in net income of associates	–	–	7	–	7				
Other income	1,449	286	127	(195)	1,667				
Expenses	40,371	49,897	3,380	(6,542)	87,106				
Income before income tax	38,464	93	58	–	38,615				
Net income attributable to equity shareholders	33,222	768	122	–	34,112				
Net income	33,664	769	46	–	34,479				
For the year ended December 31, 2004									
Revenues and other income	79,723	48,810	2,415	(4,744)	126,204				
Service	69,015	48,486	2,080	(4,375)	115,206				
Non-service	6,111	–	321	(163)	6,269				
Other income	4,597	324	14	(206)	4,729				
Expenses	48,020	46,958	3,038	(4,744)	93,272				
Income (loss) before income tax	31,703	1,852	(623)	–	32,932				
Net income (loss) attributable to equity shareholders	27,435	1,289	(693)	–	28,031				
Net income (loss)	27,387	1,267	(695)	–	27,959				
	Amount	%	Amount	%	Amount	%	Amount	%	
Increase (Decrease)									
Revenues and other income	(Php888)	(1)	Php1,180	2	Php1,023	42	(Php1,798)	(Php483)	–
Service	5,660	8	1,177	2	873	42	(1,856)	5,854	5
Non-service	(3,400)	(56)	41	100	30	9	47	(3,282)	(52)
Equity share in net income of associates	–	–	–	–	7	100	–	7	100
Other income	(3,148)	(68)	(38)	(12)	113	807	11	(3,062)	(65)
Expenses	(7,649)	(16)	2,939	6	342	11	(1,798)	(6,166)	(7)
Income (loss) before income tax	6,761	21	(1,759)	(95)	681	109	–	5,683	17
Net income (loss) attributable to equity shareholders	5,787	21	(521)	(40)	815	118	–	6,081	22
Net income (loss)	6,277	23	(498)	(39)	741	107	–	6,520	23

Wireless

Revenues and Other Income

Our wireless business segment offers cellular services as well as satellite, VSAT, wireless broadband, 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, 2005 and 2004 by service segment:

	Years ended December 31,					
	2005		2004		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
(in millions)						
Wireless services:						
Service Revenues						
Cellular	Php71,998	91	Php66,782	83	Php5,216	8
Satellite, VSAT, wireless broadband and others	2,677	4	2,233	3	444	20
	<u>74,675</u>	<u>95</u>	<u>69,015</u>	<u>86</u>	<u>5,660</u>	<u>8</u>
Non-service Revenues						
Sale of cellular handsets and SIM-packs	2,711	3	6,111	8	(3,400)	(56)
Other Income	<u>1,449</u>	<u>2</u>	<u>4,597</u>	<u>6</u>	<u>(3,148)</u>	<u>(68)</u>
Total Wireless Revenues and Other Income	<u>Php78,835</u>	<u>100</u>	<u>Php79,723</u>	<u>100</u>	<u>(Php888)</u>	<u>(1)</u>

Service Revenues

Our wireless service revenues increased by Php5,660 million, or 8%, to Php74,675 million in 2005 compared to Php69,015 million in 2004, mainly as a result of the 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 95% in 2005 from 86% in 2004.

Cellular Service

Our cellular service revenues consist of:

- revenues derived from actual usage of the network by prepaid subscribers and any unused peso value of expired prepaid cards or electronic air time loads, net of discounts given to dealers;
- monthly service fees from postpaid subscribers, including (1) charges for calls in excess of allocated free local calls, (2) toll charges for national and international long distance calls, (3) charges for text messages of our 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 2005 amounted to Php71,998 million, an increase of Php5,216 million, or 8%, from Php66,782 million in 2004. Cellular service revenues accounted for 96% and 97% of our wireless service revenues in 2005 and 2004, respectively.

As at December 31, 2005, Smart and Piltel cellular subscribers reached 20,408,621, an increase of 1,200,389, or 6%, over their combined cellular subscriber base of 19,208,232 as at December 31, 2004. Prepaid subscribers accounted for 99% of our total subscriber base as at December 31, 2005 and 2004. Prepaid and postpaid net subscriber activations totaled 1,194,805 and 5,584, respectively, reflecting a total net activation of 1,200,389 in 2005. Postpaid subscribers

as at December 31, 2005 were higher than as at December 31, 2004 primarily due to increased net activations in the last two quarters of 2005.

Smart markets nationwide cellular communications services under the brand names *Smart Buddy*, *Smart Gold*, *addict mobile*, *addict mobile prepaid*, or *amp*, *Smart Infinity* and *Smart Kid prepaid*. *Smart Buddy*, *amp* and *Smart Kid prepaid* are prepaid services while *Smart Gold*, *Smart Infinity* and *addict mobile* are postpaid services, which are all provided through Smart's digital network.

Piltel markets its cellular prepaid service under the brand name *Talk 'N Text* which is provided through Smart's network. On December 22, 2004, the Board of Directors of Smart and Piltel approved the amendment of Piltel's and Smart's revenue sharing arrangement of 50-50 for the *Talk 'N Text* service to 80-20 in favor of Piltel.

In 2005, Smart launched a series of promotions to test the market demand for fixed rate or "bucket" plans for voice and text services. Under this service, branded as *Smart 25⁸*, Smart and *Talk 'N Text* subscribers had the option, for the duration of each promotion, to register for unlimited on-network (Smart-to-Smart) voice calls or unlimited on-network (Smart-to-Smart) text messaging service. During the year, the promotion took on several variations involving changes in load denominations, the periods of network availability (peak/off-peak) as well as a "double text" variation, where Smart and *Talk 'N Text* prepaid subscribers were credited with free additional text messages equivalent to their load denominations (e.g., additional free 30 short messaging service, or SMS, for Php30 load) which could be used for on-network texting and expired simultaneously with the load.

The current *Smart 25⁸* promotion, which was launched on January 4, 2006 and expires on March 3, 2006, has the following features:

- Php15, Php30 and Php60 denominations for one, two and four days, respectively, with unlimited on-network text all day;
- Php20 load denomination – unlimited overnight (11pm to 7am) text for two days and 20 free texts from 7am to 11pm, all on-network; and
- For *Talk 'N Text*, a Php15 denomination with the same features as Smart's Php20 load described above.

On August 23, 2005, Smart also operated a flat rate promotion which allows Smart and *Talk 'N Text* prepaid subscribers to make a call to another Smart or *Talk 'N Text* subscriber of up to three minutes for Php10, or extend up to five minutes for a flat rate of Php15. The flat rate promotion was relaunched on February 11, 2006 and is valid until March 11, 2006. On January 15, 2006, Smart launched the "10/10" promotion, where Smart prepaid subscribers were charged Php10 for calls up to 10 minutes (regardless if actual duration is shorter than 10 minutes.) Succeeding minutes after the 10th minute were charged with regular rates on a per minute basis. This promotion expired on February 5, 2006.



On February 12, 2006, Smart introduced a new variety of top-ups – *Smart Load* “All Text,” which has the following features:

<i>Smart Load</i> “All Text” packages	No. of Text Messages (off net, no expiry)	Unlimited Text (off- peak) promotion
Php10	10	1 day
20	20	2 days

The following table summarizes key measures of our cellular business as at and for the years ended December 31, 2005 and 2004:

	Years ended December 31,			
	2005	2004	Increase	
			Amount	%
(in millions)				
Cellular service revenues	Php71,998	Php66,782	Php5,216	8
<i>By component</i>				
Voice	70,097	65,240	4,857	7
Data	34,276	33,412	864	3
<i>By service type</i>				
Prepaid	35,821	31,828	3,993	13
Postpaid	70,097	65,240	4,857	7
<i>Others</i> ⁽¹⁾	65,613	61,047	4,566	7
	4,484	4,193	291	7
	1,901	1,542	359	23

(1) Refers to other non-subscriber-related revenues consisting primarily of inbound international roaming fees, revenues from Smart’s public calling offices and payphone businesses, revenues from Wolfpac and Smart Money Holdings Corporation and a small number of leased line contracts.

	December 31,			
	2005	2004	Increase	
			Amount	%
Cellular subscriber base	20,408,621	19,208,232	1,200,389	6
Prepaid	20,128,543	18,933,738	1,194,805	6
Smart	15,144,118	14,321,288	822,830	6
Piltel	4,984,425	4,612,450	371,975	8
Postpaid	280,078	274,494	5,584	2

	Years ended December 31,			
	2005	2004	Increase	
			Amount	%
Systemwide traffic volumes ⁽¹⁾ (in millions)				
Calls (in minutes)	5,467	5,037	430	9
Domestic	3,741	3,576	165	5
International	1,726	1,461	265	18
Inbound	1,557	1,292	265	21
Outbound	169	169	–	–
Text messages	43,586	40,953	2,633	6
Smart	35,396	33,622	1,774	5
Piltel	8,190	7,331	859	12

(1) Excludes traffic volumes relating to Smart 25⁸ Unlimited Call and Text promotions.

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 Php864 million, or 3%, to Php34,276 million in 2005 from Php33,412 million in 2004, primarily due to an increase in subscriber base and inbound international revenues which compensated for a 18% drop in the average outbound voice usage per subscriber from 19 minutes per month in 2004 to 16 minutes per month in 2005.

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 Php3,993 million, or 13%, to Php35,821 million in 2005 from Php31,828 million in 2004. Cellular data services accounted for 50% of cellular service revenues in 2005, compared to 48% in 2004.

The following table shows the breakdown of cellular data revenues for the years ended December 31, 2005 and 2004:

(in millions)	Years ended December 31,			
	2005	2004	Increase (Decrease)	
			Amount	%
Text messaging				
Domestic	Php30,443	Php26,662	Php3,781	14
International	1,731	1,869	(138)	(7)
	<u>32,174</u>	<u>28,531</u>	<u>3,643</u>	<u>13</u>
Value-added services				
Non-Zed ⁽¹⁾	2,404	1,762	642	36
<i>Smart Zed</i> TM	540	564	(24)	(4)
<i>Smart Money</i>	102	61	41	67
Mobile Banking	5	6	(1)	(17)
Roaming SMS and WAP	596	904	(308)	(34)
	<u>3,647</u>	<u>3,297</u>	<u>350</u>	<u>11</u>
Total	<u>Php35,821</u>	<u>Php31,828</u>	<u>Php3,993</u>	<u>13</u>

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

Text messaging-related services contributed revenues of Php32,174 million in 2005, an increase of 13%, compared to Php28,531 million in 2004, and accounted for 90% of the total cellular data revenues in 2005 and 2004. The increase in revenues from text messaging-related services resulted mainly from the ongoing *Smart 25⁸ Unlimited Text* promotion and an increase in *Pasa Load* transactions. Text messaging revenues from the *Smart 25⁸* promotions totaled Php3,770 million. Value-added services contributed revenues of Php3,647 million in 2005, increased by Php350 million, or 11%, from Php3,297 million in 2004 primarily due to increased ringtone/logo download activities, info-on-demand as well as increased *Smart Money* usage emanating from *Smart Padala* and *Smart Load* retailers' use of *Smart Money* to replenish their load wallet.



Subscriber Base, ARPU and Churn Rates

Prepaid subscribers accounted for approximately 99% of our 20,408,621 subscribers as at December 31, 2005, while postpaid subscribers accounted for the remaining 1%. The cellular prepaid subscriber base grew by 6% to 20,128,543 as at December 31, 2005 from 18,933,738 as at December 31, 2004, whereas the postpaid subscriber base increased by 2% to 280,078 as at December 31, 2005 from 274,494 as at December 31, 2004.

Our net subscriber activations for the years ended 2005 and 2004 were as follows:

	Years ended December 31,			
	2005	2004	Decrease	
			Amount	%
Prepaid	1,194,805	6,235,518	(5,040,713)	(81)
Smart	822,830	4,490,153	(3,667,323)	(82)
Piltel	371,975	1,745,365	(1,373,390)	(79)
Postpaid	5,584	25,517	(19,933)	(78)
Total	1,200,389	6,261,035	(5,060,646)	(81)

Our quarterly net subscriber activations (reductions) for 2004 and 2005 were as follows:

	2004				2005			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q ⁽¹⁾	4Q ⁽¹⁾
Prepaid	1,380,339	1,676,314	1,433,664	1,745,201	1,050,638	536,840	(11,230)	(381,443)
Smart	1,162,301	1,207,542	797,686	1,322,624	920,885	314,607	(53,953)	(358,709)
Piltel	218,038	468,772	635,978	422,577	129,753	222,233	42,723	(22,734)
Postpaid	16,866	7,691	10,445	(9,485)	(6,357)	116	10,506	1,319
Total	1,397,205	1,684,005	1,444,109	1,735,716	1,044,281	536,956	(724)	(380,124)

(1) Subscriber reductions were attributable to the termination of our SIM-swapping promotion in May 2005.

Revenues attributable to our cellular prepaid service amounted to Php65,613 million in 2005, a 7% increase over the Php61,047 million earned in 2004. Prepaid service revenues in 2005 and 2004 accounted for 94% of voice and data revenues. Revenues attributable to Smart's postpaid service amounted to Php4,484 million in 2005, a 7% increase over the Php4,193 million earned in 2004 and accounted for 6% of voice and data revenues.



The following table summarizes our cellular ARPUs for the years ended December 31, 2005 and 2004:

	Years ended December 31,							
	Gross		Increase (Decrease)		Net		Increase (Decrease)	
	2005	2004	Amount	%	2005	2004	Amount	%
Prepaid								
Smart	Php357	Php428	(Php71)	(17)	Php294	Php355	(Php61)	(17)
Piltel	257	311	(54)	(17)	212	259	(47)	(18)
Prepaid – Blended	332	401	(69)	(17)	274	333	(59)	(18)
Postpaid – Smart	1,869	1,741	128	7	1,368	1,286	82	6
Prepaid and Postpaid Blended	353	424	(71)	(17)	289	349	(60)	(17)

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-provider 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-provider 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 prepaid subscribers in 2005 was Php357, a decrease of 17%, compared to Php428 in 2004. This decline was attributable mainly to a decrease in the average text messaging revenue per subscriber as well as lower average outbound local and international voice revenue per subscriber and lower average inbound revenue per subscriber in 2005. On a net basis, ARPU in 2005 decreased by 17% to Php294 from Php355 in 2004. Gross monthly ARPU for *Talk 'N Text* subscribers in 2005 was Php257, a decrease of 17% compared to Php311 in 2004. The decline was similarly attributable to a decrease in the average text messaging revenue per subscriber as well as lower average outbound local and international voice revenue per subscriber and lower average inbound revenue per subscriber in 2005. On a net basis, ARPU in 2005 decreased by 18% to Php212 from Php259 in 2004.

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 ARPU for postpaid subscribers increased by 7% to Php1,869 while net monthly ARPU increased by 6% to Php1,368 in 2005 as compared to Php1,741 and Php1,286 in 2004, respectively. Prepaid and postpaid monthly gross blended ARPU was Php353 in 2005, a decrease of 17% compared to Php424 in 2004. Monthly net blended ARPU decreased by 17% to Php289 in 2005 from Php349 in 2004.



Our quarterly prepaid and postpaid ARPUs for 2005 and 2004 were 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
2005						
First Quarter	Php356	Php289	Php269	Php220	Php1,767	Php1,257
Second Quarter	357	294	262	212	1,896	1,360
Third Quarter	343	285	234	194	1,889	1,389
Fourth Quarter	370	308	261	220	1,923	1,467

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.

Prior to June 2004, a prepaid cellular subscriber was recognized as an active subscriber when that subscriber activated and used the SIM card in the handset, which contained pre-stored air time. The pre-stored air time, which can be used for both voice and text, was reduced from Php100 to Php50 in April 2004. In May 2005, this was changed to Php1 plus 50 free SMS which could only be used upon purchase or reload of air time of any value. Subscribers can reload their air time by purchasing prepaid “call and text” cards that are sold in denominations of Php300, Php500 and Php1,000; 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 but had not reloaded by May 31, 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. “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 swap their SIM cards between mobile operators upon full usage of the pre-stored air time, which may result in our subscriber base reflecting a certain number of transient subscribers at any one point in time. In May 2005, we terminated our “SIM swapping” promotions; as a result, our churn rates increased beginning in the third quarter and continuing on to the end of 2005.

For Smart prepaid, the average monthly churn rate for 2005 was 4.0%, compared to 2.7% in 2004, while the average monthly churn rate for *Talk ‘N Text* subscribers was 5.5% in 2005 compared to 3.5% in 2004. The increased churn in our prepaid service can be attributed primarily to the termination of “SIM-swapping” activities described above.

The average monthly churn rate for Smart's postpaid subscribers for 2005 was 2.0%, compared to 1.4% in 2004, as a result of increased competition in this market segment. 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, Wireless Broadband and Other Services

Our revenues from satellite, VSAT, wireless broadband and other services consist mainly of rentals received for the lease of Mabuhay Satellite's transponders and Telesat's VSAT facilities to other companies, wireless broadband service revenues for Meridian, charges for ACeS Philippines' satellite phone service and service revenues generated from a PLDT Global subsidiary's mobile virtual network operations. Meridian offers a number of wireless broadband services with 25,428 subscribers as of December 31, 2005, including 21,759 *Smart WiFi* subscribers.

Gross revenues from these services for 2005 amounted to Php2,677 million, an increase of Php444 million, or 20%, from Php2,233 million in 2004.

Non-service Revenues

Our wireless non-service revenues consist of:

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

Our wireless non-service revenues decreased by Php3,400 million, or 56%, to Php2,711 million in 2005 as compared to Php6,111 million in 2004, primarily due to lower handset sales. In 2005, activations were driven more by SIM-pack sales and SIM swap activities up to May 2005.

Other Income

All other income/gains such as rental income and gain on disposal of property, which do not fall under service and non-service revenues, are included under this classification. Our wireless business segment generated other income of Php1,449 million in 2005, a decrease of Php3,148 million, or 68%, as compared to Php4,597 million in 2004, primarily as a result of the net gain of Php4,419 million relating to Piltel's debt/swap exchange recognized in 2004.

Expenses

Expenses associated with our wireless business in 2005 amounted to Php40,371 million, a decrease of Php7,649 million, or 16%, from Php48,020 million in 2004. A significant portion of this decrease was attributable to lower cost of sales, financing costs, and selling and promotions, partially offset by higher cash expenses, particularly rent, maintenance and compensation and benefits. As a percentage of our total wireless revenues and other income, expenses associated with our wireless business decreased to 51% in 2005 from 60% in 2004.

Cellular business expenses accounted for 95% of our wireless business expenses, while satellite, VSAT, wireless broadband and other business expenses accounted for the remaining 5% of our wireless business expenses in 2005 and 2004.



The following table summarizes the breakdown of our wireless-related expenses for the years ended December 31, 2005 and 2004 and the percentage of each expense item to the total:

	Years ended December 31,					
	2005		2004		Increase (Decrease)	
	2005	%	2004	%	Amount	%
(in millions)						
Wireless services						
Depreciation and amortization	Php10,156	25	Php10,940	23	(Php784)	(7)
Cost of sales	6,148	15	11,122	23	(4,974)	(45)
Rent	5,592	14	3,962	8	1,630	41
Compensation and benefits ⁽¹⁾	4,249	11	3,341	7	908	27
Maintenance	3,655	9	2,597	5	1,058	41
Selling and promotions	3,092	8	4,261	9	(1,169)	(27)
Professional and other contracted services	1,656	4	1,241	3	415	33
Taxes and licenses	1,542	4	1,215	2	327	27
Communication, training and travel	960	2	791	2	169	21
Insurance and security services	947	2	937	2	10	1
Financing costs	591	2	5,137	11	(4,546)	(88)
Provisions	575	1	417	1	158	38
Amortization of intangible assets	244	1	155	–	89	57
Asset impairment	–	–	430	1	(430)	(100)
Equity share in net losses of associates	–	–	72	–	(72)	(100)
Other expenses	964	2	1,402	3	(438)	(31)
Total	<u>Php40,371</u>	<u>100</u>	<u>Php48,020</u>	<u>100</u>	<u>(Php7,649)</u>	<u>(16)</u>

(1) Includes salaries and benefits, incentive plan, pension and manpower rightsizing program, or MRP, costs.

Depreciation and amortization charges decreased by Php784 million, or 7%, to Php10,156 million in 2005, substantially due to a decrease in the depreciable asset base as certain of our wireless assets were fully depreciated by the end of 2004 and partially offset by the effect of our change in estimated useful lives of certain components of property, plant and equipment consistent with the requirements of Philippine Accounting Standards, or PAS, 16, which increased depreciation charges in 2005. For further details, see *Note 8 – Property, Plant and Equipment* to the accompanying audited consolidated financial statements.

Cost of sales decreased by Php4,974 million, or 45%, to Php6,148 million due to the termination of SIM-swapping activities in May 2005. The breakdown of cost of sales for our wireless business for the years ended December 31, 2005 and 2004 is as follows:

	Years ended December 31,					
	2005		2004		Decrease	
	2005	2004	Amount	%		
(in millions)						
Cost of cellular handsets and SIM-packs sold	Php5,905	Php10,839	(Php4,934)	(46)		
Cost of satellite air time and terminal units	243	283	(40)	(14)		
	<u>Php6,148</u>	<u>Php11,122</u>	<u>(Php4,974)</u>	<u>(45)</u>		

Rent expenses increased by Php1,630 million, or 41%, to Php5,592 million on account of an increase in domestic fiber optic network, or DFON, facilities leased from PLDT. As at December 31, 2005, we had 4,305 GSM cell sites and 5,982 base stations, compared with 3,951 GSM cell sites and 5,303 base stations as at December 31, 2004.

Compensation and benefits expenses increased by Php908 million, or 27%, to Php4,249 million, primarily due to salary increases, higher long-term incentive and manpower reduction costs of Smart. On the other hand, Smart's employee headcount decreased by 152, or 3%, to 5,087 in 2005 compared to 5,239 in 2004.

Maintenance expenses increased by Php1,058 million, or 41%, to Php3,655 million, mainly on account of higher expenses for electricity and power generation for cell sites and higher repairs and maintenance costs for network facilities.

Selling and promotion expenses decreased by Php1,169 million, or 27%, to Php3,092 million due to lower advertising and promotion costs incurred.

Professional and other contracted services increased by Php415 million, or 33%, to Php1,656 million, primarily due to increased legal, technical service and payment facility fees.

Taxes and licenses increased by Php327 million, or 27%, to Php1,542 million primarily due to an increase in Smart's business-related taxes.

Communication, training and travel expenses increased by Php169 million, or 21%, to Php960 million, due to higher local travel and training costs, as well as an increase in delivery, freight and hauling expenses incurred in 2005.

Insurance and security services increased by Php10 million, or 1%, to Php947 million, primarily 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.

Financing costs in 2005 amounted to Php591 million, a decrease of Php4,546 million, or 88%, from Php5,137 million in 2004, primarily as a result of a 6% and 18% appreciation of the Philippine peso to the U.S. dollar and Japanese yen, respectively, from December 31, 2004 to December 31, 2005. Foreign exchange losses were recorded in 2004 with the peso depreciation of 1% against the U.S. dollar, aggravated by a peso depreciation of approximately 6% against the Japanese yen from December 31, 2003 to December 31, 2004. In addition, interest income increased due to higher cash balances in 2005 as compared to 2004. The breakdown of our financing costs for our wireless business for the years ended December 31, 2005 and 2004 is as follows:

(in millions)	Years ended December 31,			
	2005	2004	Change	
			Amount	%
Accretion on financial liabilities – net	Php2,560	Php3,177	(Php617)	(19)
Interest on loans and related items	1,799	1,754	45	3
Foreign exchange losses (gains) – net	(3,047)	751	(3,798)	(506)
Interest income	(1,057)	(724)	(333)	(46)
Loss (gain) on derivative transactions – net	118	(8)	126	1,575
Dividends on preferred stock subject to mandatory redemption	251	284	(33)	(12)
Financing charges	52	1	51	5,100
Capitalized interest	(85)	(98)	13	13
	<u>Php591</u>	<u>Php5,137</u>	<u>(Php4,546)</u>	<u>(88)</u>

Provisions increased by Php158 million, or 38%, to Php575 million, primarily due to an increase in write-down of slow-moving handsets to net realizable values, and a net reversal of provision for carrier accounts in 2004 following subsequent collections from such carrier accounts. The breakdown of provisions for the years ended December 31, 2005 and 2004 is as follows:

	Years ended December 31,		Increase	
	2005	2004	Amount	%
(in millions)				
Doubtful accounts	Php253	Php204	Php49	24
Write-down of inventories to net realizable value	322	213	109	51
	<u>Php575</u>	<u>Php417</u>	<u>Php158</u>	<u>38</u>

Amortization of intangible assets increased by Php89 million, or 57%, to Php244 million due to the amortization of Meridian's intangible assets from September 2004 onwards.

Asset impairment amounted to Php430 million in 2004, primarily due to impairment losses recognized in respect of our investment in ACeS International Limited, or AIL; no impairment charge was recognized in 2005.

Equity share in net losses of associates amounted to Php72 million in 2004, mainly due to net losses incurred by a wireless subsidiary's joint venture investment.

Other expenses decreased by Php438 million, or 31%, to Php964 million due to a decline in various business and operational-related expenses such as office supplies expense.

Provision for Income Tax

Provision for income tax increased by Php484 million, or 11%, to Php4,800 million in 2005 from Php4,316 million in 2004, as Smart's income tax holiday expired in the second quarter of 2004 and as Piltel's income tax position reversed from net tax loss in 2004 to net tax payable in 2005. In 2005, the effective tax rate for our wireless business was 12% compared to 14% in 2004 due to the net movement in deferred tax assets as previously unrecognized deferred tax assets were taken-up in 2005 with the increased likelihood that Smart and Piltel would be able to realize the future tax benefits on these assets.

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

Net Income

Our wireless business segment recorded a net income of Php33,664 million in 2005, an increase of Php6,277 million, or 23%, over Php27,387 million registered in 2004, primarily due to the growth in our cellular service revenues and a 16% decrease in wireless expenses, which more than offset the decreases in our wireless non-service revenues and other income.

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. Total fixed line revenues generated from our fixed line business in 2005 totaled Php49,990 million, an increase of Php1,180 million, or 2%, from Php48,810 million in 2004.

The following table summarizes revenues from our fixed line business for the years ended December 31, 2005 and 2004 by service segment:

	Years ended December 31,					
	2005		2004		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
(in millions)						
Fixed line services:						
Service Revenues						
Local exchange	Php20,503	41	Php20,799	43	(Php296)	(1)
International long distance	12,245	24	12,803	26	(558)	(4)
National long distance	5,254	10	6,735	14	(1,481)	(22)
Data and other network	10,394	21	7,114	14	3,280	46
Miscellaneous	1,267	3	1,035	2	232	22
	49,663	99	48,486	99	1,177	2
Non-Service Revenues	41	-	-	-	41	100
Other Income	286	1	324	1	(38)	(12)
Total Fixed Line Revenues and Other Income	Php49,990	100	Php48,810	100	Php1,180	2

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 as at and for the years ended December 31, 2005 and 2004:

	Years ended December 31			
	2005	2004	Increase (Decrease)	
			Amount	%
Total local exchange service revenues (in millions)	Php20,503	Php20,799	(Php296)	(1)
Number of fixed lines in service	2,113,799	2,152,027	(38,228)	(2)
Number of fixed line employees	9,197	9,692	(495)	(5)
Number of fixed lines in service per employee	230	222	8	4

Revenues from our local exchange service decreased by Php296 million, or 1%, to Php20,503 million in 2005 from Php20,799 million in 2004. The decrease was primarily due to a 2% decline in the number of fixed lines in service and the appreciation of the peso which required us to make downward adjustments in our monthly local service rates. The percentage contribution of local exchange revenues to our fixed line service revenues decreased to 41% in 2005 compared to 43% in 2004.

Fixed line net reduction in 2005 was 38,228 compared to a net reduction of 33,924 in 2004. While fixed line additions totaled 7,706 for postpaid fixed line services, prepaid fixed lines in service declined by 45,934 in 2005. As at December 31, 2005, postpaid and prepaid fixed line subscribers totaled 1,790,897 and 322,902, respectively, which accounted for approximately 85% and 15%, respectively, of our 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 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. 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 2005, we implemented six downward adjustments and three upward adjustments in our monthly local service rates compared to six upward adjustments and one downward adjustment in 2004. The average Philippine peso to U.S. dollar rate factored in our monthly local service rates in 2005 was Php55.085 to US\$1.00, compared to an average of Php56.044 to US\$1.00 in 2004. This change in the average peso-to-dollar rate translated to a peso appreciation of 2%, which resulted in an average net decrease of approximately 1% in our monthly local service rates in 2005.

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, 2005 and 2004:

	Years ended December 31,			
	2005	2004	(Decrease)	
			Amount	%
Total international long distance service revenues (in millions)	Php12,245	Php12,803	(Php558)	(4)
Inbound	10,203	10,685	(482)	(5)
Outbound	2,042	2,118	(76)	(4)
International call volumes (in million minutes, except call ratio)	2,226	2,348	(122)	(5)
Inbound	2,079	2,192	(113)	(5)
Outbound	147	156	(9)	(6)
Inbound-outbound call ratio	14.1:1	14.1:1	-	-

Our total international long distance service revenues decreased by Php558 million, or 4%, to Php12,245 million in 2005 from Php12,803 million in 2004 due to the peso appreciation coupled with the decrease in call volumes largely as a result of alternative means of communications such as e-mailing, texting and internet telephony. The percentage contribution of international long distance service revenues to our fixed line service revenues decreased to 24% in 2005 from 26% in 2004.

Our revenues from inbound international long distance service decreased by Php482 million due to a decrease in inbound traffic volume by 113 million minutes to 2,079 million minutes in 2005. In addition, the 2% appreciation in the average value of the peso to the U.S. dollar to Php55.085 during 2005 from Php56.044 during 2004 contributed to the decrease in our inbound international long distance revenues in peso terms since settlement charges for inbound calls are billed in U.S. dollars or in special drawing rights, an established method of settlement among international telecommunications carriers using values based on a basket of foreign currencies that are translated into pesos at the time of billing.

Our revenues from outbound international long distance service decreased by Php76 million in 2005, primarily due to a decline in outbound call volumes by 9 million minutes to 147 million minutes and the peso appreciation in 2005.

On September 15, 2005, we introduced *PLDT ID-DSL*, a service that allows overseas calls for registered *myDSL* plan subscribers using a regular PLDT fixed line or a voice pad dialer for as low as US\$0.10 per minute or US\$0.08 per minute, respectively, depending on the subscribers' DSL plan/package.

To address the market's demand for low-priced international calls, PLDT modified the *Budget Card*, a prepaid call card, offering a reduced IDD rate of Php5 per minute, as a promotional offer starting September 24, 2005, for calls to 89 overseas destinations including the United States, Canada, Japan and China. *Budget Cards* are sold in denominations of Php200 and Php100, which must be consumed within 30 days from first use.

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, 2005 and 2004:

	Years ended December 31,			
	2005	2004	Increase (Decrease)	
			Amount	%
Total national long distance service revenues (in millions)	Php5,254	Php6,735	(Php1,481)	(22)
National long distance call volumes (in million minutes)	1,904	1,853	51	3

Our national long distance service revenues decreased by Php1,481 million, or 22%, to Php5,254 million in 2005 from Php6,735 million in 2004 as a result of: (1) a decrease in average revenue per minute brought about by our fixed rate per call promotion starting February 14, 2005; and (2) the integration of local exchanges into a single calling area, which resulted in calls between two exchanges located within the same province no longer being considered as national long distance calls, but rather as local calls. Accordingly, the percentage contribution of national long distance revenues to our fixed line service revenues decreased to 11% in 2005 compared to 14% in 2004.

On February 14, 2005, we launched a Php10 per call promotion to PLDT landline subscribers nationwide and for calls to PLDT, to Smart and *Talk 'N Text* subscribers. This promotion was launched with the objective of determining a more effective tariff structure that would stimulate landline usage. Under the promotion, NDD calls between any PLDT landline subscriber nationwide or to all Smart and *Talk 'N Text* subscribers were charged Php10 per call instead of being charged on a per minute basis.

On May 12, 2005, PLDT began offering the Php10 per call promotion with an additional Php5 per call for the same unlimited talktime to Smart and *Talk 'N Text* subscribers. PLDT to PLDT NDD calls below the equivalent Php10 toll usage were charged based on the regular rate per

minute. On August 12, 2005, PLDT ceased offering the Php10 per call promotion to calls terminating to Smart and *Talk 'N Text* subscribers.

Beginning September 12, 2005, PLDT charged an optional Php20 add-on monthly service fee for PLDT landline subscribers who may want to continue to avail themselves of the Php10 per call promotion for calls within our network.

In January 2006, PLDT launched the *10-10-10* promotion. This promotion offers a flat rate of Php10 for unlimited calls terminating PLDT to PLDT and Smart and *Talk 'N Text* subscribers for a Php50 monthly service fee.

Our national long distance call volumes increased by approximately 3% to 1,904 million minutes in 2005 from 1,853 million minutes in 2004. This was mainly due to the Php10 per call promotion offered to PLDT landline subscribers nationwide.

The integration of some of our local exchanges into a single local calling area, as approved by the NTC, also negatively affected our national long distance call volumes, and consequently, our revenues. Because of this integration, calls between two exchanges located within the same province are no longer considered national long distance calls but are treated as local calls.

Data and Other Network Services

Our data and other network services in the 2005 posted revenues of Php10,394 million, an increase of Php3,280 million, or 46%, from Php7,114 million in 2004, primarily due to increases in leased lines and IP-based data services, particularly Dignet and DSL, respectively. The revenue contribution of this service segment to our fixed line service revenues increased to 21% in 2005 from 15% in 2004.

Data and other network services we currently provide include leased lines, IP-based, packet-based and switch-based services. These services are used for domestic and international communications such as private networking, broadband and narrowband internet-based data communications, and packet-based communication.

Of our total revenues in 2005, leased lines accounted for 55%, IP-based services accounted for 29%, packet-based services accounted for 11% and switched-based services accounted for the remaining 5%, compared to 56%, 25%, 13% and 6%, respectively, in 2004. These percentage increases indicate a continuing demand for broadband services, particularly the high bandwidth clear data requirements of business process outsourcing companies, or BPOs, and call centers. We expect this trend to continue due to growth in the areas of e-commerce, online services and BPOs particularly among call centers, medical transcription, animation and shared services.

Internet-based products are bannered by *PLDT Vibe*, *PLDT DSL (myDSL and BizDSL)* and I-Gate. *PLDT Vibe*, or PLDT's dial-up/narrowband Internet service, is targeted for light to medium residential or individual internet users; while *PLDT DSL* broadband Internet service is targeted for heavy individual internet users as well as for small and medium enterprises. I-Gate, our dedicated leased line Internet access service, on the other hand, is targeted to enterprises and value-added service providers.

As at December 31, 2005, the number of PLDT's fixed line subscribers for *PLDT Vibe* stood at 382,115, of which 136,279 were exclusive postpaid users, 222,234 were exclusive prepaid users, and 23,602 were both postpaid and prepaid users. As at December 31, 2004, *PLDT Vibe*

subscribers totaled 305,210, of which 127,292 were exclusive postpaid users, 155,243 were exclusive prepaid users, and 22,675 were both postpaid and prepaid users. In addition, PLDT DSL has reached 88,811 subscribers as at December 31, 2005 compared with 48,289 subscribers in 2004. PLDT offers a number of DSL packages with speeds and monthly fees varying from 256 kbps at Php999 per month to up to 1 Mbps at Php3,000 per month.

The continued growth in data services revenues can be attributed to several product offerings. The steady demand for dedicated connectivity or private networking from the corporate market using PLDT's traditional bandwidth offerings – Fibernet, Arcstar, Acacia, I-Gate, Diginet, BRAINS, among others – continues to provide us with a stable revenue source. In addition, we provide Smart's increasing fiber optic and leased line data requirements, which are included under our national data services.

In March 2005, we introduced *PLDT WeRoam*, a wireless broadband service offering running on Smart's nationwide wireless network (using GPRS, EDGE and WiFi technologies) and PLDT's extensive IP infrastructure. Some of the recent enhancements to the service are the inclusion of international roaming in key roaming countries all over the globe and national WiFi roaming access. Principally targeted to the corporate market, the service has experienced a take-up of more than 5,000 contracted customers as of December 31, 2005.

Miscellaneous

Miscellaneous service revenues are derived mostly from directory advertising and facilities rental. In 2005, these revenues increased by Php232 million, or 22%, to Php1,267 million from Php1,035 million in 2004. 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. The percentage contribution of miscellaneous service revenues to our fixed line service revenues increased to 3% in 2005 from 2% in 2004.

Non-service Revenues

Non-service revenues of Php41 million recognized under our fixed line business represent proceeds of computer sales in 2005 in relation to our DSL promo.

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 2005, our fixed line business segment registered a decrease in other income of Php38 million, or 12%, to Php286 million in 2005 from Php324 million in 2004, primarily due to lower service and facility fees.

Expenses

Expenses related to our fixed line business in 2005 totaled Php49,897 million, an increase of Php2,939 million, or 6%, compared to Php46,958 million in 2004. The increase was primarily due to higher depreciation and amortization, compensation and benefits and selling and promotions expenses partially offset by lower financing costs and provisions expenses.



The following table shows the breakdown of our total fixed line-related expenses for the years ended December 31, 2005 and 2004 and the percentage of each expense item to the total:

	Years ended December 31,					
	2005		2004		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
(in millions)						
Fixed line services:						
Depreciation and amortization	Php20,251	41	Php10,125	22	Php10,126	100
Financing costs	8,581	17	14,105	30	(5,524)	(39)
Compensation and benefits ⁽¹⁾	8,319	17	7,792	17	527	7
Maintenance	3,309	7	3,211	7	98	3
Provisions	2,260	4	4,431	9	(2,171)	(49)
Rent	1,712	3	1,700	4	12	1
Selling and promotions	1,567	3	1,159	2	408	35
Professional and other contracted services	1,023	2	1,050	2	(27)	(3)
Taxes and licenses	884	2	762	2	122	16
Insurance and security services	628	1	700	1	(72)	(10)
Communication, training and travel	447	1	449	1	(2)	-
Cost of sales	53	-	-	-	53	100
Asset impairment	-	-	365	1	(365)	(100)
Other expenses	863	2	1,109	2	(246)	(22)
Total	Php49,897	100	Php46,958	100	Php2,939	6

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

Depreciation and amortization charges increased by Php10,126 million, or 100%, to Php20,251 million mainly due to the effect of our change in estimated useful lives of certain components of property, plant and equipment consistent with the requirements of PAS 16, in line with our continuous network upgrade and expansion, which resulted in increased depreciation charges for 2005, and higher depreciation of our regular asset base primarily resulting from additional completed projects. Please see *Note 8 – Property, Plant and Equipment* to the accompanying audited consolidated financial statements for further discussion.

Financing costs decreased by Php5,524 million, or 39%, to Php8,581 million due to: (1) the strengthening of the peso relative to the U.S. dollar and Japanese yen resulting in foreign exchange gains in 2005 as compared to foreign exchange losses recorded during 2004; (2) lower interest on loans and related items owing to lower debt balances in 2005 as compared to 2004; and (3) lower recorded loss on derivatives in 2005 as compared to 2004. The breakdown of financing costs for our fixed line business for the years ended December 31, 2005 and 2004 is as follows:

	Years ended December 31,					
	2005		2004		Change	
	Amount	%	Amount	%	Amount	%
(in millions)						
Interest on loans and related items	Php9,058		Php10,699		(Php1,641)	(15)
Loss on derivative transactions – net	510		872		(362)	(42)
Foreign exchange losses (gains) – net	(1,889)		1,888		(3,777)	(200)
Hedge costs	1,234		1,011		223	22
Capitalized interest	(419)		(497)		78	16
Interest income	(385)		(248)		(137)	55
Accretion on financial liabilities – net	322		235		87	37
Financing charges	150		145		5	3
Total	Php8,581		Php14,105		(Php5,524)	(39)

Compensation and benefits expenses increased by Php527 million, or 7%, to Php8,319 million primarily due to the effect of the collective bargaining agreement-related increases in salaries and benefits and an increase in incentive plan-related accruals, partially offset by a reduction in headcount due to PLDT's MRP.

Maintenance expenses increased by Php98 million, or 3%, to Php3,309 million primarily due to higher maintenance costs for foreign cable and wire facilities as more operating and maintenance-related restorations were incurred in 2005 as compared to 2004.

Provisions decreased by Php2,171 million, or 49%, to Php2,260 million, primarily on account of a lower provision by PLDT for anticipated uncollectible accounts from various specifically identified domestic telecommunications carriers which were provided for in 2004 complemented by a decrease in our write-down of inventories to net realizable value. The breakdown of provisions for our fixed line business for the years ended December 31, 2005 and 2004 is as follows:

(in millions)	Years ended December 31,			
	2005	2004	(Decrease)	
			Amount	%
Doubtful accounts	Php1,944	Php3,751	(Php1,807)	(48)
Write-down of inventories to net realizable value	157	361	(204)	(57)
Onerous contracts and assessments	159	319	(160)	(50)
	<u>Php2,260</u>	<u>Php4,431</u>	<u>(Php2,171)</u>	<u>(49)</u>

Rent expenses increased by Php12 million, or 1%, to Php1,712 million due to an increase in international leased circuits and rental charges occupied by various equipments, partially offset by lower rentals for bundled sales/value added service units.

Selling and promotion expenses increased by Php408 million, or 35%, to Php1,567 million, primarily as a result of an increase in PLDT's promotional activities in relation to various products and services, partially offset by lower commissions paid in 2005.

Professional and other contracted services decreased by Php27 million, or 3%, to Php1,023 million primarily due to lower advisory and legal fees in 2005 for various services, partially offset by an increase in facility management fees and collection agency fees.

Taxes and licenses increased by Php122 million, or 16%, to Php884 million mainly on account of higher NTC supervision and license fees, fringe benefit taxes in respect of our stock option plan and other business-related taxes paid in 2005 as compared to 2004.

Insurance and security services decreased by Php72 million, or 10%, to Php628 million, primarily due to lower premiums on property all-risk, industrial all-risk and industrial fire insurance, partially offset by higher security services due to a rate increase for contracted security guards.

Communication, training and travel expenses decreased by Php2 million to Php447 million due to a decrease in mailing, courier and delivery services, as well as a decrease in local travel and training in 2005 as compared to 2004.

Cost of sales of computers amounting to Php53 million were recognized in 2005 in relation to our DSL promo. No similar charges were incurred in 2004.

Asset impairment amounted to Php365 million in 2004 owing to an impairment of a fixed line subsidiary's facilities; no impairment charge was recognized in 2005.

Other expenses decreased by Php246 million, or 22%, to Php863 million due to lower office supplies consumption and printing costs resulting from PLDT's continuing cost-containing activities.

Provision for (Benefit from) Income Tax

Benefit from income tax amounted to Php676 million in 2005 compared to a provision for income tax of Php585 million in 2004, primarily due to taxable loss of PLDT brought about by higher realized forex in 2005 and the effect of tax rate adjustment.

Net Income

In 2005, our fixed line business segment contributed a net income of Php769 million, a decrease of Php498 million, or 39%, as compared to Php1,267 million in 2004 mainly as a result of a 6% increase in fixed line-related expenses, particularly depreciation and amortization which more than offset the 2% increase in fixed line-related revenues.

Information and Communications Technology

Revenues and Other Income

Our information and communications technology business is conducted by ePLDT and its subsidiaries.

In 2005, our information and communications technology business generated revenues of Php3,438 million, an increase of Php1,023 million, or 42%, from Php2,415 million in 2004. Going forward, we expect revenues from our call center business to continue to contribute significantly to our information and communications technology revenues with the growing demand for our call center services.



The following table summarizes revenues from our information and communications technology business for the years ended December 31, 2005 and 2004 by service segment:

	Years ended December 31,				Increase (Decrease)	
	2005	%	2004	%	Amount	%
(in millions)						
Service Revenues						
Call center	Php1,944	57	Php1,283	53	Php661	52
Internet and gaming	556	16	569	24	(13)	(2)
<i>Vitro</i> TM data center	376	11	173	7	203	117
Others	77	2	55	2	22	40
	<u>2,953</u>	<u>86</u>	<u>2,080</u>	<u>86</u>	<u>873</u>	<u>42</u>
Non-service Revenues						
Point-of-Product Sales	351	10	321	13	30	9
Other Income	127	4	14	1	113	807
Equity share in net income of associates	<u>7</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>7</u>	<u>100</u>
Total ICT Revenues and Other Income	<u>Php3,438</u>	<u>100</u>	<u>Php2,415</u>	<u>100</u>	<u>Php1,023</u>	<u>42</u>

Call Center

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

- Parlance which owns and operates a 1,392-seat call center facility with 1,872 customer service representatives, or CSRs, exclusively for one of the largest direct-to-home satellite television service providers in the United States for customer support and billing requirements; Parlance is expanding with another 740-seat call center facility in Mandaluyong City which is currently expected to be completed in March 2006;
- Vocativ which owns and operates a 1,190-seat call center facility with 1,111 CSRs, providing customer and technical support to its clients in the Philippines, U.S. and U.K.; and
- Ventus which owns a 370-seat call center facility located in Iloilo province and commenced commercial operations in March 2005. CSR headcount in Ventus-Iloilo reflected seasonal swings from a core of 50 CSRs to a high of 350 CSRs in 2005, as the company addressed seasonal requirements of its clients. Ventus will be expanding in Metro Manila with an 830-seat call center facility in Ortigas, Pasig City to accommodate current and new client requirements. The new facility is currently expected to be completed by March 2006.

In addition, domestic call center projects are being undertaken directly by ePLDT which operates an 80-seat call center facility in Makati and a 315-seat call center facility in Quezon City, with a combined headcount of 530 CSRs. The total seat count of each call center facility covers workstations of CSRs and business support units that are intrinsic to the delivery of the business.

Call center revenues consist of:

- inbound calls for customer care, product inquiries, sales and technical support based on active minutes, billable hours and full-time equivalents;
- outbound calls for sales and collections based on active minutes, billable hours and full-time equivalents; 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 2005 increased by Php661 million, or 52%, to Php1,944 million from Php1,283 million in 2004, primarily due to the combined effects of the following:

- Vocativ's upward price adjustment for calls and an increase in programs being handled;
- an upward price adjustment by Parlance for its inbound and outbound projects, coupled with an increase in the number of registered minutes for inbound projects and hours for outbound projects;
- expansion of existing Parlance and Vocativ facilities by 283 and 91 seats, respectively, from 1,109 and 1,099 in 2004 to 1,392 and 1,190 in 2005;
- commencement of Ventus operations in Iloilo in March 2005; and
- continuous ramp up of CSRs by 1,489, or 70%, from a total of 2,136 in 2004 to 3,625 in 2005.

Call center revenues accounted for 66% and 62% of total information and communications technology service revenues in 2005 and 2004, respectively.

Internet and gaming

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 through DSL, web consulting and development, hosting and other value-added services;
- a 69% interest in Digital Paradise, an internet café business which assumed the assets of Netopia Computer Technologies, Inc., and the brand *Netopia*. *Netopia* is now one of the largest and fastest growing internet café chains in the country with 181 branches and over 8,200 work stations. Digital Paradise offers high-speed internet services, including internet advertising, gaming and printing;

- 51% interest in Airborne Access, the country's leading operator of WiFi hotspots, which provides wireless internet access in hotspots equipped with Airborne Access WiFi access points;
- a 51% interest in Digital Paradise Thailand, an affiliate of Digital Paradise, offering similar products and services. Digital Paradise Thailand currently has three branches in addition to its head office all situated in Bangkok, Thailand; and
- a 60% interest in netGames, a publisher for Massively Multi-player Online Game in the Philippines. netGames is the Philippine licensee of Khan Online, the country's first full 3D online game. netGames commenced full commercial operations in February 2005.

Internet Service revenues consist of:

- revenues derived from actual usage of the 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;
- sales revenues from retailing of prepaid cards for cellular, landline and internet access;
- franchise fees for *Netopia* Internet cafés, including a one-time subscription fee and monthly recurring franchise fees based on certain conditions on the franchise agreement; and
- share in revenues of text, voice and internet messages for cellular, landline and internet-based content and applications.

Revenues from our internet business in 2005 decreased by Php13 million, or 2%, to Php556 million from Php569 million in 2004, primarily due to a decrease in Infocom's revenues in 2005, which was partially offset by the consolidation of Digital Paradise in June 2004. Our internet business revenues accounted for 19% and 27% of service revenues from information and communications technology business in 2005 and 2004, respectively.

*Vitro*TM data center

ePLDT operates an internet data center under the brand name *Vitro*TM. Granted pioneer status as an internet data center by the BOI, *Vitro*TM 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*TM 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 of services; and
- monthly service fees or one-time fees generated from professional services of Vitro's certified professionals.

In 2005, *Vitro*TM contributed revenues of Php376 million, an increase of Php203 million, or 117%, from Php173 million in 2004, primarily due to an increase in co-location revenues, server hosting and other services. *Vitro*TM revenues accounted for 13% and 8% of service revenues from our information and communications technology business in 2005 and 2004, 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 2005 increased to Php77 million from Php55 million in 2004 largely due to IT helpdesk/contact center services rendered coupled with an increase in the number of digital certificates sold.

Please refer to *Note 9 – Investments in Associates* to the accompanying audited 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 reselling certain Microsoft licenses, server solutions, networking products, storage products and data security products. In 2005, non-service revenues generated by our information and communications technology business increased by Php30 million, or 9%, to Php351 million compared to Php321 million in 2004, primarily due to higher revenues from sales of networking 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 increased to Php127 million in 2005 from Php14 million in 2004 primarily due to Infocom's sale of its *NOW* cable internet business on February 1, 2005.

Equity Share in Net Income of Associates

Equity share in net income of associates amounted to Php7 million in 2005 due to share in the earnings of ePDS, an unconsolidated subsidiary.

Expenses

Expenses associated with our information and communications technology business totaled Php3,380 million in 2005, an increase of Php342 million, or 11%, from Php3,038 million in 2004, primarily due to an increase in cash expenses, particularly compensation and benefits, partly offset by an impairment provision recognized in 2004. As a percentage of our information and communications technology revenues, expenses related to our information and communications technology business were at 98% and 126% for 2005 and 2004, respectively.

The following table shows the breakdown of our total information and communications technology-related expenses for the years ended December 31, 2005 and 2004 and the percentage of each expense item to the total:

	Years ended December 31,					
	2005		2004		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
(in millions)						
Information and communications technology services:						
Compensation and benefits ⁽¹⁾	Php1,350	40	Php892	29	Php458	51
Selling and promotions	421	13	291	10	130	45
Depreciation and amortization	415	12	340	11	75	22
Rent	362	11	353	12	9	3
Maintenance	283	8	316	11	(33)	(10)
Communication, training and travel	98	3	70	2	28	40
Professional and other contracted services	82	2	67	2	15	22
Provisions	54	2	3	–	51	1,700
Financing costs	39	1	22	1	17	77
Taxes and licenses	36	1	20	1	16	80
Asset impairment	26	1	617	20	(591)	(96)
Insurance and security services	14	–	7	–	7	100
Equity share in net losses of associates	–	–	2	–	(2)	(100)
Other expenses	200	6	38	1	162	426
Total	Php3,380	100	Php3,038	100	Php342	11

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

Compensation and benefits increased by Php458 million, or 51%, to Php1,350 million, mainly due to the expansion of our call center and internet and gaming businesses, which resulted in an increase in headcount coupled with an increase in salaries, bonuses and various incentives of employees.

Selling and promotion expenses increased by Php130 million, or 45%, to Php421 million mainly as a result of the commercial release of *Khan Online* in February 2005 following the commencement of netGames' commercial operations. Furthermore, Vitro's increase in sales of software products in 2005 as compared to 2004 resulted in higher selling and marketing expenses.

Depreciation and amortization charges increased by Php75 million, or 22%, to Php415 million, primarily due to an increase in the depreciable asset base in relation to the expansion of our call center and internet and gaming businesses.

Rent expenses increased by Php9 million, or 3%, to Php362 million primarily due to Vitro's lease of hosting equipment for use in its Bureau of Internal Revenue project and the expansion of our internet and call center businesses.

Maintenance expenses decreased by Php33 million, or 10%, to Php283 million primarily due to Vitro's lower hardware maintenance costs related to its IBM and CISCO equipments partially offset by higher hosting-related costs incurred in 2005 as compared to 2004.

Communication, training and travel expenses increased by Php28 million, or 40%, to Php98 million due to the increased cost of bandwidth and information system charges, coupled by the increase in telecommunications costs incurred by our call center business for its outbound calls. Furthermore, CSR trainings for our call centers during 2005 contributed higher foreign travel and training costs compared to 2004.

Professional and other contracted services increased by Php15 million, or 22%, to Php82 million, primarily due to an increase in consultancy, legal and audit fees in 2005.

Provisions amounted to Php54 million, an increase of Php51 million from 2004 primarily due to specifically identified doubtful accounts pertaining to Infocom as of the end of 2005.

Financing costs increased by Php17 million, or 77%, to Php39 million, primarily due to higher foreign exchange losses from dollar-denominated receivables in 2005 as compared to 2004.

Taxes and licenses increased by Php16 million, or 80%, to Php36 million, mainly on account of documentary stamp taxes paid by ePLDT and Ventus in their issuance of additional capital stock in 2005 as compared to 2004.

Asset impairment in 2004 amounting to Php617 million was due to an impairment provision in relation to an investee company recognized in 2004 compared to Php26 million in 2005.

Insurance and security services increased by Php7 million, or 100%, to Php14 million primarily due to higher premium costs and an increase in the assets insured in 2005 as compared to 2004.

Equity share in net losses of associates amounted to Php2 million in 2004 due to net losses incurred by some unconsolidated ICT subsidiaries in their start-up operations.

Other expenses increased by Php162 million, or 426%, to Php200 million mainly due to recognition of royalty fees to *Khan Online* in 2005 and an increase in other business-related costs.

Provision for Income Tax

Provision for income tax amounted to Php12 million in 2005, a decrease of Php60 million, or 83%, as compared to Php72 million in 2004, primarily due to lower reversal of Infocom's recorded deferred income tax asset in 2005 as compared to 2004.

Net Income (Loss)

In 2005, our information and communications technology business segment registered a net income of Php46 million compared to a net loss of Php695 million posted in 2004 mainly on account of the higher net income contribution of our call center business and impairment provision recognized in 2004, partially offset by Infocom's operating loss in 2005 and Digital Paradise's high operating costs due to its ongoing expansion.

Liquidity and Capital Resources

The following table shows our consolidated cash flows for the years ended December 31, 2005 and 2004 as well as consolidated capitalization and other selected financial data as at December 31, 2005 and 2004:

	Years ended December 31,	
	2005	2004
(in millions)		
Cash Flows		
Net cash provided by operating activities	Php74,903	Php74,287
Net cash used in investing activities	11,690	23,939
Capital expenditures	14,990	21,162
Net cash used in financing activities	59,484	42,330
Net increase in cash and cash equivalents	2,743	7,949
	December 31,	
	2005	2004
(in millions)		
Capitalization		
Long-term portion of interest-bearing financial liabilities – net of current portion:		
Long-term debt	Php84,860	Php121,012
Obligations under capital lease	381	601
Preferred stock subject to mandatory redemption	11,974	14,615
	<u>97,215</u>	<u>136,228</u>
Current portion of interest-bearing financial liabilities:		
Long-term debt maturing within one year	18,684	28,018
Obligations under capital lease maturing within one year	717	425
Notes payable	–	58
	<u>19,401</u>	<u>28,501</u>
Total interest-bearing financial liabilities	116,616	164,729
Total equity	74,369	47,187
	<u>Php190,985</u>	<u>Php211,916</u>
Other Financial Data		
Total assets	Php251,984	Php264,751
Property, plant and equipment – net	176,974	194,525
Cash and cash equivalents	30,064	27,321

As at December 31, 2005, our consolidated cash and cash equivalents totaled Php30,064 million. Principal sources of consolidated cash and cash equivalents in 2005 were cash flows from operating activities amounting to Php74,903 million and drawings from Smart's debt facilities aggregating Php5,471 million. These funds were used principally for capital outlays of Php14,990 million, total debt principal payments of Php44,710 million and interest payments of Php10,929 million.

Operating Activities

Our consolidated net cash flows from operating activities in 2005 increased by Php616 million, or 1%, to Php74,903 million, from Php74,287 million in 2004.

A growing portion of our cash flow is generated by our wireless business, which accounted for 59% and 58% of our service revenues in 2005 and 2004, respectively. Revenues from our fixed line and information and communications technology services accounted for 39% and 2%, respectively, of our service revenues in 2005 compared to 40% and 2%, respectively, in 2004.

Cash flows from operating activities of our wireless business amounted to Php46,340 million in 2005, an increase of Php4,274 million, or 10%, compared to Php42,066 million in 2004. Our fixed line business contributed Php27,760 million in 2005, a decrease of Php3,261 million, or 11%, compared to Php31,021 million in 2004. The overall increase in our cash flows from operating activities was due to lower working capital requirements partially offset by higher income taxes paid mainly by our wireless business. Our wireless business segment accounted for 62% of our cash flows from operating activities while our fixed line segment accounted for 37% during 2005. We currently believe that our continuing strong cash flows from operating activities on a consolidated basis will allow us to defray our current liabilities despite our current ratio being less than 1:1 as at December 31, 2005.

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 aggregating Php16,100 million, Php6,166 million and Php1,540 million, respectively. Smart has also obtained the necessary consents from its lenders to make similar distributions to PLDT in 2005, amounting to about Php20,000 million, of which dividends amounting to Php6,000 million, Php8,000 million, Php3,225 million and Php2,492 million were paid by Smart to PLDT in March, June, September and December 2005, respectively. In September and December 2005, Smart redeemed 200 million and 180.8 million preferred shares, respectively, previously issued to PLDT at a redemption price of Php13.875 per share, or a total redemption price aggregating to Php5,283 million.

Investing Activities

Net cash used in investing activities in 2005 amounted to Php11,690 million, a decrease of Php12,249 million, or 51%, compared to Php23,939 million in 2004. This decrease resulted from a decline in capital expenditures by Php6,172 million partially offset by an increase in short-term investments of Php3,418 million.

In 2005, short-term investments increased by Php1,206 million primarily due to the maturity of Smart's prepaid forward exchange contracts of Php3,873 million, which was outstanding in 2004, partially offset by Smart's additional investment of Php2,667 million.

Our consolidated capital expenditures in 2005 totaled Php14,990 million, a decrease of Php6,172 million, or 29%, from Php21,162 million in 2004, primarily due to Smart's and PLDT's lower capital spending. Smart's capital spending of Php8,786 million in 2005 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 Php5,500 million was principally used to finance the expansion of its fixed line data and IP-based network services. ePLDT and its subsidiaries' capital spending of Php620 million was primarily used to fund its *Vitro*TM, Digital Paradise and call center business operations. The balance represented other subsidiaries' capital spending. Consolidated capital expenditures in 2004 amounted to Php21,162 million, of which Php14,721 million, Php5,794 million and Php517 million were attributable to Smart, PLDT and ePLDT, respectively. The balance represented other subsidiaries' capital spending.

Financing Activities

On a consolidated basis, we used net cash of Php59,484 million for financing activities in 2005, compared to Php42,330 million in 2004. The net cash used in financing activities in 2005 was mainly attributable to debt repayments and interest payments by PLDT in line with its ongoing debt reduction program and dividend payments distributed to common and preferred stockholders.

Debt Financing

Additions to our consolidated long-term debt in 2005 totaled Php5,471 million from Smart's drawings related to the refinancing of its Phase 5A/5B loan facilities. Payments in respect of principal and interest of our total debt amounted to Php44,323 million and Php10,929 million, respectively, in 2005, of which Php31,173 million and Php9,152 million were attributable to PLDT, respectively.

The following table shows our long-term debt, including current portion as at December 31, 2005 and 2004:

	December 31,		Increase (Decrease)	
	2005	2004	Amount	%
(in millions)				
U.S. Dollar Debt:				
Export Credit Agencies-Supported Loans	Php23,126	Php41,266	(Php18,140)	(44)
Fixed Rate Notes	52,354	68,795	(16,441)	(24)
Term Loans	14,288	20,492	(6,204)	(30)
Restructured Loans	4,767	4,815	(48)	(1)
Satellite Acquisition Loans	3,040	4,064	(1,024)	(25)
	<u>97,575</u>	<u>139,432</u>	<u>(41,857)</u>	<u>(30)</u>
Japanese Yen Debt:				
JBIC's Overseas Investment Loan	3,139	5,363	(2,224)	(41)
Export Credit Agency-Supported Loan	709	1,212	(503)	(42)
	<u>3,848</u>	<u>6,575</u>	<u>(2,727)</u>	<u>(41)</u>
Philippine Peso Debt:				
Peso Fixed Rate Corporate Notes	1,576	1,675	(99)	(6)
Term Loans	166	985	(819)	(83)
Restructured Loans	379	363	16	4
	<u>2,121</u>	<u>3,023</u>	<u>(902)</u>	<u>(30)</u>
	<u>Php103,544</u>	<u>Php149,030</u>	<u>Php(45,486)</u>	<u>(31)</u>

For a complete discussion of long-term debt, see *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements.

Our long-term debt decreased by Php45,486 million, or 31%, to Php103,544 million as at December 31, 2005 largely due to debt amortizations and prepayments in line with PLDT's efforts

to reduce its overall debt level and also due to the appreciation of the peso. PLDT's debt was reduced by 33% to Php73,397 million by December 31, 2005. In addition, the debt levels of Smart, Mabuhay and ePLDT as at December 31, 2005 relative to the debt balances as at December 31, 2004 decreased by 22%, 25% and 44% to Php26,941 million, Php3,040 million and Php165 million, respectively, due to the peso appreciation and debt amortizations during 2005.

As at December 31, 2005, 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 at our request on December 3, 2004 and September 26, 2004, respectively. In addition, PLDT also waived further disbursements from the US\$149 million Kreditanstalt für Wiederaufbau refinancing facility effective September 1, 2004, thus, canceling the undrawn portion of US\$9 million. As at December 31, 2005, Smart had undrawn facilities of US\$30 million pursuant to the commercial facility with Nordic Investment Bank and the US\$70 million loan facility with Finnish Export Credit Ltd., signed on August 8, 2005 and August 10, 2005, respectively, for its GSM Phase 8 financing. These facilities are expected to be drawn in the first quarter of 2006. Smart also had available facilities under its €50 million Framework Agreement with Bayerische Hypo-und Vereinsbank Aktiengesellschaft up to a maximum aggregate amount of €44 million. Please see *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements for a detailed discussion of our long-term debt.

The scheduled maturities of our outstanding consolidated long-term debt at nominal values as at December 31, 2005 are as follows:

Year	US\$ Loans ⁽¹⁾		JP¥ Loans ⁽²⁾ (in millions)		Peso Loans	Total
2006 ⁽³⁾	US\$307	Php16,336	JP¥3,418	Php1,540	Php929	Php18,805
2007	347	18,426	3,418	1,539	35	20,000
2008	110	5,839	1,709	770	24	6,633
2009	267	14,133	–	–	25	14,158
2010	48	2,552	–	–	834	3,386
2011 and onwards	924	49,011	–	–	380	49,391
	US\$2,003	Php106,297	JP¥8,545	Php3,849	Php2,227	Php112,373

(1) The exchange rate used was Php53.062 to US\$1.00.

(2) The exchange rate used was Php0.4504 to JP¥1.00.

(3) January 1, 2006 to December 31, 2006.

Approximately Php62,982 million principal amount of our consolidated outstanding long-term debt as at December 31, 2005 is scheduled to mature over the period from 2006 to 2010. Of this amount, Php44,904 million was attributable to PLDT, Php14,872 million to Smart, and the remainder to Mabuhay Satellite, Maratel and ePLDT.

Debt 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 financial ratios as required under our loan covenants and other debt instruments.

Please see *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements 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 have restored the payment of common dividends in May 2005 and currently intend to 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.

PLDT’s current credit ratings are as follows:

<u>Rating Agency</u>	<u>Credit Rating</u>	<u>Outlook</u>	
Moody’s Investor Service	Foreign Currency Senior Unsecured Debt Rating	Ba2	Negative
	Local Currency Corporate Family Rating	Ba1	Positive
Standard and Poor’s	Foreign Currency Senior Unsecured Debt Rating	BB+	Stable
Fitch	Long-term Foreign Currency Rating	BB	Stable
	Long-term Local Currency Rating	BB+	Stable

On February 20, 2006, Fitch Ratings has revised its outlook on PLDT’s long-term foreign currency from negative to stable. PLDT’s long-term foreign currency, global bonds and senior notes has been affirmed at “BB” and convertible preferred stock at “B+.” The revision in outlook reflects that of the outlook of the Republic of the Philippines as foreign currency and senior debt instrument ratings are constrained by the sovereign foreign currency rating. At the same time, PLDT’s long-term local currency rating has been affirmed at “BB+” with a stable outlook.

On December 22, 2005, Moody’s Investor Service, or Moody’s, upgraded the long-term ratings of PLDT. Moody’s indicated that the upgrade reflects ongoing improvements in PLDT’s financial profile as it continues to enjoy healthy free cash generation and reduces its debt load. The rating outlook on the local currency rating is positive, while on the foreign currency rating it is negative, reflecting the sovereign outlook. At the same time, Moody’s withdrew PLDT’s preferred stock ratings following conversion of rated stock in December 2005. On February 16, 2005, Moody’s had 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. It is Moody's view is that there is a differential between PLDT's foreign currency rating and its 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 foreign currency debt moratorium which the Philippine government may declare in case of an event of default by the Philippine government.

On November 3, 2005, Standard and Poor's Ratings Group, or Standard and Poor's, announced that it raised 25 non-sovereign credit ratings in Latin America and the Asia/Pacific region following a review of the transfer and convertibility risk in these markets. According to Standard and Poor's, the reassessment of the transfer and convertibility risk means that certain issuers that are deemed to be well insulated from direct and indirect sovereign risk may achieve a foreign currency rating that exceeds the sovereign foreign currency rating. As a result of this reassessment, PLDT's foreign currency rating was upgraded two notches to "BB+" with a stable outlook from "BB-" with a negative outlook.

On October 13, 2005, Moody's placed the ratings of PLDT on review for possible upgrade. At the same time, Moody's assigned PLDT a local currency corporate family rating of Ba2 and placed it on review for possible upgrade. The review for upgrade results from continual improvements in PLDT's financial risk profile.

On October 12, 2005 and October 10, 2005, Standard and Poor's and Fitch announced that the solicitation of consent from holders of the 11.375% Notes due 2012 and 10.625% Notes due 2007 to amend certain covenants has no impact on the rating nor outlook of PLDT. For a detailed discussion of the consent solicitation, see *Other Information*.

On August 31, 2005, Standard and Poor's, had affirmed its long-term foreign currency rating on PLDT at "BB-" with a negative outlook. The outlook reflects that of the Republic of the Philippines' sovereign ratings. At the same time, the rating on PLDT's existing Series III preferred stock was raised to "B+" from "B." On January 17, 2005, Standard and Poor's had 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 had downgraded the foreign currency rating on the Republic of the Philippines to "BB-."

On July 11, 2005, Fitch revised the outlook on PLDT's long-term foreign currency rating to negative from stable. The revision in outlook reflects a similar change in Fitch's outlook on the Republic of the Philippines' "BB" long-term foreign currency rating to negative from stable. PLDT's long-term foreign currency rating, global bonds and senior notes were maintained at "BB" and convertible preferred stock remained unchanged at "B+." The outlook on PLDT's long-term local currency rating was affirmed as "BB+" and the stable outlook on this rating remained in place. On May 3, 2005, Fitch had upgraded PLDT's long-term local currency rating to "BB+" with a stable outlook. Simultaneously, Fitch had affirmed PLDT's long-term foreign currency rating, global bonds and senior notes at "BB" and PLDT's convertible preferred stock at "B+."

Equity Financing

PLDT raised Php275 million and Php274 million from the exercise by certain officers and executives of stock options in 2005 and 2004, respectively. 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 Php59 million in 2005 and Php7 million in 2004.

Cash dividend payments in 2005 amounted to Php10,972 million, of which Php9,587 million and Php1,385 million were paid to common and preferred shareholders, respectively, compared to Php1,456 million in 2004, all of which were paid to preferred shareholders of PLDT. On March 1, 2005, PLDT declared cash dividends of Php14 per common share to holders of record as at March 31, 2005 paid on May 12, 2005. This was the first cash dividend declaration to common shareholders in four years since April 2001. In addition, on each of May 5, 2005 and November 8, 2005, PLDT declared cash dividends of Php21 per common share to holders of record as at June 3, 2005 and November 28, 2005 paid on July 14, 2005 and December 28, 2005, respectively.

As of December 19, 2005, all of the 4,616,200 outstanding shares of PLDT's Series III Convertible Preferred Stock were mandatorily converted into common shares at 1.7129 common shares for every Series III Convertible Preferred Stock (see *Note 16 – Equity* of the accompanying consolidated financial statements for further discussion.)

As at December 31, 2005, 180,789,003 PLDT common shares were outstanding.

Contractual Obligations and Commercial Commitments

Contractual Obligations

The following table discloses our consolidated contractual obligations outstanding as at December 31, 2005:

	Payments Due by Period				
	Total	Within 1 year	2–3 years	4–5 years	After 5 years
(in millions)					
Long-term debt ⁽¹⁾	Php112,373	Php18,805	Php26,633	Php17,544	Php49,391
Long-term lease obligations:					
Operating lease	3,636	632	1,091	853	1,060
Capital lease	1,700	895	355	15	435
Unconditional purchase obligations ⁽²⁾	11,120	4,752	2,122	2,123	2,123
Other long-term obligations	15,890	–	8,844	7,046	–
Total contractual obligations	Php144,719	Php25,084	Php39,045	Php27,581	Php53,009

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

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

Long-term Debt

For a discussion of our long-term debt, see *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements.

Long-term Operating Lease Obligations

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 at December 31, 2005, PLDT's aggregate remaining obligation under these contracts amounted to approximately Php17 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 at December 31, 2005, PLDT's aggregate remaining obligation under this agreement was approximately Php30 million.

Other Long-term Operating Lease Obligations. The PLDT Group has 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 Php3,272 million as at December 31, 2005 in respect of office and cell site rentals with over 3,000 lessors nationwide, PLDT has lease obligations aggregating Php119 million as at December 31, 2005, and ePLDT has lease obligations aggregating Php198 million as at December 31, 2005 in respect of certain office space rentals.

Long-term Capital Lease Obligations

For a discussion of our long-term capital lease obligations, see *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements.

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 entered into with ACeS International Limited, or AIL, in March 1997, which was amended in December 1998, under which PLDT was granted the exclusive right to sell AIL services in the Philippines. In exchange, the Air Time Purchase Agreement required PLDT to purchase from AIL a minimum of US\$5 million worth of air time annually over ten years commencing on January 1, 2002, the date of commercial operations of the Garuda I Satellite.

In the event that 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.

PLDT and the other founder NSPs are endeavoring to amend the Air Time Purchase Agreement due to the occurrence of partial satellite loss, changes in the primary business of ACeS and other events affecting the business.

In March 2003, PLDT, together with the other founder NSPs, entered into a Standstill Agreement with AIL suspending the application and enforcement of the minimum and supplemental air time payments under the original Air Time Purchase Agreement. The parties agreed that AIL shall provide PLDT and the other founder shareholders, with unlimited use of air time for the year 2003 in exchange for a fixed fee in the amount of US\$3.8 million for PLDT. Moreover, PLDT was also obliged to purchase from AIL 13,750 satellite phone units in 2003 at US\$395 F.O.B. per unit, subject to quarterly price adjustments. The parties to the Standstill Agreement also agreed to negotiate in good faith and use their best efforts to reach an agreement on a revised Air Time Purchase Agreement before November 15, 2003 that would cover, among other things, the amended minimum and supplemental air time payment provisions subject to the approval of AIL's creditors.

On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement effective January 1, 2002 following the lapse of the November 15, 2003 deadline set in the Standstill Agreement for the negotiation of a revised Air Time Purchase Agreement. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. See *Note 20 – Related Party Transactions* and *Note 23 – Provisions and Contingencies* to the accompanying audited consolidated financial statements for further details relating to the Air Time Purchase Agreement with AIL.

As at December 31, 2005, PLDT's aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,120 million.

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 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 agreed to amend the agreement 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.

Other Long-term Obligations

Mandatory Conversion and Purchase of Shares. As discussed in *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements, as at December 31, 2005, PLDT had issued a total of 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for a total of 58 million shares of Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel adopted in June 2001.

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 PLDT common shares. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion of the Series V, VI and VII Convertible Preferred Stocks will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US\$36.132 per share, and JP¥4,071.89 per share, respectively.

As at December 31, 2005, 2,480,553 shares of Series V Convertible Preferred Stock and 896,190 shares of Series VI Convertible Preferred Stock had been converted to PLDT common

shares. As at December 31, 2005, 240,887 shares of Series V, 4,398,914 shares of Series VI and 3,842,000 shares of Series VII Convertible Preferred Stocks remained outstanding. The aggregate value of the put option based on outstanding shares as at December 31, 2005 was Php15,890 million, of which Php8,844 million is puttable on June 4, 2008 and Php7,046 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 Php15,564 million, based on the market price of PLDT common shares of Php1,835 per share as at December 31, 2005.

Please refer to *Note 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements for further discussion.

Commercial Commitments

As at December 31, 2005, our outstanding commercial commitments, in the form of letters of credit, amounted to Php1,493 million. These commitments will expire within one year.

Quantitative and Qualitative Disclosures about Market Risks

Our operations are exposed to various risks, including liquidity risk, foreign currency risk and interest rate risk. The importance of managing these risks has significantly increased in light of considerable change and continuing volatility in both 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.

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 Currency Risk Management

As at December 31, 2005, the Philippine peso had appreciated by 6% against the U.S. dollar to Php53.062 to US\$1.00 from Php56.341 to US\$1.00 as at December 31, 2004. As at December 31, 2004, on the other hand, the peso depreciated by 1% to Php56.341 to US\$1.00 from Php55.586 to US\$1.00 as at December 31, 2003. As at December 31, 2005, the Philippine peso had appreciated by 18% against the Japanese yen to Php0.4504 to JP¥1 from Php0.5495 to JP¥1 as at December 31, 2004. On the other hand, as at December 31, 2004, the peso depreciated by 6% to Php0.5495 to JP¥1 from Php0.5193 to JP¥1 as at December 31, 2003. As such, we recognized foreign exchange gains of Php5,513 million in 2005 as compared to foreign exchange losses of Php2,710 million recorded in 2004.

While a certain percentage of our revenues is either linked to or denominated in U.S. dollars, substantially all of our indebtedness and related interest expense, 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 at December 31, 2005, approximately 98% of our total consolidated debts were denominated in foreign currencies, principally in U.S. dollars. Of our foreign currency-denominated debts, 3% are in Japanese yen on a consolidated basis and the balance in U.S. dollars. Thus, a weakening of the Philippine peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 53% of our consolidated debts, or 44% net of our U.S. dollar cash balances as at December 31, 2005), 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 Philippine 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 17 – Interest-bearing Financial Liabilities* to the accompanying audited consolidated financial statements.

To manage our foreign currency risks, stabilize cash flows, and improve investment and cash flow planning, we enter into forward foreign exchange contracts, foreign currency swap contracts, currency option contracts 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 currency risks.

Specifically, we use forward foreign exchange contracts, foreign currency swap contracts and currency option contracts to manage the foreign currency 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, a 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 at December 31, 2005, PLDT’s outstanding forward foreign exchange contracts, principal-only long-term cross-currency swap contracts and currency option contracts amounted to US\$220 million and JP¥1,282 million; US\$550 million; and US\$175 million, respectively. Smart has no outstanding forward foreign exchange contracts as at December 31, 2005.

For further discussions of these contracts, see *Note 24 – Financial Assets and Liabilities – Derivative Financial Instruments* to the accompanying audited 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 at December 31, 2005, PLDT’s outstanding interest rate swap contracts amounted to US\$125 million. For further discussions of these contracts, see *Note 24 – Financial Assets and Liabilities – Derivative Financial Instruments* to the accompanying audited consolidated financial statements.

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

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, we do not believe inflation has had a material impact on our operations. The average inflation rate in the Philippines in 2005 was 7.6%, compared to 6.0% in 2004.

OTHER INFORMATION

Smart's 3G Service Roll-out

On December 29, 2005, Smart was awarded a 3G license by the NTC. Ranked highest by the NTC in garnering a perfect score on a 30-point grading system designed to gauge the capability of telecommunication operators to effectively provide extensive 3G services, Smart was assigned the largest radio frequency allocation and had the choice of frequency spectrum that will best enable it to rapidly deploy its 3G network nationwide and at the same time offer the highest quality of 3G service.

On February 14, 2006, Smart launched its third generation or 3G service on a free-trial basis. Subscribers using Smart's network with 3G handsets in selected key areas may avail of services such as video calling, video streaming, high-speed internet browsing and special 3G content downloading under Smart's 3G network.

Strategic Partnership with NTT DoCoMo, Inc.

On January 31, 2006, NTT DoCoMo, Inc., or DoCoMo, agreed to acquire from NTT Communications, Inc., or NTT Communications, 12.6 million common shares of PLDT, representing 7% of PLDT's outstanding common shares held by NTT Communications, for a consideration equivalent to approximately US\$440 million. The consideration was determined based on the 30-day weighted average price of PLDT's common stock of Php1,825. NTT Communications will retain 12.6 million shares of PLDT with a similar 7% equity shareholding. In connection with DoCoMo's aforementioned acquisition of PLDT shares, PLDT, First Pacific Company Limited and certain of its affiliates, or the FP Parties, NTT Communications and DoCoMo entered into a Cooperation Agreement dated January 31, 2006, under which the parties agreed to amend, and grant DoCoMo certain benefits under, the Stock Purchase and Strategic Investment Agreement dated September 28, 1999 (as amended), among PLDT, the FP Parties and NTT Communications, the Shareholders' Agreement dated March 24, 2000 between the FP Parties and NTT Communications, the Advisory Services Agreement dated March 24, 2000 (as amended) and the Registration Rights Agreement dated March 24, 2000 between PLDT and NTT Communications. DoCoMo and NTT Communications have also agreed certain procedures relating to the exercise and sharing of the benefits of certain rights under the aforesaid agreements. In addition, PLDT and DoCoMo agreed to certain strategic business relationships in the field of mobile communications services which, among other things, will enable Smart to offer DoCoMo's i-mode mobile internet service exclusively to Smart's subscribers and to collaborate with DoCoMo in the development and roll-out of Smart's 3G networks using W-CDMA standard.

ePLDT's Acquisition of Level Up!

On February 16, 2006, ePLDT acquired a 60% equity interest in Level Up!, a leading publisher of online games in the Philippines with about an 80% share of the online gaming market.

The acquisition of Level Up!, together with netGames, ePLDT's online gaming subsidiary, will strengthen the position of ePLDT as the dominant online gaming company in the country.

Related Party Transactions

In the ordinary course of business, a number of companies related to but 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 any of its subsidiaries are a party, in which a director or key officer or owner of more than 10% of the outstanding common stock of PLDT, or any member of the immediate family of a director or key officer or owner of more than 10% of the outstanding common stock of PLDT had a direct or indirect material interest, as at December 31, 2005 and 2004 and for the years ended December 31, 2005 and 2004 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 DFON; (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 conventional international telecommunication services. Total fees under these agreements totaled Php256 million and Php336 million for the years ended December 31, 2005 and 2004, respectively. PLDT's outstanding obligations under these agreements amounted to Php23 million and Php49 million as at December 31, 2005 and 2004, respectively.

Agreements between Smart and Asia Link B.V. — agreements under which Asia Link undertakes to provide technical support services and assistance in the operations and maintenance of Smart's cellular business. Total fees under these agreements totaled Php567 million and Php507 million for the years ended December 31, 2005 and 2004, respectively. Under these agreements, Smart had outstanding payables of Php194 million and Php267 million as at December 31, 2005 and 2004, 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 Insurance Co., Inc., or Malayan, wherein premiums are directly paid to Malayan. Total insurance expenses paid under these agreements amounted to Php468 million and Php488 for the years ended December 31, 2005 and 2004, respectively. Two directors of PLDT have direct/indirect interests in or serve as a director/officer of Gotuaco and Malayan.

For a more detailed discussion of the related party transactions enumerated above, see *Note 20 – Related Party Transactions* to the accompanying audited consolidated financial statements.